

# Corruption and Good Governance

*Discussion paper 3*

Management Development and Governance Division  
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## Foreword

The challenge facing all societies is to create a system of governance that promotes, supports and sustains human development. But the search for a clearly articulated concept of governance in market economies has only just begun. *Reconceptualising Governance*, our second discussion paper published in January 1997, defines governance as the exercise of political, economic and administrative authority to manage a nation's affairs. It is the complex mechanisms, processes, relationships and institutions through which citizens and groups articulate their interests, exercise their rights and obligations, and mediate their differences. Governance embraces all of the methods—good and bad—that societies use to distribute power and manage public resources and problems.

Sound governance, taken a step further, is a subset of governance wherein public resources and problems are managed efficiently and in response to the critical needs of society. Effective democratic forms of governance rely on public participation, accountability and transparency.

Public accountability covers the spectrum of approaches and practices used by governments to ensure that activities and output meet intended goals and standards. While realisation of the government's goals and objectives is a subject of complex and long-standing debate, financial accountability presents an urgent challenge that requires an immediate and practical solution, especially given the rising concern for transparency and responsible governance.

The perceived absence of integrity in governments severely weakens the credibility of democratic institutions. Improving integrity, or developing and implementing strategies for the prevention or control of corruption, is an integral part of ensuring accountability. Corruption,

be it in the public or private sectors, results in the misuse of scarce resources that greatly affects the entire economy. Particularly in areas supported by external assistance, corruption can devalue the reputation and efforts of international development agencies.

The adoption of the United Nations General Assembly resolution requesting that the Secretary General assist Member States in designing strategies to prevent and control corruption on January 28, 1997, provides greater impetus for UNDP to more systematically approach the issue of corruption. *Corruption and Good Governance* is a contribution to this effort. The third in the series of UNDP discussion papers on governance, this study is intended to further clarify and articulate the concept of governance. The first paper examined the relationship between public sector management and governance. The second paper provided a conceptual framework for analysing governance issues.

I am grateful to Professor Susan Rose-Ackerman of Yale University who prepared this study, and to the UNDP technical advisory team—Fred Schenkelaars, Maria Zwanikken and Pauline Tamesis—who prepared the initial outline of the paper and facilitated its production. Useful comments were provided by the staff of the Management Development and Governance Division, Bureau of Policy and Programme Support and the members of the Publication Committee of the Department of Public Affairs.

The views expressed in the paper are not necessarily shared by UNDP's Executive Board or the member governments of UNDP.

*G. Shabbir Cheema*

*Director*

*Management Development and Governance Division*

*Bureau for Policy and Programme Support*

*UNDP*

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## Executive Summary

Corruption is a symptom of something gone wrong in the management of the state. Institutions designed to govern the relationships between citizens and the state are used instead for the personal enrichment of public officials and the provision of benefits to the corrupt.

The United Nations General Assembly, concerned about the seriousness of the problems posed by corruption, adopted a resolution on January 28, 1997 requesting that the Secretary General assist Member States in designing strategies to prevent and control corruption. This essay is a contribution to that effort. It complements the ongoing work of the United Nations Development Programme (UNDP) that has begun to emphasise improved governance as a condition for sustainable human development. UNDP has become increasingly interested in corruption as part of the work of its Management Development and Governance Division (MDGD). Programmes that explicitly attempt to reduce malfeasance in government are complementary to the MDGD's broader mandate to help countries reform their institutional structures.

This review begins by isolating the underlying economic causes of corruption in industrial and developing countries. Clearly, history, culture and individual moral scruples also matter and will be important sources of variability across national borders and within individual countries. Nevertheless, the desire for financial enrichment is a powerful motivating force throughout the world. Thus whatever other factors influence the incidence of corruption, potential benefits and costs matter as well.

But is corruption costly in the developing world, or is it simply a reasonable way to cope with a rigid and poorly operating state? Corruption is, at most, a second-best response to a government failure.

At worst, it is a highly distortionary method of public choice. A state with endemic corruption can be especially brutal to the very poor, who have no resources to compete with those willing to pay bribes.

Corruption restricts investment and holds back economic growth. It undermines programmes designed specifically to aid the poor. The poor are harmed by systemic corruption, but the causes of poverty seem more fundamental and deep-seated. It is difficult to document a simple relationship between the distribution of income and the level of corruption. Furthermore, in states with no social safety net and few economic opportunities for the very poor, the bribes collected by civil servants can perform a redistributive function, albeit one that is very inefficient and inequitable. Poor families that have a relative in the government benefit, while others are made worse off.

The study next assesses options for combating corruption. When corruption is endemic, piecemeal reform efforts are unlikely to be worthwhile. Partial solutions can be marginally productive in countries with strong clean-government traditions. Other countries need more fundamental reforms because they are caught in a “corruption trap”, in which corruption feeds on itself producing more corruption. This section suggests possible reforms and considers how they can be carried out in a sustainable way. Unfortunately, the history of anticorruption efforts is filled with programmes that succeeded at first, only to be undermined by subsequent governments or by economic and political crises. In some cases, though, reforms have become institutionalised. There are no quick or certain fixes, but the reform experiences of a number of countries suggest some important lessons. The section discusses both generic reforms designed to increase the risks of engaging in corrupt activities and specific reforms to reduce incentives for corruption in particular programmes.

The concluding section considers the role of the international lending and donor communities in supporting systemic reform and in assuring the integrity of the projects they finance. It also evaluates other international efforts to combat corruption. A serious anticorruption

tion initiative requires “ownership” by a country’s leaders. No comprehensive reform programme can be credible without support from a country’s political and economic elite. Narrowly focused cleanups may lack legitimacy if they simply help a corrupt ruler to more efficiently extract economic gains from society. With respect to projects funded by donors’ grants and loans, one important issue is conditionality. Clearly, donors want to avoid corruption in their own projects. If they cannot, projects should not be approved or should be cancelled if they have already begun. A number of international efforts are underway to discourage corruption in business dealings. These are worthy, but they cannot succeed unless they are complemented by concentrated efforts within individual countries.



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## Introduction

Corruption is a symptom of something gone wrong in the management of the state. Institutions designed to govern the relationships between citizens and the state are used instead for the personal enrichment of public officials and the provision of benefits to the corrupt. The United Nations (UN) General Assembly, concerned about the seriousness of the problems posed by corruption, adopted a resolution on January 28, 1997 requesting that the Secretary General help Member States design strategies to prevent and control corruption.<sup>1</sup> A cooperative effort is envisaged in which the UN works with other intergovernmental and non-governmental organisations to develop an implementation plan. This study is a contribution to that effort. Its recommendations must, of course, be combined with detailed information about individual countries in order to produce operational strategies for particular cases.

One goal of this paper is to determine when price mechanisms, so often a source of economic efficiency and a contributor to growth, can, taking the form of bribery, undermine the legitimacy and effectiveness of government. In the words of the General Assembly resolution, corruption “may endanger the stability and security of societies, undermine the values of democracy and morality and jeopardise social, economic and political development” (Resolution 51/59).

Sometimes, of course, it does make sense to allocate scarce public services to the highest bidder. When foreign exchange is rationed or imports are restricted by quotas, it will generally be efficient to auction off such scarce benefits. Similarly, when a country wants to privatise a state firm, an auction is an effective way to raise revenue and also to ensure that the firm goes to the buyer who values it most.

Nevertheless, the wholesale use of price mechanisms in the public sector is not justified. Corruption cannot be eradicated simply by legalising payments and transferring public functions to the private sector. Corrupt tax and customs officials undermine the ability of the state to raise revenue. Procurement contracts that are obtained corruptly may be inflated in value to reflect the bribes paid. Corrupt privatisations rob the government treasury of needed funds. Corruption of the legislature and the judiciary undermines the goals of democratic choice and impartial legal decision-making. Vote-buying by political candidates can turn electoral contests into bidding wars.

Many public benefits are designed to be allocated to specific, deserving groups. In particular, the benefits of antipoverty programmes should obviously not be allocated on the basis of willingness-to-pay. But in-kind redistributive programmes to provide health care, housing, education or food for the poor could be converted into voucher systems. Markets can sometimes be harnessed to improve poverty programmes, but only if beneficiaries are chosen without bribery and favouritism.

The General Assembly resolution recognises that the fight against and prevention of corruption ought to be part of any serious attempt to reform the governance institutions of developing and transition states. It calls on the Secretary General to work with Member States in developing national anticorruption strategies. This request fits well with the United Nations Development Programme's (UNDP's) existing programme on governance. UNDP defines governance as "the exercise of political, economic and administrative authority in the management of a country's affairs at all levels. Governance comprises the complex mechanisms, processes and institutions through which citizens and groups articulate their interests, mediate their differences and exercise their legal rights and obligations" (UNDP 1997a: iv). Governance includes the performance of state institutions, as well as interactions among government, the private commercial sector and civil society, including non-profit and volunteer groups.

UNDP stresses that improved governance is a condition for sustainable human development (UNDP 1995, 1997a, 1997b). It supports targeting assistance to promote governing institutions such as legislatures and the judiciary, public and private management, civil society institutions as advocates and monitors, and decentralisation of government. It emphasises the importance of transparency, accountability and the rule of law—features of government that can check self-seeking behaviour by public officials and those with whom they deal. One of its priorities is to help non-governmental organisations and governments interact fruitfully. Another is to help improve the legal and regulatory environment in which these organisations operate (UNDP 1997a).

UNDP views corruption control as relevant to the work of its Management Development and Governance Division (MDGD). In 1989 the UN joined with the Dutch government to sponsor an international seminar on “Corruption in Government”. In more recent years UNDP has cooperated with the international non-profit organisation, Transparency International, which is committed to fighting corruption world-wide, to sponsor meetings in Latin America. Many of the MDGD’s projects on accountability and electoral reform can reduce corrupt incentives.<sup>2</sup>

This study demonstrates why a reduction in corruption will improve the prospects for sustainable human development. It begins with a review of the economic roots of corrupt incentives, canvasses the costs of systemic corruption for growth and poverty reduction, and concludes with an outline of reform proposals for both individual countries and the international community. There is a broad complementarity between the anticorruption strategies discussed here and the broader governance improvement programmes that are already a focus of UNDP projects. Many of the policies central to the UNDP governance effort can play an important role in reducing corrupt incentives.



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## 1. Economic Causes of Corruption

The state intervenes in the economy to lay out a framework for economic and social activity—it establishes property and personal rights, provides police protection and national defence and promulgates laws governing private transactions such as contracts, firm organisation and marriage. It enforces the law and sets up courts, where private legal disputes can be resolved. The state may correct market failures and provide public goods that are not supplied by private markets. The state may redistribute income; equalise opportunities for education, health and employment; and reduce risk by providing pensions and unemployment and disability insurance. It may also further certain moral, religious or cultural values.

But the state can also be an instrument of repression. It can restrict the behaviour of individuals and groups beyond that needed to further public aims. It can benefit narrow but powerful groups with access to legislatures and chief executives. Top officials may organise the state to enrich themselves. Even when a state's aims are broadly democratic, public policies can be implemented in wasteful and incompetent ways. Lower-level officials may take advantage of their power and insist on bribes. Government failure may be as prevalent as market failure. Both private individuals and public agents may seek to benefit personally from their privileged positions in the economy or the polity.

All states, whether benevolent or repressive, manage the distribution of valuable benefits and the imposition of onerous costs. The distribution of these benefits and costs is generally controlled by agents with discretionary power. Private individuals and firms who want favourable treatment may be willing to pay these agents. And what is wrong with paying for what you want? That is, after all, the basis of

the market system. The problem arises from the fact that the recipient is an agent. The agent is responsible to a principal whose goals will seldom line up with those of the “paying customer”. Low-level bureaucrats are *agents* of superior officials, ministers are responsible to the governing coalition, elected officials are responsible to the voting public, judges are responsible to legal norms. Payments are corrupt when they are illegally made to public agents with the goal of obtaining a benefit or avoiding a cost. This definition leaves room for different societies to set the border between legal gifts and illegal payoffs, but in thinking about where it ought to fall, one must ask whether payments to agents further or undermine public goals. For an overview of corruption cases throughout the world see Benaissa (1993).

Commercial bribery can also occur without the intervention of public agents. A supplier bribes a purchasing agent to induce a sale, a customer pays off an airline clerk to obtain access to first class, a firm’s public relations department pays a reporter to write a favourable story. Managers at the top levels of a corporation might be paid to provide inside information on upcoming deals to investors and stock brokers. Such incidents are quite common and create the same problem as the bribery of public officials. In both cases an agent is paid to put the interests of the bribe payer above the interests of the principal. Commercial bribery implies that the firm whose agents are taking bribes needs better internal controls. High-level, corrupt deals require public oversight to protect the interests of diffuse stockholders. This paper will not deal further with this type of malfeasance, but much of the discussion of official corruption also applies to purely private transactions.

In determining the implications of corrupt payoffs, it will be important to establish whether officials acted outside of their area of competence in return for the bribe or whether they are providing something the payer should have received without a payoff. Similarly, it is important to determine whether the underlying rules are clear. Does one know what an honest system would produce, or are the rules vague and constantly changing? How much discretion does the cor-

rupt official have? Can he or she modify the rules to create additional corrupt opportunities, or are the rules of the game a set of well-known and well-accepted background conditions? The consequences of corruption are obviously much worse if officials can produce additional opportunities for private gain. To make some of these issues concrete, consider the case of Pakistan, by no means the worst case, but one in which corruption indicates a poorly functioning state that imposes high costs on private business and citizens (box 1).

The most important situations in which corruption can dictate who obtains the benefits and bears the costs of political, judicial and bureaucratic actions include:

- *Bribes clear the market.* The government may be charged with allocating a scarce benefit to many individuals and firms using legal criteria other than willingness-to-pay.

- *Bribes act as incentive bonuses.* Officials in the public sector may have little incentive to do their jobs well, given official pay scales and the level of internal monitoring. They may impose delays and other roadblocks. Bribes increase the value of public employment. Thus job applicants may pay to obtain public sector jobs.

- *Bribes lower costs of doing business.* Those engaged in legal pursuits seek to reduce government-imposed costs, be they taxes, customs duties or regulations. Bribes are a way around restrictive rules. In addition, those engaged in illegal businesses want to avoid state intrusion into their activities.

- *Bribes transfer monopoly rents to private investors, with a share going to corrupted officials.* Governments frequently transfer large financial benefits to private firms through procurement contracts, privatisations and the award of concessions.

- *Bribery of politicians buys influence, and bribery by politicians buys votes.* Bribes can substitute for legal forms of political influence. Politicians may pay and receive bribes and illegal contributions.

- *Bribes can override legal norms.* The judiciary has the power to impose costs and transfer resources between litigants.

### Box 1 Corruption in Pakistan

Corruption in Pakistan is pervasive and entrenched (Noman 1988). Cross-country surveys commonly rank Pakistan as worse than average in terms of its level of corruption and red tape (Mauro 1995). Overall political risk is in the middle range, better than some nations in Africa and the Middle East but among the highest in Asia (Piggott 1996). Although Pakistan's present government is committed to reducing corruption, its reforms have not yet had an impact. Corruption and poor governance limit economic growth and retard the development of a healthy private sector. Three types of evidence support this conclusion.

First, in a 1995 survey of 200 firms in manufacturing and commerce, corruption and crime were viewed as the fourth most important constraint. Seventy-eight percent of respondents acknowledged that they gave bribes to officials. The annual sums paid commonly ranged between 125,000 and 625,000 rupees (roughly \$4,000–\$20,000). Bribes as a percentage of gross sales were highest for microenterprises—at 2.45%, lower for small and medium-size firms, and higher again for the largest enterprises. The survey is consistent with the conclusion that bribery deters entry of new microenterprises but acts as a proportionate, not a progressive tax on the sales of growing firms (Rose-Ackerman and Stone 1996).

The government departments that gave firms the most trouble were tax, labour and customs. The sources of difficulty were corruption and bribes (80%), harassment, hassles, red tape and delays. The tax administration was viewed as severe a constraint as the level of taxes. Labour regulators were seen as petty and time-consuming rent seekers. Firms also complained about delays and high customs and duties, ranking those problems higher than corruption, possibly because corruption was a way to mitigate those difficulties.

Most business people, however, see corruption as a symptom of bad regulations, rather than as a solution to onerous government requirements. Firms indicated that they were willing to pay to increase government efficiency, and hence reduce corrupt opportunities. Firms would also be willing to pay an average of 2% of gross sales to simplify the tax system, even if their tax liability remained the same.

The second piece of evidence concerns the customs service. Corruption is concentrated at bottleneck points in the economic system, where public officials act as gatekeepers dispensing valuable benefits. One such bottleneck is the customs service, and, indeed, bribing customs agents is a

*(Box 1 continues next page)*

**Box 1 (continued)**

familiar alternative to smuggling throughout the world. Pakistan's import tariff schedule has been so extensively modified by special-purpose exemptions, that duties are often impossible to determine *ex ante*, thus generating corrupt incentives. Data from Pakistani customs provide indirect evidence on corruption. As nominal tariff rates increase, the proportion of official rates that is actually collected falls. Furthermore, the variance of the collected tariff rate increases as more and more exemptions are given (Pritchett and Sethi 1994).

Corruption in exporting and importing can discourage business people from entering markets. In Pakistan importers did not report higher levels of corruption than non-importers. And firms that exported more than 20% of their sales paid *less* in bribes, measured both as a percentage of gross sales and per employee, than did non-exporters. The optimistic explanation for this finding is a government initiative to simplify taxes for exporters into a single fee that is an extremely small percentage of total sales. Interpreted in this light, the Pakistani government clearly has the ability to reduce discretion and corruption if it is willing to give such reforms high priority. The pessimistic interpretation should not, however, be ignored: firms producing for the domestic market may be protected by import barriers, enabling them to earn rents, some of which are being extracted by public officials in the form of payments (Rose-Ackerman and Stone 1996).

Third, the agricultural sector deserves more study because of its economic importance and political influence. Evidence of corruption in agriculture is less systematic but is, nevertheless, troubling. Irrigation is of central importance to Pakistani agriculture and represents an important aspect of public spending. The system is administered corruptly, at least in some parts of the country. In seeking to explain the outcome, observers point to the low salaries of public officials and working conditions that provide few incentives for good performance (Murray-Rust and Vander Velde 1994; Vander Velde and Svendsen 1994).

The solutions are to streamline and simplify tax, customs and regulatory laws; to improve working conditions and oversight in the bureaucracy; and to reform tax laws so that large-scale agriculture is no longer favoured.

*Sources:* Based on background material prepared by Professor Rose-Ackerman for the *World Bank Pakistan 2010 Report*, Economist Intelligence Unit 1996, Mauro 1995, Murray-Rust and Vander Velde 1994, Noman 1988, Piggott 1996, Pritchett and Sethi 1994, Vander Velde and Svendsen 1994 and Webster and Charap 1993.

These categories are not mutually exclusive. A bribe that acts as an incentive payment, for example, might also allocate a scarce benefit or provide a tax exemption. Nevertheless, each raises enough distinctive issues to be considered separately.

## **Payments that Equate Supply and Demand**

Governments frequently provide goods and services for free or sell them at below-market prices. Often they are dual prices—a low state price and a higher free market price. Firms will then pay off officials for access to less expensive state supplies. In China, for example, some producer goods are sold at both state-subsidised prices and on the free market. Although the price differences have shrunk in recent years, they have been very large. Chinese researchers reported that in 1989 the market price of coal was 674% of the subsidised price. The market prices of seven other producer goods were from 250% to 478% of the prices fixed by the state. Not surprisingly, payoffs to obtain supplies at state prices were very common.<sup>3</sup> In Nigeria, when the price of oil was set artificially low relative to the market price in neighboring Benin, smuggling facilitated by corruption was wide-spread according to a report in a Nigerian news magazine. The price difference provided benefits both to the smugglers and to the officials who were paid to overlook the illegal trade.<sup>4</sup>

When the supply of credit and the interest rate are controlled by the state, bribes may be paid for access. Interviews with business people in Eastern Europe and Russia indicate that payoffs are frequently needed to obtain credit (De Melo, Ofer and Sandler 1995; Webster 1993a; Webster and Charap 1993). In Lebanon a similar survey revealed that loans could not be obtained without the payment of bribes (Yabrak and Webster 1995). In some cases personal influence and corruption lead banks into high-risk lending, sometimes to borrowers who have no intention of repaying the funds. Then the problem is not scarcity, but a system with too few controls over the level and distribution of funds.

Multiple exchange rates often do not reflect underlying economic fundamentals, so there are incentives to pay bribes to get scarce foreign exchange at good rates. For example, Paraguay's multiple exchange rate system led to corruption before recent reforms (World Bank 1994). Transparency International, on a mission to South Africa, identified the country's twin currency system as a source of payoffs (Transparency International 1995). The financial rand was abolished in March 1995, a policy change that should have removed some of the incentives.<sup>5</sup>

Similarly, the allocation of scarce import and export licences is a frequent source of corruption, with bribes linked to the value of the monopoly benefits conferred. According to one study of Nigeria, the regime in power in the early 1980s resisted free trade reforms favoured by the International Monetary Fund (IMF) because the existing import licensing system was an important source of payoffs and patronage. Eventually, however, when the Manufacturers Association of Nigeria finally began to push for its abolishment, the system was eliminated (Herbst and Olukoshi 1994, pp. 465, 481–82). The incentives to make payoffs are clear enough in these cases, but what are their efficiency consequences? Do they simply equate supply and demand, functioning much like prices in a legal market?

### *What if the Service is Scarce?*

The simplest case is one in which the briber is qualified for the benefit he seeks but the official requires that he pay for it. Suppose the service is scarce so that the number of people qualified to obtain the service exceeds supply. If the corrupt market operates efficiently, the service will be provided to the applicants with the highest willingness to pay. If there is no price discrimination, the market clearing bribe will be equivalent to the price in an efficient market. The state could have legally sold the service with the same result, though achieving a different distribution of revenue. Bribes raise the incomes of civil servants. Legal payments go into the government's treasury. But even

that difference may be illusory. If the labour market is competitive, the government can reduce the pay of civil servants to below private sector wages because of the payoffs available to public officials (Besley and McLaren 1993; Flatters and MacLeod 1995). In short, if both the corrupt market and the labour market are competitive, illegal payoffs are like market prices. The winners are those willing to pay the most in bribes; the losers are those willing to pay in other forms, such as time spent waiting in line or persistence in petitioning officials.

Consider first, however, the ways in which inefficient or unfair results can arise even in this simple case. The goals of a programme may be undermined if services are provided only to those with the greatest willingness to pay. This will obviously be true for services designed to benefit the needy or the well-qualified. Thus the sale of import and export licences or restaurant licences could be efficient, but the allocation of subsidised credit, housing or university admissions by price would undermine distributive goals, even if those admitted are nominally qualified under the law. For example, corruption grew in public housing programmes in the United States, where the number of qualified households far outstripped the number of places in subsidised units. Another example: in India some states give a means-tested pension to the poorest people. The number who qualify exceeds the funds. Non-governmental organisations working with the poor report that applicants often must pay to qualify and then must pay postal workers to deliver the benefit checks.

Bureaucratic discretion exercised through bribery is costly given programmes' goals. If a corruptly administered programme is meant to benefit the needy, the poorest applicants are unlikely to be able to obtain the scarce public service. One's response to a finding of corruption should be to rethink how participants are selected, not condone bribery. If, for example, an honest system is characterised by costly queues, the public agency must redesign the way it reviews applications or set clearer, tougher standards of worthiness to reduce the gap between supply and demand.

Second, consider cases in which allocation to those with the greatest willingness to pay is acceptable. One must ask whether corrupt markets are likely to differ much from open, competitive ones. In general, they will not work as efficiently as legal markets (Bardhan 1996; Cartier-Bresson 1995; Gambetta 1993; Rose-Ackerman 1978). The illegality of bribery induces participants to spend resources to keep the transaction secret. Thus information about bribe prices will not be well publicised. Prices may be relatively sticky because of the difficulty of communicating market information. Some potential participants may refuse to enter the market because of moral scruples and fear of punishment, and public officials may themselves limit their dealing to insiders, trusted friends and relations to avoid disclosure. For all of these reasons, a corrupt system may be not only less competitive but also more uncertain than a legal market. Bribes paid may vary widely across participants. For example, surveys of business people in Pakistan and Ukraine indicate high interfirm variability (Rose-Ackerman and Stone 1996). And those who obtain services corruptly have no recourse if officials do not live up to their side of the bargain.

If officials must allocate a fixed number of licences each year or grant a contract with well-specified terms, then bribery is essentially redistributive unless the problems raised above prevail. But in practice many officials can exercise monopoly power by determining the quantity of services provided. They may be the only people with authority to issue a permit, overlook a violation of the law or grant a contract (Findlay 1991; Klitgaard 1988; Rose-Ackerman 1978; Shleifer and Vishny 1993). Officials, like private monopolists, may seek to set supply below the officially sanctioned level to increase the economic rents available for division between themselves and the bribe payers. Or, corrupt officials might seek to provide an increased supply of the service if the government has set the supply below the monopoly level. The market for commercial real estate in Russia is an example of a market in which a scarce and valuable resource is allocated by rent-seeking officials with wide-spread discretion (box 2).

### **Box 2 The Commercial Real Estate Market in Russia**

The commercial real estate market in Russia is organised in a way that encourages corruption. Local governments own most commercial real estate—in 1995 the proportion was approximately 95%. The struggle for real estate assets is part of a broader conflict between the central and local governments. The subnational governments are winning. Even when the central government attempts to require that property be privatised, local governments simply refuse to obey—decreeing that federal law has no force in their community.

Ownership rights are vested in local councils, which are legislative bodies. As a practical matter, however, the head of an administration has a great deal of personal influence in the management of real estate assets. One reason for the strong local authority is that the laws and decrees enacted by central authorities are ambiguous, leaving the rules unclear. In some local governments the committee for the preservation of architectural and historical monuments also has considerable power, since almost all buildings in the city center are on the register, and even unhistorical buildings can come under its purview. Although its formal powers are unclear, in practice these committees often have veto power over property sales. As the author of a report on the topic states, the committee “participates in the rental revenue streams either on a formal or informal basis” (Harding 1995, p. 7). Housing maintenance agencies must give their consent before a lease or sale occurs. In day-to-day contact with renters, they can “influence the allocation of space and collect rents”, probably also on “a formal or informal basis”. Local bureaus of technical inventory maintain property records. Although they lack formal authority, their monopoly over technical information gives them leverage. Other regulatory agencies with influence over the use of property are the land reform committee, the fire department, the sanitation and health department and the district administration. The lack of standard procedures combined with the weakness of leases means that these agencies feel little pressure to cooperate or to refrain from imposing additional demands after a lease is signed.

Commercial real estate allocation does not follow commercial principles. Present occupants are favoured, and rental rates are far below market prices. The user’s relationship to the head of the administration is often a factor determining rental rates. The low rents mean that “a huge economic rent

*(Box 2 continues next page)*

**Box 2 (continued)**

accrues to local officials” (Harding 1995, p. 10), and excessive demand is pervasive. Officials use their control over urban real estate not only to enrich themselves, but also to subsidise social organisations such as social clubs—charities that obtain space cheaply and then use it for commercial activity.

Harding (1995, p. 14) explains why reform will be difficult. The problem is not just the incentives for graft, but also a tradition of heavy government involvement in real estate. The stream of personal benefits that accrue to city officials clearly plays a large role in perpetuating non-commercial management. City officials benefit personally from controlling real estate allocation, in terms of both money and influence. But an important and related dynamic is often missed. Russia has a strong tradition of extensive government involvement in economic activity on every level. This tradition, which predates the Soviet era, leads both officials and citizens to expect that the government will actively intervene in business operations and economic development. While many of the formal institutional mechanisms for this practice were removed in the initial stages of transition, several levers remain: taxation, regulation and control of real estate.

Moscow and St. Petersburg have overcome the diffuse ownership structure in commercial real estate. These cities have a special enclave status that gives them greater legislative and administrative freedom. With access to outside technical assistance, they have restructured the management of their real estate assets. Unfortunately, this has simply permitted city managers to exploit their monopoly power more effectively. The city is both primary developer and regulator, leading to conflicts of interest and favouritism towards “friendly” developers. “The corruption endemic in the development of this market is widely perceived” (Harding 1995, p. 19). Officials work for both private developers and the city, or they may receive a good apartment or shares in a development company.

In response to these problems in Russia Harding (1995) suggests several reforms. A mandatory programme requiring local governments to divest themselves of real estate would be best, but that is unlikely. The federal government should seek to uphold the legality of its buyout program that is being openly challenged by recalcitrant local governments. Harding also recommends a series of technical reforms to clarify the rules and move towards a more commercially viable market in urban commercial real estate.

*Source:* Harding 1995.

### *What if Supply is Not Limited?*

Instead of assuming that the service is scarce, suppose that it is available to all who qualify, like a passport or a driver's licence, or a benefit like old-age pensions in the United States. Bribery is clearly not an efficient way to allocate the benefit, even to the qualified, but one might wonder whether bribery would occur at all in the absence of scarcity. It could if officials have sufficient monopoly power to create scarcity either by delaying approvals or withholding them unless they are paid bribes (Paul 1995). Officials with monopoly power will set supply to maximise their profits (Dey 1989; Shleifer and Vishny 1992, 1993). These attempts to create scarcity can generate bribes if applicants have no alternative source from which to receive the service and no effective means of appeal. Qualified applicants will pay less if they have other options and if denunciations are not very costly in time and money (Alam 1995; Cadot 1987). The greater is the discretion of officials and the fewer are the options open to private firms and individuals, the higher are the costs of a system that condones corruption, even when all those who obtain the service are qualified. The costs are the time and trouble imposed by officials in their efforts to create corrupt demands (Bardhan 1996; Klitgaard 1988).

### *What if the Briber is Unqualified?*

Bribes are frequently paid so that unqualified people and firms can obtain benefits. For example, students might pay to alter the results of university admissions tests, or people might pay doctors to declare them eligible for disability benefits. Corrupt officials may give benefits to high bribers who are not qualified. Similarly, even those who are qualified may seek unauthorised gains or try to avoid costs. Shleifer and Vishny (1993, p. 601) call such a case "corruption with theft"—their archetypal example is a firm that bribes officials to avoid paying customs duties, but the range of examples is broader than those in

which the government loses revenue. It also includes cases in which a qualification process is undermined or a regulation violated. Clearly, the unqualified will often be those with the highest willingness to pay, since they have no legal way to obtain the service.

## **Bribes as Incentive Payments for Bureaucrats**

Bribes may give low-level officials an incentive to do their job effectively. But when is tolerance of payoffs acceptable? In the cases discussed above, even when corruption served an allocative function, it was a second-best response. A legal sale would have been superior. Such is generally the case here as well, although some research suggests why the first-best solution will often be difficult to achieve.

Firms and individuals will pay to avoid delay. For example, if the government or a parastatal does not pay its bills on time, contractors or customers may offer a bribe to ensure speedy payment. In Argentina a scheme in which insurance companies bribed officials to get delayed claims paid by a state-run reinsurance company degenerated into a system of outright fraud against the state, organised by corrupt state officials and middlemen (Moreno Ocampo 1995). In many countries informal payoffs are required to expedite services such as obtaining a telephone connection, a passport or a driver's licence. Sometimes the service is available only to the corrupt, not to the patient, honest citizen. In St. Petersburg in 1992 the going rate for a telephone installation was \$200 (Webster and Charap 1993). An Indian newspaper recently published a list of the "fees" for a range of routine public services.<sup>6</sup> A study of the informal economy in Ukraine reports the payoffs for a range of services needed by private businesses. Other data reveal the extremely high costs in management time of dealing with state officials (box 3).

Some scholars have constructed economic models in which bribes have desirable incentive properties. For example, payoffs to those who manage queues can be efficient (Lui 1985). Payments will give officials

### Box 3 Corruption in Ukraine

Weak and ineffective governments can impose two types of costs on businesses—the costs of seeking to comply with ambiguous and constantly changing rules and the costs of making illegal payoffs to avoid the rules or to induce officials to act. On the one hand we might expect that those who pay high bribes will report fewer problems in dealing with the government, since they have paid to avoid such difficulties. On the other hand, if payoffs reflect the success of bureaucrats in seeking and sharing in firms' excess profits, high payoffs will correspond with high costs in dealing with government. Corruption may improve the efficiency of individual transactions when the state is weak and ineffective, but tolerance of corruption can make state performance even worse. Ukraine is in the second camp—invasive public officials are the norm.

A survey of business people in Ukraine revealed that the motivations for corruption were high tax levels complicated by an inefficient tax and regulatory administration, high uncertainty about the rules, discretionary licensing procedures and an invasive corps of field-level bureaucrats. For example, lower-level officials are empowered to calculate a company's tax liability (often creatively) and issue stiff fines for violations (Novitzkaya, Novitzky and Stone 1995).

Because strict compliance with rules is extremely difficult and enforcement discretionary, there is ample room for negotiation. A mid-1994 survey of 75 small and medium-size enterprises documented the “unofficial” fees paid and the percentage of firms that reported paying them (Kaufmann and Kaliberda 1996). Such fees continue at high levels according to a similar 1996 survey. Most firms reported paying fees in connection with importing and exporting inputs and outputs. Phone lines almost

*(Box 3 continues next page)*

incentives to favour those who value their time highly and to work quickly. One study argues that in developing countries the corruption of tax collectors can be efficient as long as the government can impose a binding revenue constraint (Flatters and MacLeod 1995). The government minister sets a revenue target, a nominal tax liability schedule and the wage rate of the tax collector. Corruption gives the tax collector an incentive to seek tax revenue and is tolerated if the collector turns in an

**Box 3 (continued)**

invariably involved an informal payment. Payments to tax, fire and health inspectors were common, as were unofficial lease fees and payments for access to credit. According to Kaufmann (1997) the high cost of dealing with state officials through bribery induces many firms to operate in the informal sector and many others to underreport sales, costs and payroll to the authorities. The losses to the state are large and come in addition to the investment and new entrants that are discouraged.

An extraordinary amount of management time is spent dealing with the government, averaging 28% for the firms surveyed in 1994. By 1996 the percentage had risen to 37% (Kaufmann 1997). These figures are much higher than the percentages reported in other countries (although, of course, such comparisons are limited by differences in firm sizes and sectoral composition). Elsewhere, the percentages ranged from 7% in El Salvador to 15% in Brazil and Lithuania.

To improve the business climate and reduce corruption in Ukraine, Kaufmann (1997) recommends eliminating licences and permits, except for health and safety purposes, streamlining the customs service, reducing export regulations and other trading restrictions, eliminating price controls and deregulating the gas sector. He also recommends accelerating privatisation and thoroughly reforming the tax system. The goal is not just to reduce corruption but to induce more businesses to switch to the formal sector and to encourage new productive investment. To accomplish such changes, however, these proposals must be combined with reform of the civil service, reform of the way the government operates and changes in basic attitudes in both the public and the private sector.

*Sources:* Kaufmann 1997, Kaufmann and Kaliberda 1996, Novitzkaya, Novitzky and Stone 1995, and Rose-Ackerman and Stone 1996.

amount equal to the revenue target. The larger the difference between nominal tax liabilities and the revenue target, the greater is corruption.

Flatters' and MacLeod's conclusions that such routine corruption be tolerated is extremely problematic. First, tolerance of corruption in an important agency such as tax collection may encourage its spread to other areas where the consequences are harmful. Second, the authors assume that officials have only limited discretion. For example, they

assume that tax collectors discover the tax liabilities of citizens and firms, not create those liabilities as a bribe extraction device. If firms' and individuals' vulnerability to corrupt demands varies, an arbitrary and unfair pattern of payments would develop. This pattern would differ across taxpayers in a way that reflects collectors' leverage, not the underlying tax rules. If taxpayers differ in their propensity and willingness to bribe and if the tax breaks given in return for the payoffs are not publicised, the result can be a system based on special favours given to some, but not others. The overall legitimacy of the government may suffer. At the very least the disadvantaged taxpayers will feel unfairly treated.

Third, there are alternatives to corruption that avoid the costs of illegal payment systems. Queues can be managed through a set of differential fees based on the value of speed to the applicant. The US passport office, for example, provides high-cost expedited service. The extra fees are not, however, pocketed by civil servants, though revenue collection offices are sometimes permitted to retain a portion of the funds they take in.

Corruption in tax collection can contribute to an uncertain business climate. Firms may pay bribes in an attempt to obtain certainty, in this case about their tax liabilities, but certainty may be illusory since corrupt deals cannot be enforced.<sup>7</sup> The short-term impact of bribes may be to enhance efficiency in tax collection or business regulation. But difficulties arise when one looks at the issue systemically. Payments made by individual firms to increase certainty result in a wide variance in conditions across firms. For example, although they present no direct evidence of corruption, Pritchett and Sethi (1994) show that higher tariff rates are associated not only with lower proportional collections, but also with greater variance in rates actually paid. Potential entrants will view such an economic environment as risky and unpredictable. Nominal tax liabilities will be poor predictors of actual tax liabilities for a firm and for its competitors. Individualised attempts to reduce uncertainty can in fact increase uncertainty and

unpredictability society-wide. Ingrained corruption can also retard state reform. Firms that have benefited from payoffs will resist efforts to increase the clarity of rules and laws. They and their allies within the state apparatus will oppose reform efforts designed to make the economy more open and competitive.

In short, bribes can sometimes be characterised as incentive payments to public officials that substitute for legal reforms in the civil service system. But a policy of active tolerance, especially by outside aid donors such as UNDP, is likely to hurt the prospects for long-term reform and make it difficult to create a state that citizens view as legitimate. Payoffs that are seen as acceptable should be legalised, but not all “incentive-pay” schemes will actually improve bureaucratic efficiency. Some may simply give officials an incentive to create more delays and red tape, and to favour the unscrupulous and the well-off.

## **Bribes that Reduce Costs**

Governments impose regulations, levy taxes and enforce criminal laws. Individuals and firms may pay for relief from these costs. Under public regulatory programmes firms may pay for a favourable interpretation of the rules or a discretionary judgment in their advantage. They may pay to avoid or lighten the regulatory load, or to clarify regulatory requirements. Corrupt incentives may be especially high for newly privatised state enterprises dealing with fledgling regulatory agencies that do not have a well-developed track record. Developing and transition economies with newly private public utilities must set up strong, apolitical regulatory agencies with transparent and open processes (Tenenbaum 1996).

In a federal government inconsistent rules can make payoffs difficult to avoid. A study of private enterprises in Brazil recounted the (perhaps apocryphal) tale of one entrepreneur who reported that he was visited by state and federal inspectors simultaneously. The goal of the joint visit was to ensure that the firm would be observed violating

at least one of the governments' inconsistent rules on the placement of fire extinguishers (Stone, Levy and Paredes 1992, p. 29).

Taxes are always burdensome. Thus businesses and individuals may collude with tax collectors to lower the sums collected. The savings are divided between the taxpayer and the official. In some countries the wealthy pay few taxes. The Gambia, Ghana and Mozambique and are three such cases in Africa (Dia 1996; Stasavage 1996). In parts of Eastern Europe and the former Soviet Union where nominal tax rates are very high, business people report high payoffs (De Melo, Ofer and Sandler 1995; Novitzkaya, Novitzky and Stone 1995; Webster and Charap 1993). In Italy many allegations of corruption involve payoffs to tax inspectors for favourable audits. According to one source, tax avoidance is common in the Philippines, with the poor contributing twice as much as the rich. Jobs with the Bureau of Internal Revenue and the customs service are popular with recent university graduates because of the opportunities for payoffs (*Far Eastern Economic Review*, April 20, 1995).

Concerted reform efforts can yield substantial rewards. For example, in the urban centers of the United States at the beginning of the twentieth century reform-minded mayors frequently moved to increase the fairness of the property tax system. Seth Low in New York City introduced a plan to assess property at market value. The result was a reduction in the tax rate and an increase in revenues (Schiesl 1977).

Customs officials are particularly likely to engage in corruption since they control something that firms value: access to the outside world. Payoffs are used to reduce tariffs and export fees, and to obtain import and export licences. Sometimes the revenue losses from a combination of corruption and smuggling are large. In the Philippines one source estimated that 63% of imports pay no duty (*Far Eastern Economic Review* April 20, 1996).

Customs reform in Indonesia and Mexico came after widespread evidence of corruption.<sup>8</sup> This is an area in which the prescriptions of the market-oriented economist and the anticorruption reformer coin-

cide. Free trade policies generally improve efficiency and reduce the economic rents available to corrupt officials. Tolerance of corruption leads to wide-spread inequities and inefficiencies. Corrupt incentives rise with tax and tariff rates. Corruption in internal revenue and customs services is common throughout the world. Case studies for a number of African countries illustrate both the magnitude of the problem and some promising avenues for reform (box 4).

### *Tolerating Corruption at Home*

The economic impact of bribes paid to avoid regulations, supersede criminal law and lower taxes depends on the efficiency of the underlying programmes that are subject to corrupt distortions. Suppose a state has many inefficient regulations and levies burdensome taxes on business. Then, given the inefficient legal framework, payoffs to avoid regulations and taxes may raise efficiency.<sup>9</sup> Even if the corrupt market has some of the problems outlined above, the result may still be greater efficiency than compliance with the law. This defence of payoffs is commonly espoused by foreign investors in the developing world and appears in discussions of investment in Eastern Europe and the former Soviet Union. It is a pragmatic justification that grows out of frustration with the existing legal order. The case is important because it is an attempt to justify corruption carried out to obtain benefits to which one is *not* legally entitled. Bribers are better off than they would be if they had to comply with the law. This case is analogous to Shleifer and Vishny's corruption with theft.

But are individuals and firms obligated to obey only laws that they judge to be efficient and just? Clearly, in the industrial world individuals and firms are not entitled to decide on their own which laws to respect. Industry's response to environmental, health and safety rules that it finds burdensome is not generally to bribe US officials or enlist the help of criminals to evade the law. Of course, some firms do act illegally, but scandals seldom involve firms with national reputations. Instead, such firms work to change the laws in Congress, make legal

#### **Box 4 Evasion of Taxes and Customs Duties**

Many developing and transition countries suffer from an inability to collect sufficient tax and customs revenue. Corruption of tax and customs officials and tax evasion through smuggling, organising off-the-books and fraudulent accounting all contribute to lost revenue. A vicious spiral can develop in which revenue shortfalls lead to ever higher nominal tax rates, which are then even more likely to be evaded. For any given type of tax or tariff there is likely to be a revenue-maximising rate beyond which increased evasion eliminates the expected revenue gains of higher rates.

The problem often cannot be solved simply by reforming tax and customs collection. Individuals and businesses may underpay taxes in part because they do not accept the legitimacy of the regime in power, believing that public spending choices are distorted by the corrupt search for private gain.

The extent of the revenue shortfall can be gleaned from a number of country studies. In The Gambia, before the military came to power in 1994, foregone revenue from customs duties and the income tax was 8%–9% of GDP (six to seven times the country's spending on health). Income tax evasion alone amounted to 70% of the revenue due. A 1992 study found that only 40% of small and medium-size enterprises paid taxes, and that many individuals did not file returns. Underpayment of customs was facilitated by lack of clear guidelines and published tariff rates. Giving extensive discretion to officials encouraged corrupt payoffs designed to evade tariffs (Dia 1996).

In the 1980s Ghana tried an enclave approach to tax and customs reform by creating a new National Revenue Service. Prior to the reform, tax revenues were 4.5% of GDP. Corruption, moonlighting and other inefficiencies were common. Salaries were low and accountability poor. Under the reform the most corrupt officials were dismissed or retired. Wages and working conditions were improved. Higher salaries were accompanied by incentive systems to reward strong performance by individuals and by the agency as a whole. Revenue targets were established, and the National Revenue Service was given a bonus of 3.5% of tax revenue and 2.5% of customs revenue. Between 1984 and 1988 tax and customs revenue rose from 6.6% to 12.3% of GDP. The reforms illustrate the importance of combining improved base pay with incentives for good performance. The programme was not without problems, however. The rest of the civil service chafed at

*(Box 4 continues next page)*

**Box 4 (continued)**

the special treatment afforded tax collectors, and the Ministry of Finance objected to its loss of authority. The programme could not have gone forward without strong support from the top (Dia 1996).

An attempt to reform customs and tax collection in Zaire illustrates how an enclave approach can fail if credible reform is difficult to achieve. First, efforts to collect taxes lacked legitimacy because the government made large expenditures on projects that promised few development benefits. World Bank officials were also concerned about the possibility of large unrecorded extra-budgetary outflows—that is, corruption. Second, a project initiated with World Bank and French assistance was unable to undo fraudulent exemptions from taxes and duties. An initially successful effort to remove exemptions was soon overturned, and computers and files were destroyed. The project did not succeed in developing a cadre of professional tax collectors. Instead, it created new opportunities for rent seeking, and aid was eventually suspended (Dia 1993).

In Mozambique economic reform increased, not decreased, corruption. Interviews with private sector and donor representatives carried out in 1996 indicated that corruption was a serious problem and had grown since 1986. The available evidence suggests that bribes are paid to receive tariff exemptions. In 1995 customs collected 49% of the revenue they would have collected if no exemptions had been given. Customs officials had discretion to grant exemptions without guidelines. They created extra delays to extract payoffs. They also overestimated the value of goods and applied higher rates in an attempt to obtain payoffs. Overall taxes fell from 20% of GDP in 1993 to 17.6% in 1994, with import taxes falling from 5.1% to 3.9% of GDP.

Additional estimates of shortfalls due to tariff exemptions were found in a separate study by Low (1995). In Mali, Tanzania and Zambia the estimates were close to 50%. Of course, cross-country comparisons are difficult to make since the importance of exemptions is a function of the underlying tariff schedule. Still, these data indicate that a poorly controlled customs service can be costly. They are consistent with Pritchett and Sethi's (1994) finding that both the proportion of goods granted exemptions and the variance in customs duties paid increases as nominal rates increase. Data from Jamaica, Kenya and Pakistan showed a consistent pattern (see table 2 in Pritchett and Sethi).

*Sources:* Dia 1993, 1996, Low 1995, MacGaffey 1991, Pritchett and Sethi 1994, and Stasavage 1996.

campaign contributions, lobby public agencies and bring lawsuits that challenge laws and regulations. One can complain about the importance of wealth and large corporations in US political life, but well-documented lobbying activities and campaign contributions are still superior to secret bribes for maintaining democratic institutions.

### *Tolerating Corruption Abroad*

Some of the firms that engage in legal political activities at home feel less constrained about violating laws in developing and transition economies. Since the Foreign Corrupt Practices Act in the United States outlaws bribes paid abroad to obtain business, US companies face a domestic legal constraint (for a review of the case law see Pendergast 1995). But the perceived importance of that constraint suggests that multinationals do not generally feel obligated to obey the law in developing countries. And it is not just multinationals that behave in this way. Domestic companies often operate in the same fashion.

There are two difficulties with wide-spread tolerance of such corruption. First, investors will not necessarily pay bribes to avoid only inefficient rules and taxes. They will, instead, want to reduce the impact of all state-imposed burdens, justified or not. Both individuals and firms will use bribery to obtain benefits to which they are not entitled. Of course, one can construct models in which the laws on the books are all payoffs to politically powerful groups with no public legitimacy (Brennan and Buchanan 1980; Stigler 1971; Oxford Analytica 1996). Then, avoiding the burdens imposed by such laws seems worthy. Unless one is a strong libertarian, believing that all state action is illegitimate, such a criterion is not readily operationalised. Should firms or individuals be able to defend against a charge of corruption by showing that a law was unjust or inefficient? Should they be able to justify bribery by claiming that the law they favoured will enhance competitiveness? This would put a policy-analytic burden on the law enforcement system that it is ill-equipped to handle in practice and that is illegitimate in theory.

Second, we should not tolerate firms' judgments that well-placed payoffs are justified because they increase profits. Such an attitude can harm nations struggling to build a viable state. These states must develop public choice mechanisms that translate popular demands into law, make a credible commitment to enforce these laws and provide legal recourse to those who think they have been wronged. If, instead, investors and ordinary citizens make separate judgments about which laws are legitimate, the attempt to create state institutions will founder. Bribery will determine not only which laws are enforced, but also which laws are enacted.<sup>10</sup> All states, even those that have most successfully curbed the power of special interests, enact inefficient laws. But no state can operate effectively if individuals are able to take the law into their own hands and justify doing so with cost-benefit criteria.

The discussion thus suggests that corruption may be more tolerable, not when it increases the efficiency of individual deals, but when it is carried out in clearly illegitimate regimes that can make no claim to popular support. Then, even bribes to avoid taxes seem less harmful since, with fewer resources available, the state becomes less powerful. But costs remain. Those who benefit from making payoffs will form a strong constituency against reform because they will fear the loss of their special advantages. Furthermore, when a regime that wants to reform takes power, its efforts will be hampered if corruption has become systemic. One of the regime's first tasks must be to change the behaviour of corrupt officials, firms and individuals.<sup>11</sup> Tolerating individual efforts to circumvent even burdensome laws is not consistent with state legitimacy.

## **Payments to Obtain Major Contracts, Concessions and Privatised Firms**

Corrupt payments to win major contracts, concessions and privatised companies are generally the preserve of large businesses and high-level officials. Although low-level clerks are sometimes bribed to reveal infor-

mation and some smaller businesses bribe to get routine supply contracts, the important cases involve substantial expenditures and can have a major impact on the government budget and the country's growth prospects. These deals by definition involve top officials and frequently involve multinational corporations operating alone or in consortia with local partners. Moody-Stuart (1994) calls this "grand corruption".

### *Examples of Grand Corruption*

When the government is a buyer or a contractor, there are several reasons to pay off officials. First, a firm may pay to be included in the list of prequalified bidders and to restrict the size of the list. Second, it may pay for inside information. Third, bribes may induce officials to structure the bidding specifications so that the corrupt firm is the only qualified supplier. Fourth, a firm may pay to be selected as the winning contractor. Fifth, once a firm has been selected as the contractor, it may pay to set inflated prices or to skimp on quality.

Corruption in contracting occurs in every country, even those at the high end of the "honesty index", such as Singapore and New Zealand.<sup>12</sup> A few examples suggest the range of possibilities.

In Zimbabwe collusion between senior ministers in Posts and Telecommunications and a Swedish telecommunications company may have resulted in the circumvention of local tender board procedures. Kickbacks up to \$7.1 million have been alleged (Economist Intelligence Unit, *Zimbabwe Quarterly Report*, June 1995). In an airplane deal between the Republic of Korea and several US companies, bribes were allegedly paid to President Roh Tae Woo. Multinational suppliers have been questioned, but deny involvement. Roh Tae Woo's national security advisor acknowledged receiving money from businesses hoping to get arms contracts. He is accused of accepting \$300,000 in connection with fighter plane purchases. In particular, the head of a Korean conglomerate was accused of giving \$65,000 to the advisor. He admitted giving the money but said it was a gift.<sup>13</sup>

A major scandal in Singapore, involving several multinational firms and a senior official of the Public Utility Board, concerned payments to receive confidential information about tenders. Five major multinationals implicated in the scandal were blacklisted. The official received a 14-year jail term.<sup>14</sup>

Industrial countries have recently been involved in similar procurement scandals. In Germany bribes were paid to win contracts worth 2.5 billion deutsche marks (DM) to build Terminal 2 at Frankfurt Airport. According to the public prosecutor corruption led to an increase in prices of about 20–30%.<sup>15</sup> In the French Department of Seine-Maritime fourteen people have been charged with corruption in connection with contracts for computers. Civil servants distorted normal procedures for awarding contracts, leading to an estimated loss of 50 million francs, according to the French Department of the Interior.<sup>16</sup> In Belgium senior figures in the Socialist party are believed to have accepted \$1.9 million in bribes in connection with a defence contract.<sup>17</sup>

Not all procurement and contracting scandals involve large-scale construction or capital goods projects. Goods that are used up in consumption are prime candidates for payoffs, since it may be difficult to discover whether or not the goods were actually delivered in the proper quantity and quality. For example, in Malawi auditors found that millions of dollars of non-existent stationery had been “purchased” by the Government Press Fund. The agency had no approved written control system for local purchases.<sup>18</sup> In Kenya the government lost about \$1.5 million through irregular drug procurement by the Ministry of Health.<sup>19</sup>

Privatisation of state-owned enterprises can improve the performance of the economy and, in the process, reduce corruption. But the process of turning over state assets to private owners is fraught with opportunities for corruption and self-dealing. The sale of a large parastatal or public firm is similar to the process of tendering for a large public infrastructure project. Thus the incentives for malfeasance are similar. Corruption may undermine the efficiency rationale for

privatisation. If firms pay to preserve the monopoly power of the enterprise after it enters private hands, the result may simply be a transfer of profits from the state to the new owners. The employees of the newly privatised firm may then face demands from suppliers and customers seeking to share in the monopoly benefits.

### *The Inefficiency of Large-Scale Corruption*

Is there anything distinctive about corruption in government contracting and privatisations other than the size of the deals? At one level they appear analogous to cases in which the government disburses a scarce benefit. Only now the benefit is valued in many millions of dollars. Under competitive conditions the highest briber will be the most efficient firm, and the winner will behave efficiently ex-post, irrespective of whether or not it used a bribe to obtain the benefit. The same caveats about bribes paid to obtain benefits or avoid costs apply here, although the efficiency goal seems less problematic in this context, and the benefit obtained is not itself illegal. Nevertheless, systemic corruption can introduce inefficiencies that reduce competitiveness. It may limit the number of bidders, favour those with inside connections rather than the most efficient candidates, limit the information available to participants and introduce added transaction costs.<sup>20</sup> But does the scale of the corrupt deal and involvement of high-level officials change anything?

One essential difference is the likelihood that rulers are effectively insulated from prosecution. They are thus less restrained in their corrupt demands than lower-level officials. High-level, corrupt officials can secure higher shares of the gains than lower-level officials. Since deals involving major contracts, concessions and privatisations can noticeably affect the government budget and the country's overall prosperity, the size and incidence of the payoffs are especially relevant. Another difference is that those who obtain licences and tax breaks by bribing low-level officials are rarely thought of as behaving inefficiently once the benefit is obtained. For the major deals considered here, the

contrary argument is often made. But is there anything to it? To answer this question, first consider the incidence of corrupt payoffs and, second, ask if corruption breeds inefficiency in firms that pay bribes.

*An efficient corruption market.* To isolate these distinct issues consider a logging concession obtained corruptly by a company that bid lower than its competitors. Suppose, to begin, that the corruption market is efficient so that it operates just like an idealised competitive bidding process. Then, we can distinguish between the impact of corrupt payments on government behaviour and the way corruption affects the efficiency of the concessionaire.

Suppose that as a result of corruption the government obtains less-than-fair-market value for the resources under its control. If corruption does not restrict entry and if the official cannot affect the size of the concession, the highest briber is the firm that values the benefit most. The most efficient firm offers the highest price in a fair bidding procedure. The losses are the dead weight losses of the extra taxes that must be collected and the foregone benefits of public programmes not initiated. Honest officials receive distorted information about the value of the concession and may in the future support fewer of them. A similar analysis applies to corrupt contracts and privatisation projects. The most efficient firm will be selected under competitive bribery, but the benefits to the government will be reduced. In the contracting case, for example, part of the cost of the bribe may be hidden in the value of the contract.

The bribe will be extracted partly from returns that would otherwise flow to the government and partly from the profits of the winning firm. In the idealised competitive case the winner is indifferent between winning the concession through an honest auction or winning through a dishonest auction. But in some cases the corrupt official may have more leverage than the honest one and be able to extract a larger share of the profits. The firm prefers to deal with honest officials. Alternatively, the corrupt official may be able to structure the deal so that it is more lucrative for the winning firm than an honest

deal. The corrupt official may design the concession to maximise profits, which can be shared between officials and the bidding firm. In so doing he may sacrifice values that would be reflected in an honestly negotiated contract. For example, in a timber contract environmental damage or harm to indigenous people may be ignored. The same problem may arise for privatisation projects. Thus corrupt officials can promise to preserve the monopoly position of a privatised enterprise or contract for “white elephant” projects that do not promote economic development.

*Effect on firm behaviour.* Now consider a firm that has obtained a secure long-term timber concession at a bargain price, even when the bribe is added in. If it operates in the international timber market, its subsequent actions should depend on that market. The fact that it has underpaid for the concession should not affect its production decisions. It still seeks to maximise profits, and the concession payment is a sunk cost. The cost of corruption is felt by the public first, but no inefficiency has been introduced into the international timber market. Even if the total payment is higher than that expected in an honest system, there should be no effect.

No effect on firm behaviour is an important result, but it is too simple to reflect reality. The missing operative terms are *secure* and *long term*. A corrupt system is not just one in which individuals in key positions can benefit at the expense of the state and ordinary citizens. Rather, corrupt deals introduce uncertainties into the economic environment. And those uncertainties can affect the way private firms do business. Difficulties may arise even if the most efficient firm wins. The corrupt nature of the deal may give the firm a short-run orientation.<sup>21</sup> There are two reasons for this. First, the concessionaire (or contractor or purchaser of a privatised firm) may fear that those in power are vulnerable to overthrow because of their corruption. A new regime may not honor the old one’s commitments. Second, even if the current regime remains in power, the winner may fear the imposition of arbitrary rules and financial demands once investments are sunk. It may

be concerned that competitors will be permitted to enter the market or worry that its contract will be voided either for political reasons or for greed.<sup>22</sup> Also, the firm is vulnerable to extortionary demands by those who can document the illegal payments. For these reasons the corrupt firm with a timber contract may cut down trees more quickly than it would in less-corrupt countries. It may also be reluctant to invest in immovable capital that would be difficult to take out of the country if conditions change. In electric power the most dramatic examples of this are the floating power stations established in several developing countries to make exit easy and relatively inexpensive. In short, both the timing of production and the input mix may be inefficiently chosen because of the corrupt nature of the system.

Furthermore, it is unlikely that corruption will be limited to a one-time payment. Instead, the winner may be the firm most willing to engage in ongoing corrupt relationships up and down the hierarchy to protect its interests. For example, if the timber concession includes a royalty per log that is calibrated by the type of timber, the firm may pay inspectors to misgrade the logs. It may also pay to cut down more trees than the concession permits. Under a construction contract the high briber may anticipate paying building inspectors to approve work that does not meet the nation's safety standards (Park 1995). In fact, the expectation of a long-term relationship may be part of the appeal of signing with a corrupt firm in the first place. The corrupt firm may also retain some control by holding back promised bribes as a way to guarantee performance by the country's officials. Thus a firm might sign a contract to deliver cement to a road building agency but pay bribes only if payments are received from the public authority. Frequently, such arrangements take the nominal form of consulting contracts with payments tied to the receipt of funds under the contract.

Even when the exploitation of a country's natural resources is carried out efficiently by the corrupt firm, the struggle for rents can damage the economic and political systems. Talented people may concentrate their efforts on rent seeking rather than on productive

activities.<sup>23</sup> This can occur on both sides of the corrupt transaction. Potential entrepreneurs may decide to abandon the private sector and become public officials charged with allocating rents. In a democracy people may seek political office, not to fulfill an obligation for public service, but to extract as many rents for themselves and their supporters as possible (Diamond 1993, 1995). Similarly, private business people may concentrate on the struggle for publicly provided benefits, be they mineral concessions or aid contracts, rather than on establishing productive enterprises. Considerable evidence suggests that a strong natural resource base may hinder economic development (Gelb 1988; Sachs and Warner 1995). This outcome is explained by the fact that individuals believe the most effective way to gain wealth is to try to take it from someone else or from the state, rather than to produce (Krueger 1974).

## **Bribes that Buy Political Influence or Votes**

Corrupt elected officials can be voted out of office. But democracy is not necessarily a cure for corruption. In some systems corrupt politicians coexist with democratic forms even though citizens are aware of their practices. Corrupt payoffs are used, in part, to fund political parties and election campaigns. They fund general electoral activities, and in some countries the outright purchase of votes by politicians, although illegal, occurs quite openly. Conversely, some autocratic regimes manage to limit lower-level corruption with rents extracted by only a few top officials.

Modern political campaigns demand more resources than older style contests. Thus there is a demand for greater funding. In the absence of public funding the most convenient source of money is business interests that can benefit or be harmed by politicians' decisions. Even if contributions from business can be made legally, both firms and politicians may prefer to keep the payoffs secret if a quid pro quo is involved. Voters cannot be expected to tolerate tax breaks or con-

tracts granted in return for payoffs. In some cases an entrenched system of illegal payoffs may undermine efforts to reform the funding of political campaigns. Studies of the political systems in France and Italy demonstrate how modern parties have lost their ideological focus and have come to be dominated by “business-politicians” (Mény 1996, p. 314; della Porta 1996). Many of the recent scandals there involved illegal campaign contributions. The same is true of the recent scandals in the Republic of Korea. When Tanaka Kakuei was prime minister in Japan, he developed a system under which businesses were assigned candidates to fund and elect (Reed 1996, p. 402).

The testimony of Italian political operatives in the recent anticorruption investigations reveals how corrupt practices can become entrenched in nominally democratic systems. Party leaders placed people who sought political careers in positions where the payment of bribes was routine. The construction industry was a particularly lucrative source of funds. Specialised “party cashiers” had the job of managing the collection of bribes and the distribution of contracts. Such people generally had no official government job but were the ones that business people turned to if they had a problem dealing with the government. They collected bribes for the party coffers, keeping some share of the gains for themselves (della Porta 1996).

On the other side of the transaction were political bosses who were especially concerned with mobilising the vote. This could be done, not just with campaign funds, but also with state resources, patronage jobs and other types of government favours used to create webs of obligation. It is not clear whether the work of the Italian magistrates has entirely undermined this well-organised system, but the revelations of illegal activities by top leaders has led to a major realignment at the top of Italian politics (della Porta 1996).

In some countries votes are purchased openly. This practice has a long history going back to England and the United States in the nineteenth century. Reforms have limited such payoffs in most industrial countries, but they remain a feature of electoral politics elsewhere. The

recent election in Thailand featured a long-standing practice of small payoffs to voters. An original twist included a post-election bonus if the candidate won.<sup>24</sup> Politicians accused of amassing illegal campaign war chests in the Republic of Korea and Japan justified their actions by referring to the financial demands of campaigning in countries where voters expect gifts or other personalised benefits from candidates (Park 1995; Reed 1996).

In other countries executive branch officials purchase the votes of legislators. Special budgetary funds available to the executive with little accountability fuel this practice, especially in several Latin American countries. In Brazil, when President Collor's impeachment was before the Congress, observers worried that his allies were trying to bribe the members to obtain a favourable verdict (Geddes and Ribeiro Neto 1992).

There are several avenues of reform to consider. One is publicly funding campaigns, maintaining well-enforced restrictions on private donations. Public funding must be generous enough so that candidates can avoid amassing illegal slush funds. A number of different proposals have been made to reform campaign spending in the United States that might be applied in other countries. This is not the place to review these possibilities, except to note that poor democracies will face more severe budgetary constraints than richer ones if they move to public funding.

Complementary proposals involve redesigning the electoral process to reduce incentives to give voters personalised benefits. Such changes will not affect the incentives of political parties to collect funds from wealthy supporters, but they will reduce the incentives for politicians to buy citizens' votes. For example, under a nation-wide proportional representation system candidates have no individual districts to satisfy. Another example: some have argued that recent reforms of the Japanese electoral system should reduce incentives to provide personal favours to voters. Recent reforms of the Italian electoral system were designed with this idea in mind, although their success is questionable.

A final type of political change will be more difficult to carry out as a self-conscious policy since it involves a change in underlying political cleavages. Montinola (1996) argues that the shift from a multidimensional set of political issues to one that could be aligned along a left-right spectrum helped reduce corrupt incentives in Chile, since politicians could be more easily held accountable by the voters. This observation, if correct, is another argument supporting a government that is more streamlined and compact.

## Payments for Judicial Decisions

Judges can affect the distribution of wealth through their decisions. Thus like any public officials with similar powers, they face corrupt incentives. These incentives are higher when judges are underpaid and overburdened, and have poorly equipped and understaffed offices. Even if judges are not themselves corrupt, clerks in charge of assigning cases and advising judges may demand or accept bribes. In some Latin American countries, for example, the lack of formal court fees creates incentives for court employees and judges to charge unauthorised fees (Buscaglia 1995).

Payoffs can be a way to speed up decisions in countries where delays and backlogs are great. A six-country study in Latin America found that delays and backlogs had increased dramatically between 1973 and 1993 (Buscaglia 1995, table 1), thus raising incentives to pay bribes. Bribes can also influence judges to make decisions in one's favour. Occasionally, bidding wars have been reported, in which parties on opposing sides compete in making payoffs.<sup>25</sup>

A judiciary viewed as corrupt introduces uncertainties into the business climate. The law on the books may not mean much, and those with disputes will avoid bringing them before the courts unless they are certain that they will be the high bribers. Individuals with disputes find ways to circumvent the court system. They may hire private arbitrators or use other methods, such as the protection provided by

organised crime. Buscaglia (1995) reports that the judiciary in Latin America is so deficient that most business people try to avoid using the courts to resolve disputes. In Eastern Europe and in Russia murders of business people and bankers are common. Many appear to be execution-style killings that are part of a brutal private system of “dispute resolution”.<sup>26</sup>

Reforming the judiciary requires more than a simple change of personnel. Unless underlying conditions improve, fundamental change is unlikely. The first step is to better pay and working conditions for judges and supporting personnel, accompanied by more systematically monitoring performance, both inside and outside the system. Information on delays by type of case and court could be collected and made public. Furthermore, judges may need additional training if they are to deal responsibly with the disputes that come before their courts. An improvement in the professionalism of judges should reduce the incidence of corruption.

One way to make the judiciary work more effectively is to establish laws that are well-drafted and relatively clear. Of course, courts cannot avoid exercising discretion, but clarity will both eliminate disputes and make judicial decisions appear less arbitrary. Some developing countries, for example, are functioning with laws written in the language of the colonial power that are difficult for citizens to understand. Even when language is not a problem, some countries continue to use obsolete statutes borrowed from industrial countries many years ago. Thus although some corrupt incentives can be reduced by reforming and upgrading the judiciary, comprehensive reform requires a complete review of the legal system.

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## 2. The Costs of Corruption for Economic Development and Poverty Reduction

Corrupt deals come in many forms and can distort the allocation of resources and the performance of government in many ways. The impact of corruption on a country's economic health will obviously depend on what bribery is buying. Generally, however, cross-country research suggests that high corruption levels are harmful to economic growth. When corruption is associated with organised crime, legitimate business is discouraged, the allocation of resources is distorted and political legitimacy is compromised. Corruption has a pervasive and troubling impact on the poor since it distorts public choices in favour of the wealthy and powerful, and reduces the state's ability to provide a social safety net.

### Economic growth

Development economists have long recognised that government policies and institutions affect growth. For example, according to Pack (1988, p. 343) the pattern of export and import substitution depends on the policy environment. Only 50% of the variation in manufacturing value added to total value added is explained by income per capita and population size. High levels of protection are frequently associated with substantial rents earned by domestic producers, and successful growth demands that the state mute the opposition of these groups (Pack 1988, p. 349; Olson 1982). Inefficient public enterprises and uneconomic regional development policies depress domestic productivity (Pack 1988, pp. 351, 353). Industrial licensing schemes can be designed to maintain rents and dampen market discipline (Pack 1988, p. 358).

The economic development literature seldom explicitly considers corruption, though Bhagwati (1974) and Krueger (1974) come close, emphasising the way public policies create incentives for illegal activities. The study of corruption is, however, a natural next step for the institutionally oriented economist, whatever the empirical difficulties involved. Rather than treating government imperfections as the result of only laziness or incompetence, one views government failures as the result of self-interest on the part of politicians, bureaucrats and private individuals and firms. The central issue for research is whether corrupt payoffs are a way around inefficient rules or a source of inefficiency in themselves. Can they explain some of the evident distortions in government policies or are they an efficient response to these distortions?

Although data on corruption will always be difficult to obtain, recent cross-country studies shed some light on these questions. The papers are in the spirit of recent work by Robert Barro and others who seek to relate institutional and political variables to measures of economic growth or to other macroeconomic variables of interest. For reviews of the literature on democracy and growth see Przeworski and Limongi (1993) and Barro (1994).

Research on corruption and on the quality of government institutions has been made possible by data sets prepared by proprietary firms that provide information to companies deciding where to invest. Although the methodologies behind the preparation of these data series are not always transparent, they are generally based on the opinions of people knowledgeable about the countries in question, such as investors, scholars, bankers and financial analysts. Scholars' use of such data is justified by the claim that they have withstood a market test, but the proprietary nature of the information means that it is not as well-documented or as replicable as most social scientists would like. Nevertheless, it is the best macro-level data available.

Statistical studies using these data indicate that strong legal and governmental institutions and low levels of corruption have beneficial effects on economic growth and other economic variables. Other work

shows that more competitive economies suffer less corruption because they have fewer economic rents available for capture.

### *Is Corruption Associated with Poor Performance?*

Mauro (1995), using a corruption index from the early 1980s, demonstrates that high levels of corruption are associated with low levels of investment measured as a share of GDP.<sup>27</sup> The index, developed by Business International, ranks countries on a scale of 0 to 10 based on a judgment of how frequently corruption was required in business transactions. High numbers indicate low levels of corruption. Mauro (1997) combines the Business International data with an index for 1982–95 derived from the International Country Risk Guide prepared by Political Risk Services. He ran statistical tests on 106 countries.<sup>28</sup> The results are similar. In the 1997 study a one standard deviation improvement in the corruption index is associated with a more than 4 percentage point increase in the investment rate and a more than half a percentage point increase in the annual growth rate of per capita GDP.

Because the corruption indices are highly correlated with other measures of bureaucratic efficiency, such as the level of red tape and the quality of the judiciary, Mauro was unable to measure the marginal effect of any one of these measures, holding the others constant. The data do, however, support the claim that the level of red tape is a function of the prevalence of corruption, not reduced by the payment of bribes. Corruption is a symptom of other underlying problems. It is not an independent variable.<sup>29</sup> Putting the separate indices together in a measure of bureaucratic efficiency, “if Bangladesh (with a score of 4.7) were to improve the integrity and efficiency of its bureaucracy to the level of that of Uruguay (score 6.8), its investment rate would rise by almost five percentage points and its yearly GDP growth rate would rise by over half a percentage point” (Mauro 1995, p. 705).

The results suggest that corruption affects growth predominantly through its impact on the level of investment, not on the composition

of the investment portfolio. But Mauro (1997) also demonstrates that highly corrupt countries tend to underinvest in human capital by spending less on education—education provides less lucrative corruption opportunities than more capital-intensive public spending. Corruption can occur in the purchase of textbooks and school supplies, and in school construction, but it provides fewer opportunities for massive wealth transfers than spending on infrastructure and the military.

A complementary study by Keefer and Knack (1995) uses the International Country Risk Guide (ICRG) index as well as one compiled by Business Environmental Risk Intelligence. The authors focus primarily on the importance of strong property rights regimes in facilitating investment and growth. As part of this effort they also examine the importance of government institutions, including the measure of corruption included in the ICRG data. Like Mauro, they discovered that the corruption index was so highly correlated with other measures of government quality that it could not legitimately be used alone. Instead, they averaged it with expropriation risk, rule of law, risk of contract repudiation by the government and the quality of the bureaucracy. The study examined rates of economic growth for 97 countries over 1974–89. The authors showed that indices of the quality of government institutions do at least as well as in explaining investment and growth as do measures of political freedoms, civil liberties and the frequency of political violence. An improvement of one standard deviation in the ICRG index leads to an increase in growth rates that would bring Honduras to the level of Costa Rica or Argentina to the level of Italy.

Another study considered whether World Bank projects are more likely to be judged satisfactory when countries have strong institutions, including low levels of corruption. Kilby (1995), using the same ICRG data set, found that projects were more likely to be given an unsatisfactory rating by the Bank's Operations Evaluation Division if borrower countries ranked poorly on measures of political instability and corruption.

### *How Does Competitiveness Affect Corruption?*

Ades and Di Tella (1994), using the Business International corruption index from the early 1980s supplemented by additional information from the early 1990s, asked how the competitiveness of the economy affects a country's corruption ranking.<sup>30</sup> They argue that more competitive countries should be less corrupt. Lacking a direct measure of competitiveness, they use various proxies and obtain results consistent with their theory. Their proxies are the share of merchandise imports in GDP, the distance of the country from world markets, an index of labour power and the strength of antitrust laws. They also include as controls measures of economic prosperity, education levels and political rights. As Ades and Di Tella themselves recognise, these measures all have weaknesses. The share of imports ought to take the size of the economy into account. The United States has a relatively small import share but is quite competitive because of the size of its internal market. Import share has a quite different meaning in China than in Mali. In addition, the proxies ignore the competitiveness of export markets and the nature of the government contracting process.

### *Are There Exceptions?*

Some who believe that a focus on corruption is misplaced point to countries that do not fit the statistical pattern. They point to countries, mostly in East Asia, that are reputed to have high levels of corruption and impressive growth rates. These skeptics are correct in noticing that corruption is not a unitary phenomenon. High levels of corruption can produce quite different effects depending on what the payoffs are used to purchase. Still, recent evidence suggests that reducing corruption and insider dealings would have improved the performance of even high-growth Asian economies. Thus Wei (1997) has shown that corruption acts like a tax on foreign direct investment (FDI). Increasing the corruption level from that of relatively clean Singapore to that of

relatively corrupt Mexico is the equivalent of imposing a more than 20 percentage point increase in the tax rate. In Wei's sample there is nothing especially benign about East Asian corruption. Similarly, Ades and Di Tella (1995) argue that an aggressive industrial policy may be partly motivated by the corrupt gains that the policy makes available to officials. In such cases the direct, positive effect of the policy can be undermined by its role in increasing corruption and, hence, discouraging investment. In extreme cases the effect on growth and investment could be negative. Their empirical results demonstrate that in the presence of corruption, the positive impact of industrial policy is halved. Once again, there is nothing special about the East Asian economies.

These studies suggest that countries with poorly functioning government institutions tend to be relatively corrupt and that payoffs are seldom an adequate compensation for other government failures. Corruption seems to be harmful to economic growth, but the magnitude of the effect is unclear. Furthermore, because corruption is tied to other features of government structure, reducing corruption without a more fundamental change in the behaviour of public institutions is unlikely to be successful in promoting growth.

Although an honest and well-functioning government furthers growth, growth will not necessarily cure a corrupt government. A growing pie may imply just that there are more rents to divide. Corruption may be more tolerable if the pie is growing since everyone can receive some benefits, but for that very reason it may be more likely to spread. An economic downturn will then leave the regime in power vulnerable to overthrow, since it can no longer satisfy all those who have shared in the spoils (box 5).

## Organised Crime

Corrupt businesses are sheltered from competition with legitimate businesses by their illegality. In corrupt systems they also operate without fear of prosecution by paying off the police and politicians or

### Box 5 Rent Seeking and Political Transformation in Algeria

A fiscal crisis often reveals underlying tension in a seemingly stable political system. When the status quo is based on the sharing of economic rents, a downturn puts pressure on the system. Powerful high-level officials and their allies try to preserve their benefits as the pie shrinks.

In Algeria the Front de Libération Nationale (FLN) lost power because of a severe fiscal crisis. A religious party, the Front Islamique du Salut (FIS), took over. One scholar provides an economic explanation for the rise of the FIS. The party was supported in the 1990 election by the small business sector, public sector employees and the educated segment of society. These were the groups that lost from the partial market opening and downsizing that resulted from the crisis brought on by the end of the oil boom.

From 1986 onwards, following a sharp fall in the price of oil, the government ran large budget deficits. To deal with this crisis, it introduced reforms designed to overturn the centralised, industry-based socialist programs and to develop the private market. These reforms did not succeed. Instead, state involvement in the economy remained high and was based on close links between individuals inside and outside the government. The government's distributive policies continued to protect the poor, and "liberalisation" was carried out through an alliance of large industrialists and state actors at the expense of the middle class and public employees. According to knowledgeable observers, this alliance was based on payoffs, bribes, threats, promises and trades. Political corruption increased in the 1980s, raising costs for the middle classes who were less politically powerful than large industrialists. The disaffected groups turned to the FIS.

This case illustrates the risks of adopting the forms of market liberalisation without the substance. The essence of a true liberalisation programme is a reduction in the role of the state and a policy of opening markets to those with entrepreneurial skills, irrespective of their personal connections. The privatisation of state-owned enterprises should not be an inside deal, and the development of small and medium-size businesses should not be hampered by excessive red tape and demands for payoffs.

*Source:* Chhibber 1996.

including them directly in their businesses. Illegal businesses are especially vulnerable to extortionary demands. Law enforcement authorities—from the police to prosecutors to judges—can demand payments

to overlook criminal law violations or limit penalties. If evidence of criminal behaviour is clear, such businesses cannot credibly threaten to report corrupt demands.

Of course, those engaging in illegal businesses are hardly innocent victims. They seek not only immunity from prosecution but assurance of monopoly power in the illegal market. In both the United States and Latin America gamblers and drug dealers have paid officials to raid their competitors or to restrict entry.<sup>31</sup> In Thailand some local authorities shelter criminal enterprises from competition and from the law (Phongpaicht and Piriyarangsan 1994, pp. 51–97). Alternatively, instead of inducing state officials to harass their competitors, corrupt business people may directly intimidate potential rivals, often paying the police not to intervene in their private attempts to dominate a market (Handelman 1995).

The danger for economic development arises when organised criminal groups begin to dominate otherwise legal business. Southern Italy and the countries of Eastern Europe and the former Soviet Union are cases in point. Several Latin American and Asian countries face similar risks. Organised crime groups can use the profits from their illegal enterprises to infiltrate legal businesses. These profits, earned without paying taxes, can also be used to obtain public contracts (Gambetta 1993; Varese 1994).

The stakes are especially high in Eastern Europe and the countries of the former Soviet Union. Nothing less than the entire wealth of the state is up for grabs. Although some of their industrial plants are out of date, these countries are nevertheless largely developed and rich in natural resources. The value of sharing in the privatisation of a socialist state dwarfs the benefits of sharing in the privatisation of a public utility in Western Europe or a steel mill in the developing world. Both criminal groups wealthy from illegal businesses and legitimate businesses seek to share in the wealth. If criminal groups can create uncertainty and the threat of violence, they will drive competitors away, especially Western firms, leaving them with a free field (Shelley 1994). In fact, FDI

from legitimate businesses is not large in the countries of the former Soviet Union. Although a recent study argues that privatisation in Eastern Europe and the former Soviet Union has been on balance beneficial, despite admitted problems, this should not be read as an argument against serious legal reform (Kaufmann and Siegelbaum 1997).

Even in industrial countries some legitimate businesses are especially vulnerable to criminal infiltration. Organised crime is wealthy and unscrupulous. It is willing to use not only bribery, but also threats and violence to enforce its contracts and get its way. This gives it a competitive advantage in several fields. First, one type of business especially open to the influence of organised crime is one in which entry is relatively inexpensive but can be discouraged by threats. Private garbage collection is a good example. Entry is inexpensive—one need only purchase a truck. But garbage trucks operate alone on public streets. Thus it is relatively easy to intimidate unwanted rivals by attacking their trucks without attracting police attention. To ensure even less risk, but at a cost, the police can be paid to look the other way (Reuter 1987). Similarly, whenever a business needs a licence to operate, the ability to corrupt officials to secure a licence for yourself and deny one to your rivals provides an obvious competitive advantage.

Second, legal businesses that benefit from prime urban locations are especially at risk in countries with weak or corrupted police forces. This includes restaurants and shops serving tourists and business travelers. Manufacturers can hide in out-of-the-way locations (Charap and Webster 1993), but these service businesses cannot go underground to avoid notice. If the police are unreliable, criminal groups may demand protection money, part of which goes to protect the business from attacks by the group itself (De Melo, Ofer and Sandler 1995; Webster 1993a; Webster and Charap 1993).

Third, in communities or countries where capital is scarce or underpriced, organised crime may fill the gap by providing funds at high rates and by being willing to use threats and violence to enforce loan contracts (Webster 1993a; Webster and Charap 1993; Yabrac and

Webster 1995). Fourth, businesses that are effective venues for money laundering, such as banks and casinos, risk criminal takeovers. In all countries casinos are at risk (Reuter 1987, pp. 63–69). In countries such as those in the former Soviet Union, where banking regulations are lax or poorly enforced, financial institutions have been established and taken over by organised crime groups (Shelley 1994).

Fifth, businesses that work mostly for the state, such as in road repair and building construction, are prime candidates for influence by organised crime. If a government has been corrupted by organised crime in connection with its illegal businesses, it may be a relatively short step to make payoffs to obtain public contracts on favourable terms. In the extreme, organised crime groups manage cartels that share contracts and pay off public officials to buy their complicity, or at least their silence. In southern Italy, for example, more than half of the small and medium-size businesses interviewed reported withdrawing from a public tender after pressure from criminal groups or their political allies (“Still Crooked”, *The Economist*, February 5, 1994).

Wealthy criminal groups may find it too risky to invest their profits directly in the country where they were earned. Questions might arise concerning their origin, and if a criminal investigation is launched the funds could be seized by the state. Thus criminal groups may seek to launder the funds abroad and then invest them at high returns either outside the country or as new, “clean” investments in the country of origin. Many experts claim, for example, that a share of the foreign investment entering Russia is actually money controlled by Russian criminals that has been laundered to disguise its origin. Laundering both hides the funds’ origin and makes the investors eligible for special subsidies available only to outside money (Shelley 1994).

The wealth, unscrupulousness and international connections of many organised criminal groups suggest how difficult they are for any one country to control. The danger is that rather than being a temporary stage of development, criminal activity will become thoroughly

intertwined with politics. Then, the state will have little interest in controlling criminal influence and will descend into kleptocracy. Optimists might contend that criminals will modify their ways once they actually control the government. But this view seems utopian. One would expect that those in control would seek to limit entry through threats of violence and the elimination of rivals, as they have done in the drug business. These regimes are what Olson (1993) calls “stationary bandits”. Furthermore, organised crime bosses may be more interested in quick profits earned by exporting a country’s assets and raw materials than in the difficult task of building up a modern industrial base. The end result is the delegitimation of the state-building enterprise and the undermining of capitalist institutions.

## Poverty

The empirical work summarised above suggests that high levels of corruption reduce the rate of economic growth. Pervasive corruption signals that the state is functioning poorly. Economic actors with few scruples, such as those engaged in illegal businesses, have a comparative advantage. A country is poorer overall when corruption levels are high. It may be caught in a corruption trap, in which corruption breeds more corruption and discourages legitimate business investment.

Thus reducing corruption and improving the functioning of the state should benefit many citizens, including the poorest. But what does this conclusion imply about the relative position of the neediest citizens in a corrupt regime? The answer depends on the nature of the benefits purchased with bribes and how the payoffs are distributed.

- *The poor will receive a lower level of social services.* Anytime public benefits are distributed on the basis of ability to pay, the poor will suffer. Using an illegal price system to distribute pensions, public housing, education and health will disadvantage those unable to pay. This is true for legal user fees, and it is true for illegal bribes. But the point remains.

- *Infrastructure investment will be biased against projects that aid the poor.* In a state where corruption is pervasive, officials will design public projects to maximise bribery receipts and to minimise the chance of detection. This strategy favours projects that are excessively large and complex. Furthermore, projects may be poorly targeted towards the poor, since such a goal does not increase corrupt receipts. Taxes and foreign aid loans and grants will cover the cost of these projects instead of being used for projects that benefit the worst off. Even projects such as the building of schools or health clinics will provide fewer benefits to the poor if their costs are inflated by payoffs.

- *The poor will face higher tax burdens or fewer services.* If corruption pervades the collection of taxes and customs duties, the proportion of the total tax bill imposed on those without the power and wealth to pay off tax collectors will increase. Of course, the very poor are unlikely to be a promising source of revenue, but they will face increased pressure to contribute. One consequence may be a decision to move into the informal, underground economy where tax collectors cannot find them. Alternatively, if the poor are unable to pay taxes, the result of corrupt deals will be a shrunken state unable to provide many services.

- *The poor are disadvantaged in selling their agricultural produce.* Many of the poor are small-scale agricultural producers. They depend on middlemen to get their products to market. If these people have induced the state to grant them local monopolies over particular geographical areas, farmers become disadvantaged. Corrupt officials have an incentive to create such monopolies and use them to extract personal gains. Agricultural marketing boards have frequently operated in this fashion and are familiar sources of patronage and corrupt payoffs for rulers.

- *The growth of indigenous, small-scale enterprises is limited.* In some countries many poor people are concentrated in cities and live off of small-scale business enterprises. Their ability to escape poverty using these enterprises may be severely restricted by the corruption of the state regulatory and taxing apparatus. Such corruption keeps them off the books and limits their ability to grow.

A bribe may determine who obtains a government contract or a privatised firm, where the basic terms have been set without regard for the possibility of corruption. Then the bribe represents a transfer from the profits of the winner and the government treasury to the pockets of the official. Unless the bribe comes entirely from the winner's profits, the state suffers a revenue shortfall, but this is of no special concern to the poor segment of the population.

In other cases bribes are collected by political parties and candidates, and used to purchase the votes of the poor. Although hardly a recipe for effective and legitimate government, such payoffs do represent a redistributive transfer. The overall impact of such a method of campaign finance could, however, be harmful to voters if elected politicians then favour inefficient projects appealing to major donors. The poor may suffer as a group, but still have an incentive as individuals to accept the payoffs.

Finally, consider the recipients of the bribes. Although large-scale bribery of top officials simply enriches the already wealthy, low-level officials also accept bribes. Frequently, they control access to benefits such as licences, tax assessments and customs exemptions that are very valuable to private firms and individuals. Although few civil servants qualify as poor, many support poor relatives in the countryside. Their payoffs may be an important source of funds for these family members. This reality must be taken into account in reforming the civil service. If such transfers are important, reform should be combined with improvements in the social safety net for the poor.

Poverty makes governance reform difficult but not impossible. Countries do not have to wait until they become as rich as Singapore to engage in anticorruption efforts. Consider, for example, the case of Botswana, a low-income country, albeit one well-endowed with natural resources, that is viewed as relatively clean (box 6).

### Box 6 Fighting Corruption in Botswana

Botswana has not been plagued by the systemic corruption so prevalent elsewhere in Africa (Charlton 1990, p. 6) and has enjoyed relatively good governance since independence (Raphaeli, Roumani and MacKellar 1984; Wescott 1994). Patronage is important, but graft is not. Private business people do not need to bribe government officials to carry on normal business activities; civil servants are paid a sufficient (though by no means lavish) salary so they do not need to solicit bribes in order to survive. The lack of systemic corruption, and the presence of political and macroeconomic stability, have earned Botswana the confidence of foreign investors. Botswana has the lowest “political risk” factor of any nation in Sub-Saharan Africa, including South Africa, as revealed in surveys of risk analysts, risk insurance brokers and bank credit officers published in *Euromoney*. In overall riskiness for investors Botswana ranked fifty-fifth in the world, just behind South Africa, ranked forty-ninth. The country has one of the highest rates of foreign direct investment per capita in Africa.

Although organised democratically, one party has held power for 30 years. The Botswana Democratic Party has delegated substantial power to the bureaucracy, and creation of a competent, efficient civil service was an important goal during the early independence period (Charlton 1991). The country has abundant mineral resources, with more than 50% of its GDP accounted for by mining—mostly diamonds, copper and nickel (Mhoza 1992). It has invested the proceeds of mineral extraction in basic physical and social infrastructure, including roads, water, schools and clinics throughout the nation (World Bank 1993, pp. 2–8).

Botswana’s success is tied to the country’s political stability. Stability encourages politicians to take a long-run perspective, and the economic success produced by this perspective helps maintain political stability—generating a virtuous cycle. Two important reasons explain Botswana’s political stability and economic growth. First, the country is not divided into ethnic factions (Murray and Parsons 1990), and the government has managed to spread the benefits of growth widely enough to keep the population reasonably satisfied. Second, Botswana is a small, land-locked country that is heavily dependent on foreigners for private investment and international aid to alleviate poverty. It thus has an especially strong incentive to develop sufficient state capacity to encourage outside investment in its mineral wealth and to avoid being taken advantage of by these

*(Box 6 continues next page)*

**Box 6 (continued)**

same investors. Economic pragmatism has always taken priority over political ideology or factional favouritism.

There is, however, corruption in Botswana. Prominent instances have implicated a handful of highly placed government officials in control of major government procurement, parastatal corporations or industrial incentive programmes. Several scandals in the 1980s involved Botswana's economically and socially important cattle industry (Charlton 1990). In 1985 the management of the Botswana Meat Commission, a parastatal, was accused of mismanagement and corruption. Earlier, another official was accused of illegally enriching himself through a cattle-related business, and a relative of a top official was accused of illegally obtaining cattle ranches under a government grazing-land policy. Other serious scandals investigated by the Presidential Commission of Inquiry involved the highest-level officials in the Ministry of Local Government, Lands and Housing. These included a \$10 million procurement fraud, involving teaching materials for primary schools, illegal land transactions and manipulation of the Botswana Housing Corporation for private benefit (Good 1994, pp. 501–04).

Despite these examples, rent seeking in Botswana is viewed as “relatively pale and restricted...[and] not systemic to the whole of the political economy” (Good 1994, p. 516). Rather than denying allegations raised by the media, the government has generally carried out thorough investigations. But until recently, penalties were small. Key players were usually merely moved (without demotion) to other posts in government; others were later re-elected by the ruling party “to their former positions on the central committee, with commanding majorities” (Good 1994, p. 506).

These practices may be changing. In 1994 Botswana established the Directorate on Corruption and Economic Crime (DCEC) modeled after a similar organisation in Hong Kong and staffed by former members of the Hong Kong agency and by local people (see box 9). The DCEC can investigate and prosecute offenders, design strategies to prevent corruption and provide public education. It is officially under the president's jurisdiction but is operationally independent and can prosecute whomever it wishes. Although hampered by a slow court system, it boasts a high conviction rate and has collected fines in excess of its operating costs. It is becoming an example of good practice in the region.

*Sources:* Charlton 1990, 1991, Coolidge and Rose-Ackerman 1997, Good 1994, Mhoza 1992, Murray and Parsons 1990, Piggott 1996, Raphaeli, Roumani and MacKellar 1984, Wescott 1994 and World Bank 1993a.



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### 3. Domestic Reform Strategies

Government policy can control the risks and benefits of corruption. Domestic anticorruption policy can increase the benefits of being honest, increase the probability of detection and punishment, increase the penalties levied on those who are caught and reduce corrupt opportunities. Within a country, the incentives for corruption are influenced by:

- The level of benefits and costs under the control of officials.
- The formal laws defining corruption, bribery and conflicts of interest and controlling campaign finance spending.
- The credibility of law enforcement in acting against both those who pay and those who accept bribes.
- The conditions of civil service employment.
- Incentive systems in the civil service.
- The extent of auditing and monitoring within government.
- The ability of citizens to learn about government activities and file complaints.
- The level of press freedom and the freedom of individuals to form non-governmental organisations.
- The level of active political opposition.

This list falls into several broad categories that reforming countries should consider. The following sections discuss reductions in the discretion and monopoly power of government officials, improved law enforcement, civil service reform, increased transparency and improved citizen oversight. Many of these policies are part of ongoing UNDP governance projects and are important aspects of reform programmes sponsored by other aid and lending organisations such as the World Bank and the bilateral aid donors.

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## Reducing Incentives for Payoffs

The most fundamental reforms are those that reduce the level of benefits controlled by public officials. A reform strategy must accomplish this, however, without eliminating programmes that have strong public justifications and without simply shifting the benefits into the private sector where they will show up as monopoly profits. There are several strategies to consider.

### *End Corrupt Programmes and Laws*

The most straightforward option is simply to eliminate corrupt laws and programmes. If the state has no authority to restrict exports or licence businesses, no one will pay bribes in those areas. If a subsidy programme is eliminated, the bribes that accompany it will disappear as well. If price controls are lifted, market prices will reflect scarcity values, not the value of bribes. If a parastatal is the locus of corrupt payoffs, it should be privatised. For example, although Pakistan's firms engaging in foreign trade are frequently corrupt, reform among Pakistan's export processing rules reduced corruption of exporters below that of non-exporters (Rose-Ackerman and Stone 1996). After a short experiment with Prohibition, the United States repealed the eighteenth amendment to the Constitution, which outlawed the manufacture and sale of "intoxicating liquors". The years that it was in force, 1919–33, was a period of wide-spread illegal production and sale of alcohol, and corruption of law enforcement officers. The debate over legalising drugs in the industrial world turns on the feasibility of controlling the industry through criminal law. Gambling, formerly outlawed in many jurisdictions, has recently become a legal business in many countries and US states, albeit under heavy state supervision or even state ownership.

In some countries, however, solutions that seem obvious to the economist may be unconstitutional or may violate deeply entrenched

customary or religious practices. For example, some countries mandate free health care in their constitutions. In others customary law assures free access to water or scarce inputs. In parts of the Middle East, for example, changing water laws could stir tribal or civil wars.

### *Heighten Competitiveness*

In general, any reform that increases the competitiveness of the economy will help reduce corrupt incentives. Thus policies that lower the controls on foreign trade, remove entry barriers for private industry and privatise state firms in a way that assures competition will all contribute to the fight against corruption (Ades and Di Tella 1995). Nominal reforms that actually entrench the power of existing elites can be counterproductive.

Deregulation and privatisation must be carried out with care. Deregulating in one area may simply increase corruption elsewhere. For example, a successful effort to reduce corruption in the transport of agricultural products in one African country increased corruption on the same transport route in neighboring countries. The project, sponsored by the US Agency for International Development (USAID), reduced the number of bribe-extraction checkpoints established by police and customs officials along onion transport routes in Niger. But it ultimately increased payoffs and tax levels in Côte d'Ivoire as the onions neared their destination—the food markets of Abidjan (Rogers and Iddal 1996).

The privatisation process can itself be corrupted, as can the new regulatory institutions that are needed in the privatised world. Instead of bribing the parastatal to obtain contracts and favourable treatment, bidders for the company can bribe officials of the privatisation authority. A firm privatised with its market power intact may not be corrupt, but may charge monopoly prices. Privatisation and deregulation are, on balance, desirable in a wide range of cases, but reformers must look carefully at the incentives for rent seeking that remain (box 7).

### Box 7 The Promises and Risks of Privatisation in Latin America

Privatisation has been a feature of economic reform in Latin America. Latin American countries have well-established private sectors, and most large privatisations involve public utilities or transportation companies—industries in which state ownership has been common in much of the industrial world as well. Such privatisations can be very beneficial, but improper payoffs and insider deals have marred the process. Corrupt incentives arise at a number of points in the process.

- Bribes can help determine the list of prequalified bidders. Payoffs may be solicited for inclusion on the list, and firms may pay to restrict the number of other bidders.

- When large state enterprises are privatised, there may be no reliable way to value their assets. Furthermore, the tax and regulatory regime that will prevail ex-post may be poorly specified. The uncertainties of the process create opportunities for favouring corrupt insiders, who can be given information not available to the public, information early in return for payoffs or special treatment in the bidding process. In extreme cases no auction occurs. The firm is simply awarded to those with tight political connections.

Weak conflict-of-interest laws make insider dealing easy. In Argentina several officials who designed the highway privatisation bidding process were on the staff of companies that acquired the highways (Manzetti 1996).

- The winning bidder would like to obtain the firm at the lowest possible price. Corrupt officials may present distorted information to the public making the company look weak, while revealing to favoured insiders that it is actually doing well. The insiders are then the high bidders in what appears to be an open, above-board bidding process. Ex-post evaluations reveal that the privatisation was a huge success with the new company earning very high rates of return. For example, in Venezuela a major bank was undervalued by the minister of national investment amid payoff allegations (Manzetti and Blake 1996).

- A privatised firm is worth more if it retains whatever monopoly power was available to the public firm. To an economist, the retention of monopoly rents undermines the justification for privatisation. To an impecunious state and its bidders, assuring monopoly power is in their interest. Thus the conflict between revenue maximisation and market competition arises for all privatisation deals, even those free of corruption. When a state gives lip service to competitive principles, however, it

*(Box 7 continues next page)*

**Box 7 (continued)**

may be unable to openly endorse monopolisation. Corrupt, back-channel deals can then accomplish that objective, but with some of the privatisation benefits transferred to individuals rather than to the government.

Many Latin American privatisations increased, rather than reduced, market concentration. Manzetti (1997) argues that the privatisation of the telephone company in Argentina and the electrical utility in Chile were carried out so as to produce monopoly rents for the winners. Subsequent regulatory oversight has been weak. He contrasts those cases with the more successful privatisation of telecommunications in Chile and electric power in Argentina, where the privatisation process and the subsequent regulatory regime helped encourage competition and limit monopoly rents.

Will kleptocrats always want a larger state sector than an honest ruler? The answer is no. Corrupt rulers are likely to be especially eager to privatise monopolies that earn excess profits as long as they can extract a share of the gains. They may even seek to privatise more firms than a ruler whose only goal is efficiency if the one-time gains from a sell-off are large.

Although corruption can occur at all of these points in the privatisation process, the end result hoped for is a private firm subject to market discipline and free from corrupt incentives. But a reduction in corruption is by no means assured. The firm is likely to maintain a close relationship to the state, especially if it retains some monopoly power. Further, the state frequently sells off only a portion of the state firm, at least in the early years. Such hybrids may be especially vulnerable to corrupt inside arrangements (Kaufmann and Siegelbaum 1997, p. 442).

These possibilities suggest the importance of designing the privatisation process to assure the widest level of participation rather than favouring consortia with strong ties to local elites. They also imply that the process must be transparent, especially the evaluation of assets (Kaufmann and Siegelbaum 1997; Manzetti 1996). The more transparent the process, the higher will be the bids from risk-averse investors.

Another requirement is to establish a credible regulatory framework before the tendering process begins. This will reduce the uncertainty associated with tendering and lower the possibility that the winning bidder can manipulate the process by which regulatory institutions are created (Nellis and Kikeri 1989, p. 670; Manzetti 1997).

*Sources:* Celarier 1996; Colazingari and Rose-Ackerman 1995; Kaufmann and Siegelbaum 1997; Manzetti 1996, 1997; Manzetti and Blake 1996; Nellis and Kikeri 1989; Rose-Ackerman 1996a and Yotopoulos 1989.

The integrity of the privatisation process is especially at issue in transition countries. In the former socialist countries the entire wealth of the state is being privatised—against weak private markets. Although the corrupt opportunities attending these privatisations are large, so are the long-term benefits (Kaufmann and Siegelbaum 1997). To limit corrupt opportunities both at the point of sale and in the future, great care ought to be taken to establish a transparent and reliable legal environment. This has not been done in many countries that have already privatised—with predictable results (Rose-Ackerman 1994; Shelley 1994). A study of the privatisation experience of several transition countries reveals that voucher-based mass privatisation and liquidation appear least susceptible to corruption, whereas management-employee buyouts and spontaneous privatisation are conducive to corruption because of their slow pace, high levels of discretion and lack of transparency. Initial public offerings and tenders, and trade sales are intermediate options whose slow speed is balanced against their transparency and independent administration (Kaufmann and Siegelbaum 1997).

### *Clarify Regulation*

Many regulatory and spending programmes have strong justifications and ought to be reformed, not eliminated. Corruption in tax collection obviously cannot be solved by stopping collection. In such cases one solution is to clarify and streamline the necessary laws in ways that reduce official discretion. In the reform of the Mexican customs service, for example, the number of steps in the customs process at the Mexico City airport was reduced from sixteen to three. The remaining service was streamlined to reduce delays.<sup>32</sup> One government official claimed that reforms of customs services throughout the country had increased revenues significantly.<sup>33</sup> Reformers have frequently suggested that procurement officers favour off-the-shelf items sold in private markets and that tax and subsidy systems be simplified to limit discretion (Rose-Ackerman 1978).

Rules could be made more transparent and justified publicly. Governments might favour simple non-discretionary tax, spending and regulatory laws to limit corrupt opportunities. Obviously, the value of such reforms depends on the costs of limiting the flexibility of public officials. Some risk of corruption may have to be tolerated because of the benefits of a case-by-case approach to programme administration. Even then, transparency and publicity can help overcome corrupt incentives.

Economists have long recommended reforming regulatory laws in areas such as environmental protection by introducing market-based schemes that limit the discretion of regulators. They also recommend user fees for scarce government services. These reforms have the additional advantage of removing corrupt incentives by replacing bribes with legal payments. The sale of water and grazing rights, tradeable pollution rights and import and export licences can improve the efficiency of government operations while limiting corruption. Of course, user fees are an inappropriate way to allocate services designed to benefit the poor. Though if the service is already being allocated through bribes, a legal system of charges seems a reasonable second-best response to scarcity. Alternatively, the public services could be given to the needy, who could resell them if they wished. In contrast, when the goal is to assure that the poor actually use a public benefit, such as health care or education, more direct anticorruption techniques will be needed.

### *Reform the Bureaucracy*

The final group of proposals involves administrative reforms that lower corrupt incentives. Corruption is often embedded in the hierarchical structure of the bureaucracy. Low-level officials collect bribes and pass a share on to higher-level officials, perhaps in the form of an up-front payment for the job itself. Conversely, higher ups may organise and rationalise the corrupt system to avoid wasteful competition between low-level officials. The top officials may then share the gains of their

organisational ability with subordinates, perhaps using them to run errands, transfer funds and do other risky jobs that expose them to arrest. Breaking such patterns may require a fundamental reorganisation.

First, competitive pressures can sometimes be introduced within government to lower the bargaining power of individual officials. When bribes are paid for benefits such as licences and permits, which are not constrained by budgetary limits, overlapping, competitive bureaucratic jurisdictions for the same service can reduce corruption. Since clients can apply to one of several officials, no one can extract a very large payoff. For qualified clients bribes will be no larger than the cost of reapplication. Unqualified clients will still pay bribes, but even they will not pay much if they have a choice of officials (Rose-Ackerman 1978). If all officials are corrupt, the outcome is stable. But if some establish an honest reputation, qualified applicants will prefer those officials, reducing the gains to the corrupt. This reduction in benefits may induce some marginal officials to become honest, further reducing benefits to the remaining corrupt officials. A small number of honest officials can overturn a corrupt system if congestion is not a serious problem (Rose-Ackerman 1978, pp. 137–59). If, instead, those who pay bribes are unqualified, the presence of some honest officials raises the gains to those who are corrupt, inducing more to become corrupt.

When officials, such as police officers, can impose costs, another type of overlapping jurisdiction model should be considered. Police officers seeking to control illegal businesses can be given overlapping enforcement areas. That way, gamblers and drug dealers will not pay much to an individual officer since a second one may later demand a payoff. The first police officer is simply unable to supply protection (Rose-Ackerman 1978, pp. 159–63).

Second, if it is difficult to observe corruption, the government could design programmes to make the effects of corruption more apparent. For example, the state might use private market prices as benchmarks to judge public contracts (Ruzindana 1995). Clear rules of proper behaviour could be established so that violations would be

noticed, even if bribery was not. Where possible, procurement decisions could favour standard off-the-shelf items to provide a benchmark and to lower the cost of submitting a bid.

Third, the state could make it difficult for corrupt officials to organise themselves or bribe payers. Sometimes bribe payers view themselves as the losers who would be better off in an honest world. They feel that they are the victims of extortion. Such bribe payers are potential allies in an anticorruption effort (Alam 1995). Conversely, in other cases bribery makes both payer and receiver better off with respect to an uncorrupt world. Thus control incentives must rest with outsiders (disappointed bidders, taxpayers, consumers).

## Enforcing Anticorruption Laws

A basic condition for corruption control is a viable legal framework and an institutional structure that enforces the law without accusations of political favouritism or arbitrariness. The 1989 UN seminar on corruption in government pointed to the importance of periodic reviews of anticorruption legislation to reduce ambiguities and inconsistencies, establish explicit penalties and clarify the legal status of certain behaviour. The goal is both to deter those tempted to engage in corrupt acts and to educate the public so that they will resist criminal conduct by officials (United Nations 1990, pp. 22–23).

### *Deterrence*

Strategies to reduce corruption require that one isolate the benefits and costs to bribe payers and recipients. The first issue is whether to treat the payment and receipt of bribes as crimes or as civil offences. The choice depends on the range of punishments available, the alternative procedural forms required and the additional deterrent effect of labeling an action a crime. Since corruption is a two-sided offence, the law must specify the status of both those who make payments and those

who receive them. In some countries bribe payers are treated more leniently than recipients. Because of the international nature of the offence in some high-profile cases, the law of the briber's home country may also be relevant. Since legal systems differ, these issues cannot be resolved in the abstract. Any country serious about an anticorruption strategy will need to examine its underlying statutory framework. The subsequent discussion will assume that at least some types of pay-offs make both giver and receiver subject to criminal penalties. The international aspects of the problem raise somewhat different issues that are discussed later.

The basic conclusion of work on the economics of crime holds that the optimal amount of corruption is not zero once one takes account of the costs of prevention. Deterrence expenditures should be set so that marginal benefits equal marginal costs (Becker and Stigler 1974; Rose-Ackerman 1978, pp. 108–09). The deterrence of criminal behaviour depends on the probability of detection and punishment, and on the penalties imposed—those imposed by the legal system and more subtle costs such as reputational loss or shame (Becker 1968). Major scholarly controversies concern the optimal mixture of the certainty of punishment and its level. There is no need to repeat that discussion here except to note that detection of white collar crimes, such as corruption, is a particularly challenging task. If the probability of detection is low, penalties must not only be large, but also geared to the marginal calculations of the corrupt.

Corruption is distinctive because of its two-sided nature. If just one of the parties can be deterred, the deal will not go through. Criminal law in some countries distinguishes between “active” and “passive” corruption. The briber is viewed as the active party and the public official as passive. This distinction does not capture the wide variety of circumstances under which corruption can occur. Often the public official can be described as the active party who extorts a payoff (Mény 1996, p. 311). In practice, the distinction between active and passive corruption, and between extortion and bribery, means little

given the need for both parties to agree before corruption can occur. A more useful distinction focuses on whether the benefit received in return for the bribe is one to which the briber is legally entitled (Shleifer and Vishny 1993).

For effective deterrence each side of the corrupt transaction must face penalties that reflect the gains from bribery. Officials' penalties should be tied to the size of the payoffs they receive, and bribers' to the value they receive from making a payoff—not to the size of the payoff. Convicted public officials should pay a multiple of the bribes received, and convicted bribers should sacrifice a multiple of their gains from bribery. If potentially corrupt firms are repeat players with the government, they can be deterred by debarment procedures prohibiting them from contracting with the government for several years. To have a marginal effect, the debarment penalty should be tied to the seriousness of the corruption uncovered.<sup>34</sup>

Designing an optimal deterrence strategy raises a paradox: the more severe are the penalties for officials, the lower is the incidence of corruption, but the higher are the bribes. When the risk of detection is high, officials must receive a high return for engaging in bribery. The only way around such a result is an expected penalty function that is increasing in accordance with the size of the bribe (Rose-Ackerman 1978, pp. 109–35). Or, if penalties on bribe payers are deterrent, the demand for corrupt services and the level of bribes will fall.

Goel and Rich (1989) used annual observations for federal, state and local government officials in the United States from 1970–84 to study the deterrent effect of laws against bribery. The results suggest that both a greater probability of conviction and longer prison terms deter corruption. Further, the proportion of officials convicted of corruption was negatively related to the ratio of public to private sector earnings. These results are broadly consistent with familiar proposals to raise the rewards to public employment and to increase the expected penalties for those contemplating paying or accepting bribes (Pope 1996; Quah 1993; Rose-Ackerman 1997). Still, reformers must

beware of creating more problems than they solve. A study of the checkered record of anticorruption efforts in New York City points to some of the pitfalls of overemphasising legal controls (box 8).

Conflicts of interest faced by both politicians and bureaucrats are an underappreciated problem in many developing and transition economies. Many countries have few laws regulating the private business activities of public officials, leaving them open to accusations of favouritism. A cabinet minister who is also a principal in a construction company may favour his company in awarding contracts. Politicians may support laws that give tax breaks or other benefits to firms in which they have an interest. Campaign finance laws in many countries are similarly permissive, although in a few cases they are so restrictive that they practically require that campaigns rely on off-the-books transfers. Recent scandals in France, Italy, Japan, the Republic of Korea and the United States point to the importance both of clear rules governing the solicitation of private money and the provision of sufficient legal sources of funds. Reforms in these areas fit well with an ongoing UNDP interest in legislative and civil service reform (UNDP 1997a).

### *Enforcement*

Tough laws are not sufficient. Many highly corrupt countries have exemplary formal statutes, but the statutes have no real meaning because they are seldom enforced (United Nations, 1990, pp. 22–27). Thus a country that is serious about reform must have effective investigation and prosecution bodies and a well-functioning judicial system that is not itself corrupt (Buscaglia 1995; Malik 1995).

An independent judiciary can be invaluable in checking official malfeasance. The most prominent recent examples are the magistrates in Italy who perform both prosecutorial and judicial functions. In India the Supreme Court pushed forward a corruption investigation that the government had wanted to quash by removing the prime minister from control of the federal agency investigating the case.<sup>35</sup> In Indonesia

### Box 8 The Elusive Pursuit of Absolute Integrity in New York City

A case study of anticorruption efforts in New York City by Anechiarico and Jacobs (1996) demonstrates the ineffectiveness and costliness of past efforts. Anticorruption policies have been counterproductive—creating new sets of corrupt incentives. The study argues that the goal of absolute integrity is unrealistic and misguided. Policies that aim to achieve complete rectitude instead impose rigid and cumbersome constraints that increase, rather than reduce corrupt incentives. Anticorruption programmes in New York City have led to greater delays, over-centralisation, inadequate authority for managers, defensive management, goal displacement and poor morale.

The authors are critical of many standard reform proposals, at least as carried out in New York City. For example, efforts to reduce the exchange of public sector jobs for political support or payoffs have produced a rigid and unresponsive system. Conflict-of-interest and financial disclosure laws are ineffective and discourage talented people from taking city jobs. New York City's special anticorruption agency, the Department of Investigation, is counterproductive in that it "casts a net of suspicion and sometimes fear over the city's 300,000 personnel" (Anechiarico and Jacobs 1996, p. xviii). They assess the recent proliferation of federal, state and local law enforcement agencies with jurisdiction over corruption and then study contracting, accounting and auditing. The contracting process has become unwieldy, and auditing and financial control are taking on some of the features of law enforcement investigations—both are trends that the authors deplore.

The New York City case study provides many telling criticisms of past and ongoing policies that were implemented with little concern for their negative aspects. The analysis provides cautionary lessons for reformers everywhere. Recognising that the efficient level of corruption is not zero does not, however, call for abandoning policies that concern public employment and law enforcement. The authors do not recommend abandoning the reform effort. Instead, they propose a more open discourse among those who study public administration and better information from surveys of employees and citizens on the operation of the public sector. In the police force what is needed is "a hard-headed analysis of the benefits and costs of drug prohibition and an examination of the full array of policy alternatives" (p. 197).

The authors recommend that the civil service system emphasise merit recruitment and promotion, and make greater use of positive and negative incentives. They argue that financial disclosure and conflict-of-interest restraints have gone too far, but they stop short of recommending

*(Box 8 continues next page)*

**Box 8 (continued)**

that such requirements be eliminated. They propose that the Department of Investigation focus more on improving government efficiency and effectiveness, and less on investigations of wrong doing. The public contracting system should be reformed to emphasise speed and good performance. Anechiarico and Jacobs realize the necessity of an effective auditing and accounting system, but argue that the current system should be streamlined and reoriented. The ultimate goal is to address the corruption problem "by reforming the structure and operations of agencies, rather than piling on more rules, laws, and controls" (p. 201).

Anechiarico and Jacobs' analysis is relevant for urban reformers in the United States. But it is not clear how the authors would react to the deeply entrenched corruption, extremely weak systems of accountability and high levels of political favouritism common in many transition developing countries. Corruption in the former Soviet Union arose from excessive rigidity and red tape, much like some parts of the New York City government. Liberalisation has proceeded with a great deal of corruption and influence of organised crime. The problem is too little clarity and predictability in the laws, which give too much discretion to public officials (Rose-Ackerman 1994). Vague laws and arbitrary exercises of authority are common throughout the developing world. Unlike New York City, they suffer from a legal framework that is too weak and imprecise, not one that is too rigid and powerful.

Still, Anechiarico and Jacobs's ultimate conclusions do apply outside of the industrial world. An effective, professional civil service is necessary, as are monitoring and enforcement, but they are not sufficient. Reforms that improve direct accountability to citizens and that remove underlying corrupt incentives are likely to be the most productive strategies in improving the overall effectiveness of government.

*Sources:* Anechiarico and Jacobs 1996, Rose-Ackerman 1994.

reporters expressed surprise at a 1995 decision of the Administrative Court overturning a publication ban on three news magazines that had printed critical reports of the government. The courts of that country had not been known for their independence.<sup>36</sup> In Spain the Supreme Court forced officials to reveal the way in which secret Interior Ministry

accounts were used. It held that state security could not be used as a defence if criminal activities were suspected.<sup>37</sup> In Brazil the Supreme Court's insistence that the Congressional vote on President Collor's impeachment for corruption and malfeasance be public and that the deliberations be televised helped to keep the process honest (Geddes and Ribeiro Neto 1992). Judicial reform is a priority for UNDP governance projects. The World Bank is also beginning work in this area, especially in Latin America (UNDP 1997a; Rowat, Malik and Dakolias 1995).

Some countries have had success with independent anticorruption commissions or inspector generals reporting only to the chief executive or the parliament. Independent administrative bodies have been proposed by the 1989 UN seminar on corruption in government.<sup>38</sup> The most well known agencies of this type are in Hong Kong and Singapore. In both, the turnaround in corruption combined commitment from the top, credible law enforcement by an independent agency operating under a strong statute and reform of the civil service (box 9). A tough, independent anticorruption agency can be a potent tool, but it must represent a credible long-term commitment and should include checks on its own ability.

An alternative to a general purpose anticorruption commission is one that oversees only a particular agency. For example, the School Construction Authority in New York City has established an internal agency with some independence to both ferret out corrupt contractors and propose ways to reorganise the agency to reduce corruption. The advantage of this hybrid form is its ability to work directly with the School Construction Authority to change contracting practices. The New York Authority has apparently paid for itself by saving the city many millions of dollars.<sup>39</sup>

## **Reforming the Civil Service**

Civil servants in many developing countries are very poorly paid. Although at independence most former colonies inherited civil ser-

### Box 9 Fighting Systemic Corruption in Hong Kong and Singapore

Corruption can breed further corruption. Marginal officials and private individuals become corrupt because they believe there is no feasible alternative. When corruption is common, law enforcement resources are spread too thinly to be effective. The low probability of being caught induces even more people to become corrupt, further reducing the efficacy of law enforcement. High expectations about others' corruptibility and ineffective enforcement can entrench high levels of corruption. Conversely, low levels of corruption can be maintained when people believe that corruption is rare. In such cases, law enforcement can be relatively effective, and low corruption will remain as such (Manion 1996a; Rose-Ackerman 1996b).

Many countries are caught in high corruption traps, in which marginal reforms are unlikely to do much good. Is there any hope for a successful anticorruption policy in such a situation? The experiences of Hong Kong and Singapore suggest that success is possible, but they also point to the risks and difficulties of sustaining needed policies. The fragility of many anticorruption efforts testifies to the need for a credible, long-run commitment to reducing corruption.

Corruption was endemic in Hong Kong in the 1960s (Manion 1996b; Skidmore 1996). Spurred to action by a scandal involving a high-ranking police officer, the governor established an Independent Commission Against Corruption (ICAC) in 1974. The ICAC reported only to the governor, functioning independently of the police force, which had a reputation for corruption. Officials in the ICAC were paid more than those in other government agencies and were not transferred to other departments. No one in the ICAC could end up working for a senior officer who had been subject to investigation. The ICAC was given the power to investigate and prosecute corruption cases and to engage in a campaign of public education (Klitgaard 1988, pp. 98–121; Manion 1996b; Quah 1993; Skidmore 1996).

The governor recognised that both credible enforcement and a change in the attitudes of the public and officials were necessary. The credibility of the new institution was indicated by the high number of complaints it received and by the large proportion that were not anonymous. The government's commitment to reform was also signalled by the appointment of a person of unquestioned integrity to head the ICAC and by an initial policy of investigating and prosecuting "big tigers" (Manion 1996b; Klitgaard 1988). Public surveys carried out between 1977 and 1994 reveal perceptions that the level of corruption had fallen in the early years of the ICAC. Indirect evidence suggests that corruption did, in fact, decline (Manion 1996b).

*(Box 9 continues next page)*

**Box 9 (continued)**

Should the ICAC be taken as a reform model? A number of other jurisdictions, such as Botswana, Malawi, Malaysia, Singapore and the Australian state of New South Wales (Skidmore 1996), have similar institutions. Yet the ICAC is not without problems. It reports only to the governor. An anticorruption commission reporting to an autocratic ruler could be used as an instrument of repression against political opponents, and even the ICAC has not been immune to such charges. The widespread powers of the ICAC could be abused in systems less committed to the rule of law. In Hong Kong a series of oversight committees and an independent judiciary check the ICAC. Another potential problem with emphasising law enforcement and changes in public attitudes is that needed structural reforms will be ignored.

Singapore is another country that successfully jumped from a stable, high-corruption status quo to a new, low-corruption equilibrium. Today, corruption is the exception rather than the rule in Singapore. Among Asian countries, Singapore stands out as a relatively clean place to do business. How did it earn this reputation, given that it was highly corrupt during the colonial period?

In the post-World War II period civil servants were poorly paid and inadequately supervised. Graft was pervasive in the police department (Quah 1989, 1994). When the People's Action Party (PAP) assumed power in 1959 it made anticorruption policy a priority. As in Hong Kong, the PAP realised that an incremental, piecemeal policy would not do. As part of its strategy the government strengthened the powers of the existing Corrupt Practices Investigations Bureau (CPIB). Since 1970 the Bureau has been directly under the prime minister's office. It has been a successful anticorruption agency, but it raises some of the same issues as did the ICAC in Hong Kong. The CPIB is not subject to external checks and those accused of corruption have sometimes accused the agency of heavy-handed behaviour in violation of their rights (Quah 1989).

The CPIB also requires that ministries review their work practices with the aim of reducing corrupt incentives. Strategies include reducing delays, rotating officers and increasing supervision. In addition, Singapore has reduced corrupt incentives by giving civil servants high wages, bonuses and favourable working conditions. The aim is to keep compensation packages in line with private sector alternatives (Klitgaard 1988, pp. 122-33; Quah 1989, 1993, 1994).

*Sources:* Klitgaard 1988, Manion 1996a, 1996b, Quah 1989, 1993, 1994 and Skidmore 1996.

vice pay scales that exceeded private sector wages, this advantage has eroded. Civil service wages relative to private sector wages have also fallen in transition countries of Eastern Europe and the former Soviet Union. The pattern varies across countries and over time. A study of the salaries of public school teachers in Latin America between 1979 and 1989 found that pay relative to comparable private sector employment fell in Argentina, Bolivia and Uruguay and increased in Colombia and Honduras. In some parts of the developing world public sector pay is so low that corruption is a survival strategy. Officials must supplement their pay with second jobs or payoffs. For example, in Zaire salaries contributed only 33% of the income of officials in 1986, down from almost 100% in 1969 (MacGaffey 1991, p. 14). In North Yemen salaries declined in real terms by up to 56% between 1971 and 1986. The government apparently accepted corruption as an alternative to salary reform: revenue collection was poor and law enforcement weak (Sultan 1993). Van Rijckeghem and Weder (1997) find a negative association between civil service wages (relative to private sector wages) and the level of corruption across countries.

Reform of the civil service is part of many governance reform projects supported by UNDP and other aid organisations (Nunberg and Nellis 1995; UNDP 1997a). These programmes should be designed explicitly to reduce corruption. If officials are paid much less than people with similar training elsewhere in the economy, only those willing to accept bribes will be attracted to the public sector. The rest will work in private enterprises or emigrate. But in spite of the low pay, positions in the state bureaucracy can be valuable assets. In some developing countries there is a lively market for bureaucratic positions that generate large bribes (Wade 1982, 1984). Positions in corrupt police departments are likely to be especially valuable (Phongpaicht and Piriyarangsarn 1994, pp. 99–129). Jobs in departments with few such opportunities, such as the foreign service, may not attract many qualified applicants. Civil service pay should be set at least equal to pay for

equivalent positions in the private sector so that it is possible to serve without resorting to corruption.

If potential payoffs are high, however, parity may not be sufficient. Instead, civil service wages may need to be set above going private sector wages and offer generous benefits, such as pensions, that will be received only if workers retire in good order (Becker and Stigler 1974). It will seldom be possible, however, to raise civil service salaries to levels that reflect the discretionary benefits under officials' control. Experience from the industrial world suggests that such an expensive solution is unnecessary. It may be sufficient to pay people enough to match the pay of private sector jobs requiring similar skills (Van Rijckeghem and Weder 1997). This strategy, however, must be combined with effective monitoring and a transparent, merit-based system of selecting civil servants. Criminal penalties for corruption must be added to the costs of losing a government job for malfeasance. A transparent system of selecting civil servants can prevent people from paying to be allotted desirable government jobs. If government pay scales exceed those in the private sector, people may pay for such jobs, even if few bribe possibilities are available. Since in India public schools pay teachers more than do private schools, some people purchase these jobs with their wives' dowries or loans from relatives.

### *Attacking Marginal Benefits of Corruption*

Pay reform is necessary, but not sufficient. Job loss is a one-time penalty not tied to the marginal benefits of individual corrupt deals. Once an official has stepped over the line and begun to take bribes, he or she will take ever higher and more frequent payoffs. Improved pay reduces the value of accepting bribes, but does not reduce the value to zero. High pay may simply increase the bribe an official demands to compensate for the risk of losing a desirable job. Therefore, civil service reform must include features that are tied to the marginal benefits of accepting payoffs.

These policies can take the form of either carrots or sticks. If penalties are used, they must be tied to the marginal benefits of the payoffs received. This can be a job for criminal law, and can be included in internal disciplinary processes. Conversely, rewards could be tied to the value of the service provided. Recall that bribery can sometimes act as an incentive fee for bureaucrats. If corruption's only efficiency cost derives from its illegality, payments should be legalised. Surveys of private individuals and firms in Pakistan and India indicate that even very poor people would be willing to make legal payments for improved services (Rose-Ackerman and Stone 1996). For example, fees could be used to allocate places in a queue on the basis of the value of speedy service (Lui 1985). The effectiveness of such a procedure depends on whether servers "own" the payments so that they have an incentive to speed up service. For example, an agency might establish dual tracks—expensive fast tracks for those who value speed and a slower track for the rest. Under such a system a portion of the speed payments would be used to reward officials for good performance (Paul 1995, p. 163).

In designing such systems it is important to avoid giving bureaucrats monopoly power that they can use to extract higher rents (Rose-Ackerman 1978, pp. 85–108). The availability of bribes or performance pay can, if the system is not carefully organised, simply give officials an incentive to create onerous new conditions that they can then waive in return for payments. For example, absent stringent monitoring, systems of tax farming are unlikely to function well because tax collectors have an incentive to extract excess revenue from taxpayers (Stella 1992). Despite these caveats, incentive pay systems should be seriously studied as part of the reform of the civil service.

### *Inducing Reform at all Levels*

Civil service reform will have to be a thoroughgoing effort in order to succeed. Small increases in wages and improvements in working conditions may have little impact. The system could be caught in a trap

in which high corruption levels beget even higher corruption levels. For example, suppose that moral scruples against bribery are lower the greater is the incidence of corruption. Suppose further that the state has a fixed budget for combating corruption. Then, if few officials are corrupt, anticorruption resources can be used efficiently to collect evidence, thus discouraging corruption in the future. In contrast, when a high proportion of officials are corrupt, collecting evidence is costly and relatively ineffective. An even smaller percentage of corrupt officials are caught, inducing further corrupt behaviour and so on (Andvig and Moene 1990, p. 75; Lui 1986). Reformers must, therefore, be willing to spend the resources needed to tip the system to a low-corruption equilibrium. A policy of marginally increasing the law enforcement budget may have no impact. But the increase in enforcement resources need not be permanent, simply sufficient to induce a lower corruption level (Lui 1986, pp. 222–28).

The civil service will be difficult to reform if low-level corruption is linked through hierarchical connections to corruption higher up (Wade 1982). There are two variants. Low-level officials are often the front line troops who collect bribes and share them with superiors directly or indirectly through the purchase of their offices. Initially, payoffs to superiors may be a means of buying their silence, but when such payments are institutionalised, they become a condition of employment, organised by superiors for their own gain.<sup>40</sup> In some cases a pyramid forms in which each tier purchases its positions from the one above it. In another scenario top officials collect payoffs and buy the silence of subordinates by sharing the gains with them either through high pay and perks or under-the-table benefits. Alternatively, corrupt higher ups may tolerate the petty corruption of subordinates as a way of assuring their complicity in the maintenance of the system.

The organisation of corruption will depend on the nature of the corrupt benefits. If an agency is organised so that “street level” bureaucrats, such as police officers, have the most discretionary interactions with the public, the first pattern, in which low-level officials

pay superiors, should dominate. If most major decisions are made at the top but low-level officials provide essential inputs, high-level officials will likely pay off subordinates. For example, the award of major contracts is likely to be the preserve of top officials, but they will need help in assessing bids and overseeing implementation. Sometimes low-level officials will earn high salaries if the top wishes to buy docility and peace.

When corruption pervades a hierarchy, solutions that appear reasonable in other contexts can be counterproductive. Thus one answer involves rotating officials so that they are unable to develop the close, trusting relations needed to reduce the risk of accepting payoffs. But if the entire bureaucratic agency is corrupt, superiors can use their ability to reassign officials as punishment for not playing along. Studies of corruption in an irrigation system in India found that such practices were common (Wade 1982, 1984). They have also been observed in corrupt police forces in the United States (Sherman 1974) and Thailand (Phongpaicht and Piriyarangsan 1994, pp. 99–120).

### *Eliciting the Help of International Organisations*

Civil service reform is expensive and politically difficult, and it may seem beyond the capacity of many poor countries. Yet it cannot be avoided in any credible reform effort. Civil service wages have fallen rapidly in recent years as the fiscal pressures on governments have grown. Sometimes World Bank and IMF insistence on reducing the wage bill as a condition for assistance has unwittingly contributed to corruption. Under pressure from these institutions borrower countries make across-the-board pay cuts, since they are politically easier to manage than selectively firing workers. The newly impoverished public employees turn to bribery as a way to regain some of their lost wages. Clearly, a first step towards reform is to eliminate policies imposed by international organisations that make corruption more, not less, likely.

But, of course, many of the difficulties are internal to the politics of developing countries. Countries moving towards fiscal balance may jeopardise their success by bowing to pressure from civil servants for pay hikes. This is what happened, for example, in Ghana in 1992 when civil servants' wages were increased across the board by 80% (World Bank 1995, p. 20). International institutions can be especially helpful in providing resources and technical assistance to ease the transition to a competent, less numerous and well-paid civil service system. Wage increases may indeed be necessary for good performance, but only if they are tied to performance and accompanied by a reduction in the overall level of public sector employment.

## **Instituting Checks and Balances**

Corruption can be checked by structures that form independent sources of power and information outside the government. Although not sufficient by themselves, these options complement other reforms by reducing corrupt opportunities and increasing the risks of making and accepting payoffs.

Monolithic, autocratic states can fight corruption without seeking a popular mandate. But since the ruler's actions are not constrained by the need to obtain popular support, a reform policy can be reversed if the ruler or his successors finds it convenient. The ruler may be able to manage the information available to the public to create the impression that corruption is a high priority, while accumulating a private fortune.

On the other hand checks and balances help legitimate government actions. Checks and balances refer to several different characteristics of a government system:

- The system has multiple veto points so that the government cannot act without obtaining the consent of a series of institutions organised along different lines and representing different constituencies.
- Outsiders, such as ordinary citizens or the media, can obtain information about how the government is operating and have a way of

expressing their displeasure about general policies. Non-governmental organisations can organise easily, facing few legal hurdles. They may even be subsidised.

- The structure of the government includes guarantees that protect the individual against the state. Government actions may be checked by a specific bill of rights that limits state power, and individuals can appeal attempts to extort bribes. The legal system protects and perhaps rewards individuals who blow the whistle on corrupt practices. But the state is also constrained by legal rules that protect the accused.

- Higher-level governments and international organisations can use their leverage to constrain the behaviour of individual governments.

- In a decentralised political system bribery demands can be countered by exit. Firms and individuals can threaten to relocate elsewhere. This can be a powerful constraint on governments, reducing corrupt opportunities and limiting the scope for waste.

### *Veto Power*

Multiple veto points are a characteristic of the legislative and administrative process. One set of institutions must be convinced to go along with a policy proposed by other institutions. If a majority of the US House of Representatives, a majority of the US Senate and the president agree, a bill becomes a law. If the president vetoes the bill, two-thirds of each house of Congress must agree. Therefore, a bill that blatantly favours the constituents of one of these bodies will not be enacted into law. In Germany federal regulations that will be administered by the states must be approved by the upper house, which represents the state governments. Such structures limit corruption by limiting the ability of any one political group to capture the apparatus of government and use it for its own benefit. But the need to obtain the agreement of several political bodies implies that each one may have to be legally “bought off” in the statutory provisions enacted by the legislature. Such systems

will, of course, work better if conflict-of-interest rules and campaign financing rules are well established, forcing politicians to reveal their outside sources of private income and campaign funds.

### *Information*

The private sector can be an important check on the arbitrary exercise of power by government, but only if the government provides information about its actions and people can organise into associations and non-profits. Governments must publish budgets, records of revenue collection, statutes and rules and the proceedings of legislative bodies. Such practices are standard in the industrial world, but many developing and transition countries must improve in this area. Financial data should be audited by independent authorities, such as the General Accounting Office in the United States or the Audit Commission in the United Kingdom, and made public. The US General Accounting Office reviews the performance of federal agencies and programmes, and reports to Congress. The British Audit Commission conducts external audits of local governments in England and Wales and seeks to control fraud and corruption. It also performs similar duties with respect to the National Health Service (box 10).

Unaudited, secret funds available to chief executives and top ministers are invitations to corruption. Yet many countries view such accounts as standard operating procedure. When a few top officials have access to unaudited funds, the risk of corruption or the perception of corruption arises, even if these funds are used only for genuine security threats.

A number of recent aid projects have helped transition economies and developing countries publish timely and accurate documents about the basic operations of government. Others have helped some countries, especially in Latin America, to make their budgetary accounting processes more transparent. UNDP has been involved in

### **Box 10 The United Kingdom's Audit Commission and the Paradox of Self-Monitoring**

The United Kingdom established an Audit Commission in 1983 to appoint and regulate the external auditors of local authorities in England and Wales. In 1990 its responsibilities were extended to include the National Health Service (NHS). The Audit Commission's importance stems from the increased decentralisation of government functions that accompanied the Thatcher administration. Although decentralisation may increase service quality and interjurisdictional competition, it also raises the risk of fraud and corruption. The Commission points, for example, to the growth in the number of officers operating bank accounts, purchasing services and entering into contracts.

In 1993 and 1994 the Audit Commission issued a two-part report, *Protecting the Public Purse*, that reviewed and critiqued efforts to assure probity in local governments and in the NHS. Fraud, especially in the benefits system, appears to be a serious problem, but corruption does not seem to be pervasive. In 1995–96 the number of proven cases against local governments was 21, 11 of which involved the contracting process. In its study of the NHS over a three-year period the Commission proved only 18 cases of corruption involving just over 3 million pounds. Corruption has a special status under British law. The 1916 Prevention of Corruption Act reverses the presumption of innocence. Despite this legal presumption, corruption remains difficult to prove. Local authorities reported that only 38% of corruption investigations resulted in prosecution, resignation, dismissal or recovery actions, and 45 investigations of the NHS were aborted in contrast to the 18 that were carried through.

Corruption is also difficult to detect. Here, the Audit Commission is aided by watchdog groups, such as Public Concern at Work, a charity established in 1993 that reports cases of fraud and corruption. This charity also provides free legal advice for employees and will work with employers in the public and private sectors to create an environment under which employees can express concerns.

The work of the Audit Commission highlights a problem with any programme that requires an organisation to monitor itself. If it discovers wrongdoing, the organisation itself may suffer negative consequences. If so, it has little incentive to look closely at the behaviour of its employees. This problem has been recognised in efforts to induce private corporations to monitor their employees for criminal law violations (Arlen 1994) and in efforts to encourage organisations such as the World Bank or the United

*(Box 10 continues next page)*

**Box 10 (continued)**

Nations to monitor their own programmes. The consequence of effective monitoring can be a reduction in outside support for the organisation.

In 1993 the British Department of Social Security came up with a novel solution to this problem—it provides financial incentives for the detection of fraud in housing benefit programmes. Obviously, such a system can work only if there is an outside method of confirmation. Otherwise, local governments will have incentives to manufacture frauds.

In contrast, Family Health Service Authorities, which coordinate the work of independent professionals under the NHS, have little interest in investigating fraud. The administrative costs outweigh the benefits for the Authorities, even though the benefits to taxpayers could be large.

The Commission has made a number of recommendations to reduce fraud and corruption in local governments and in the NHS. Although conditions in many developing and transition countries are very different from those in the United Kingdom, the Commission's suggestions are worth highlighting:

- The Commission recommends codes of conduct for local employees, as well as for those elected or co-opted to authorities. Such codes should cover conflicts of interest and establish a registry of officials' outside interests. The Commission points to the need to be clear about what is acceptable as hospitality.
- The NHS needs to rethink its procurement processes in light of the privatisation of many services formerly provided in-house. Former NHS staff have been employed by the private contractors vying for NHS business, creating potential conflicts of interest. The system for procuring medical equipment and drugs is insufficiently competitive.
- The Commission supports efforts to encourage and act on tipoffs and whistleblowing, and approves of "fraud lines" established by a few local governments to detect fraud in housing programmes.
- The Commission views both internal and external auditors as valuable, and recommends that local governments and NHS offices establish internal auditing offices. The Commission rejects the view that external auditors are responsible for detecting all fraud.
- The Commission worries that proactive local authorities will be criticised if they uncover fraud and corruption, while inactive governments, in which wrongdoing flourishes, will escape criticism. It endorses plans that reward authorities financially for uncovering fraud.

*Sources:* Arlen 1994 and United Kingdom, Audit Commission 1993, 1994, 1996.

programmes to improve accountability and financial management in several African countries (UNDP 1996).

Procurement regulations must keep the process open and fair (Pope 1996, pp. 93–116). Several of the procurement scandals reported above resulted either because top officials overruled the tender board or because lower-level officials charged with procurement operated without formal controls on their purchasing decisions. Procurement rules, however, must not be perceived as silly or overly intrusive. For example, a rule that the low bidder always be accepted can lead to low-quality work or facilitate bid rigging (see, for example, Klitgaard 1988, chapter 6).

Freedom of information acts in the United States and in a number of European countries are an important precondition for effective public oversight. The European Union has recently promulgated a directive requiring member states to pass such laws with respect to environmental information. These laws permit citizens to obtain government information without having to demonstrate a need to know. They may request information as members of the public, without having to show that they will be affected personally. This lack of conditionality is central to a system in which individuals, businesses, organised groups and the media play a role in monitoring government. In the United States the Government in the Sunshine Act gives citizens access to many executive branch hearings and meetings. Legislative hearings are open to the public unless national security is at stake. The availability of information helps people to discipline public officials both at the ballot box and through other avenues of protest, such as legal challenges and direct petitions.

Information is of little value unless people can use their knowledge to influence government behaviour. In countries with democratic electoral systems, citizens can vote against officials believed to be corrupt, thus giving politicians an incentive to stay honest. Corruption among politicians can be deterred by reforming campaign finance and conflict-of-interest rules. Constraints on legal donations, however,

must not be so restrictive that they virtually push candidates off the books. Legal controls must be combined with effective legal methods of financing campaigns, either with public money or with contributions from private individuals and organisations. But if campaign funds are used to buy individual benefits for voters, as they were in the machine-dominated US cities in the nineteenth century, voters may not punish corrupt officials at the polls.

Elections are not the only means through which citizens can express displeasure with corrupt officials or their policies. Officials may be able to keep their corruption secret, but unable to hide the decisions that they have been bribed to make. Citizens can learn about expensive projects with few public benefits or about wasteful government programmes. If there are independent courts and if citizens can sue to force the government to comply with the law, another route is opened up for controlling government malfeasance. For example, under a number of US environmental laws citizens can sue to force the Environmental Protection Agency to carry out non-discretionary duties and can sue polluters who fail to comply with the law. These suits can be brought by public interest groups with no direct stake in the outcome.

In countries without independent or reasonably efficient courts, however, this option is not realistic. Publicity through the media is the only option. Even undemocratic rulers are likely to be sensitive to public opinion if they do not want to be overthrown. A free press is an essential check, especially in countries without other means of constraining politicians and bureaucrats. And when elections are important, the media is a source of information for ordinary citizens with no private incentive to seek out problems in government operations.

Thus those concerned with fighting corruption should support a free press (UN 1990, pp. 15–16). But permissive laws will be insufficient if most of the media is associated with political parties or if the government keeps the press in line through advertising and printing contracts and the extension of easy credit. In trying to understand how the anticorruption cases in Italy became big news and aroused public

opinion, Gigilioli (1996, p. 286) points to the growing independence of the Italian press from the political system and its increasingly commercial orientation.

Anticorruption activists should also support freedom of information laws and oppose restrictive libel laws, especially those that give special protection to public officials (Pope 1996, pp. 129–41; Tucker 1994). Elected politicians should not be immune from charges of corruption, and allegations of libel should be handled as civil, not criminal matters.

In many poor countries the media can play only a limited role because many people, especially those living in rural areas, have little access to newspapers, television and radio, and have limited education and understanding of government operations. There are two solutions. First, educational programmes could be developed to help people understand what to expect of a legitimate government. Low-level bribery can develop if very poor people believe that they ought to provide gifts to a superior who helps them (for the case of Thailand, see Phongpaicht and Piriayangsan 1994). Second, the government should develop ways to learn about the concerns of poor and marginalised groups without subjecting them to penalties for speaking out.

Individuals face a familiar free-rider problem in seeking to control political and bureaucratic processes, and limit malfeasance. Information may be available in principle, but no one may have an incentive to look at it. Laws that make it easy to establish associations and non-profits will help. Such organisations can serve as watchdog groups overseeing government performance. For example, Transparency International has national chapters in more than 40 industrial and developing countries (Transparency International 1995, 1996). These local chapters carry out a range of activities, including Integrity Workshops, organised with the help of the Educational Development Institute at the World Bank, and some of the bilateral aid agencies. Workshops have been held in Jordan, Malawi, Tanzania and Uganda. They bring together concerned people from both the public

and the private sectors to discuss the problem of corruption. Some of the workshops have ended with the participants pledging to desist from corruption. The meeting in Tanzania produced a pledge from top government officials to reveal their assets and those of their families. UNDP and Transparency International co-sponsored regional meetings in Latin America in 1995 (Zwanikken 1996) and held a second meeting in the summer of 1996 in Lima, Peru.

Non-profit organisations can carry out and publish public opinion surveys that reveal public attitudes towards government services. Pioneering work of this sort has been undertaken by the Public Affairs Centre in Bangalore, India. The Economic Development Institute of the World Bank has sponsored several pilot projects that can provide useful models. Such surveys are a way of isolating the impact of corruption on the poor, who may otherwise have few ways of registering complaints. Other surveys have documented public views about the pervasiveness of government corruption (box 11).

An alternative to such surveys is the creation of "hot lines" that enable citizens to complain directly to the government. In the United Kingdom a number of local communities are experimenting with antifraud hot lines (United Kingdom Audit Commission 1993). Mexico's Programme for the Modernisation of Public Administration created a similar system of hot lines for businesses harassed by inspectors (Mexico 1996). The information received from such complaint mechanisms will be less systematic than that from a survey and may well be self-serving. But hot lines provide a means to make a complaint without having to establish an organisation. This method will be successful, however, only if those who complain can do so anonymously or without fear of reprisal. If telephones are not widely available to people in rural areas or in poor urban neighborhoods, other methods of collecting complaints must be found that do not subject people to attack. Further, individuals who are complained about must have a credible way of defending themselves against false accusations, whatever system is employed.

### Box 11 Public Opinion About Corruption and Service Delivery

Some of the opposition to vigorous anticorruption efforts by international aid and lending agencies arises from a claim of cultural bias. Opponents argue that industrial countries are inappropriately imposing their own views of proper behaviour on the rest of the world. Just because corruption is endemic, does not imply that citizens view it as costly. However, even if corruption is rooted in traditional practices, it may still hinder shared growth.

A survey of 150 high-level public officials and civil society representatives revealed that they believed public sector corruption to be among the most important impediments to development, along with infrastructure constraints and ineffective government institutions and state enterprises. Of course, these factors are not independent. As other survey work demonstrates, weak government institutions are highly correlated with the prevalence of corruption (Keefer and Knack 1995).

Surveys in several countries document the extent of public unhappiness with corruption. For example, such surveys have been carried out in Argentina, Tanzania, Thailand and New South Wales in Australia (Cooksey 1996; *Transparency International Newsletter* December 1995, June 1996). A pre-election survey carried out in 1995 in Tanzania revealed that corruption was the public's primary concern. A survey of parliamentarians confirmed that corruption is a serious problem, pointing especially to corruption by business people in obtaining contracts and avoiding prosecution for criminal acts (Cooksey 1996).

Surveys of business people operating in transition economies in Eastern Europe see corruption as a problem. A survey carried out in the Czech and Slovak Federal Republic in January 1992 (just before its breakup) indicated that business people viewed bribery and clientelism as serious problems in dealing with government agents (Webster and Swanson 1993). In surveys conducted in Hungary in 1991 and in St. Petersburg in 1992 and 1993, business people complained that strong personal connections and the ability to pay off loan officers led to preferential access to credit (Webster 1993; De Melo, Ofer and Sandler 1995; Webster and Charap 1993).

In South Asia surveys of businesses and citizens reveal the costs of corruption. The Public Affairs Centre in Bangalore, India produces Report Card Studies. These are surveys of slum dwellers in five cities (Ahmedabad, Bangalore, Calcutta, Madras and Pune) focusing on the delivery of urban public services. Bribery was commonly needed for access to public services, particularly water, electricity, sanitation, garbage

*(Box 11 continues next page)*

**Box 11 (continued)**

collection and transport. One in three of those questioned in Bangalore said that they had to pay bribes for public services. Ahmedabad and Madras showed similar results, while in Pune only one in seventeen reported having to pay “speed money”. In all five cities the higher was the prevalence of corruption, the lower was the capacity or willingness of public service agencies to solve clients’ problems.

A study of corruption in Thailand reveals the cultural bases of attitudes towards corruption (Phongpaicht and Piriyaangsan 1994). The authors argue that citizens still look up to government officials as patrons or masters. They regard public services as “favours which the powerful deign to bestow on them, the inferiors, the powerless ordinary people”.

Gift giving is highly valued in Thai culture. These gifts are part of the patron-client relationships between the ruler and the ruled. People surveyed differentiated between gifts and bribes in terms of value. Small gifts were tokens of appreciation; large ones were illicit bribes. They defined corruption as a form of behaviour that “seeks to reap large profits with serious impacts on society” (p. 154). But value is relative. A businessman may view an automobile as a gift. Another person may view it as a bribe. If the “normal” commission is 10%, anyone asking for 20% will be viewed as corrupt.

The concept that officials and politicians are public servants is not widely accepted. Thus many people consider it acceptable to use their high official position to make money, reward friends and demand special personal privileges (p. 150). Military and police officers use their powerful positions to protect business people, and military officers operate as chairpersons, board members and advisors to private companies. The survey respondents believe that the practice is improper but not a serious offence.

Professionals and other members of the middle class have a greater-than-average appreciation of the costs of irregular payments. The poor are also concerned about corruption that involves large sums of money and results in obvious social damage. These two groups, however, have little influence. Most of the population is resigned to the status quo and has an ingrained deference towards political and administrative positions (p. 151).

The Thai authors argue that a modern state cannot develop unless traditional practices change. They argue not only for better systems of monitoring and control, but also for greater popular pressure and education on the social costs and political risks of corruption (p. 174).

*Sources:* Cooksey 1996, De Melo, Ofer and Sandler 1995, Keefer and Knack 1995, Mohn 1997, Paul 1995, Phongpaicht and Piriyaangsan 1994, Webster 1993a, Webster and Charap 1993 and Webster and Swanson 1993.

Some countries, worried that non-governmental organisations will be used for such monitoring purposes, limit such groups or make it very costly for them to organise. Formal legal constraints may be high, and group members may be subject to surveillance and harassment. For example, Transparency International has found it difficult to set up local chapters in some developing countries, even if local people are eager to organise. In some cases several years have passed without a formal charter being obtained.

### *Individual Protection*

The third aspect of checks and balances is the way in which the government structure protects individuals against the state. The forms of administrative law and the protection they offer individuals are of critical importance (Antoniou 1990). When an official tries to extort a bribe from individuals or firms, do they have any recourse? Obviously, if the bribe must be paid to permit illegal activities or to soften a legal regulation or tax assessment, the answer is no. Corruption of this type is unlikely to be revealed by the parties to the deal unless they have been arrested and are seeking to mitigate their punishment. But those who face demands for bribes as a condition to obtain a legal benefit may fight the demand if they can appeal to an honest forum, such as an appeals board within the agency or the courts. In order to make appeals worthwhile, however, the process must be speedy and efficient, as well as honest. Complainants must have a right to obtain information about their cases from bureaucrats. For example, land consolidation in Uttar Pradesh in India was achieved with relatively low levels of corruption according to a study carried out in the 1980s. The keys were an open process with real participation by those affected, time pressure, and speedy and fair appeals (Oldenburg 1987).

The lowest German administrative courts are full of cases in which individuals assert their rights against the state. Although German officials have no general obligation to provide information to the public,

when individual rights are at issue, the petitioners must, with some exceptions, be able to obtain their files. Corruption is seldom at issue in individual administrative law complaints in Germany, possibly because of plaintiffs' access to files and the ease of appeals—which do not require a lawyer at the lower levels.

The ombudsman represents one route for citizen complaints. Many countries have established ombudsmen to hear complaints of all kinds, not just those related to malfeasance. These offices can help increase the accountability of government agencies to ordinary citizens (Antonioni 1990, pp. 68–78; Pope 1996). But they are seldom a way to uncover large-scale, systemic corruption, and most have no authority to initiate lawsuits. For example, South Africa has established a public protector building on the foundation of the Ombudsman Act of 1991. The public protector investigates alleged improper behaviour by public officials and files reports that are usually made public. Its mandate includes malfeasance and corruption, as well as traditional human rights abuses. Like most ombudsmen, the office cannot initiate legal actions, but it can refer cases to those who can. At present, the office is very small and has difficulty handling the volume of complaints that it receives. A recent UN report recommends not only that its capacity be expanded but that it develop the ability to initiate large-scale investigations of general problems rather than simply responding to individual complaints. When ombudsmen serve to fight corruption, this capacity is a valuable tool (UNDP 1996, pp. 38–40).

Ombudsmen and other complaint mechanisms are insufficient, however, if people are unwilling to complain. Reporting the speculations of others can be dangerous. If corruption is systemic, one risks being disciplined by corrupt superiors and attacked by co-workers. The results of one study of corruption in China suggest that this is a serious problem (Manion 1996a). Whistleblowers may even end up being accused of corruption themselves. Yet uncovering evidence of corruption is notoriously difficult because both sides to the transaction have an interest in keeping it secret. Thus governments should con-

sider promulgating statutes that protect and reward whistleblowers in the public and private sectors (Pope 1996, pp. 59–61). The United States, for example, has a statute that rewards those who report irregularities in government contracts (31 U.S.C. Sections 3729–3731; Kovacic 1996). But whistleblower protection is obviously pointless unless the prosecutorial system follows up, the courts are not corrupt and are efficiently run, and the penalties are severe enough to deter potential offenders.

### *Vertical Checks*

The fourth check on corruption is a federal system in which the national government can constrain the states, and the states, the localities. Similarly, institutions operating internationally may provide a check on national governments. This kind of leverage can be problematic since those who exercise it do not necessarily represent the interests of the affected citizens. There are two cases, however, in which such actions may be justified. First, corruption and waste frequently have cross-border consequences. Corrupt politicians or those engaged in legal joint ventures with private firms may try to use their political power to restrict commerce across state borders. Internationally, officials working in collaboration with corrupt businesses harm the prospects of honest businesses. Within a country, something equivalent to the Interstate Commerce Clause of the US Constitution, which permits the central government to regulate interstate commerce, can help restrict the ability of low-level governments to act in a protectionist manner (Ma 1995). National courts must enforce such restrictions on lower-level governments.

Second, state and local governments may be controlled by narrow elites who use the apparatus of government for personal gain. Although competition between jurisdictions for investment resources limits corrupt possibilities at the local level, it does not eliminate them. The smallness and intimacy of local jurisdictions may make corrupt

relations possible (Rodden and Rose-Ackerman forthcoming). Higher-level government can then provide oversight. For example, the US Federal Bureau of Investigation is active in controlling corruption in municipal governments, and federal grants frequently require that lower-level governments establish systems of accountability. The British Audit Commission is a national government agency with the authority to monitor the probity of local governments.

Sometimes the overlap is international. The involvement of US drug enforcement authorities in investigating the drug business in Colombia led a defector to choose the US justice system over the Colombian one, opening the door to information on drug cartel pay-offs to Colombian politicians.<sup>41</sup>

### *Exit*

Exit has the advantage of not requiring a concerted organisational effort. In a world with many equal governments the corruption and ineffectiveness of government officials are limited by the ability of constituents and business firms to go elsewhere (compare Weingast 1995 and Montinola, Qian and Weingast 1995). Multinational firms trying to decide where to place a manufacturing plant can limit bribe demands by identifying several feasible sites. Residents of a village whose officials extract large payoffs for routine services can move elsewhere.

Mobility, however, is not always helpful. It will make it more difficult for an individual jurisdiction to control undesirable behaviour. Suppose, for example, that one city government has installed an honest police force that cracks down on illegal gambling. The gamblers may simply move to a friendly suburb that they can control. There are several examples of this behaviour in US cities.<sup>42</sup> The ease with which funds can cross national borders, coming to rest in various “financial paradises” is another example of how multiple, competing jurisdictions can make control of corruption, fraud and tax

evasion more difficult. Thus interjurisdictional competition should be encouraged when it reduces the economic rents available for corrupt distribution and helps control waste. But it should be limited when it facilitates the illegal behaviour that corruption enables or requires.

In short, a system of checks and balances has two fundamental aspects. It implies a system that limits the power of any one political group or individual to set policy independently. It also implies that once a law or regulation is put in place, individuals and groups both inside and outside the government can find out how it is being administered, complain and set in motion a legal or political enforcement process. Different countries will establish different types of checks and balances depending on their government, legal and social structure. To be a meaningful anticorruption check, however, knowledge must be combined with institutions that can take effective action to promulgate new laws and enforce existing ones.

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## 4. The Role of the International Community

The growing interest of the international community in limiting corruption is part of a general rethinking of the function of international aid and lending organisations in the post-cold war age. The end of the cold war has changed the balance of forces and removed any need to support corrupt regimes for national security reasons. The widespread corruption and organised crime in countries such as Russia and others in the former East bloc have made the problem difficult to ignore. Some Latin American countries are also threatened by the corrupting influence of the illegal drug business. The failure of Africa to develop in the face of substantial progress in many parts of Asia and Latin America raises questions about the role of the state in development. The worldwide move to privatise and deregulate requires a rethinking of the relationship between the market and the state.

Some observers question whether the control of corruption ought to be of concern to the international community. They view it as a domestic political problem, and the concern of outsiders represents an unacceptable attempt to impose Western values. Although this may be true in some countries, many scholars from the developing world argue that this attitude is itself patronising. They make it clear that traditions of gift giving do not translate into wide-spread acceptance of corrupt practices (Ayittey 1992). But cultural relativism is not all that is a stake. Some industrial countries resist efforts to control corruption in international business because they believe that the system of making payoffs to officials in the developing world works to their benefit.

A second critique concerns technique. Even some who acknowledge the costs of highly corrupt governments argue that the control of corruption should not be linked to international trade and lending

policies, and they question the involvement of international aid and lending agencies. In line with the debate over human rights and labour standards, they argue that trade policy and development assistance should not be tied to “non-economic” issues. But corruption is in large part an economic issue. It affects the competitiveness of the global economy and the efficiency of investment and development projects.

There are four broad arenas for international involvement:

- International organisations will take an interest in the effective use of their loans or grants.
- Aid agencies may directly support anticorruption efforts, such as reform of the civil service and the budgetary and financial management systems. Other types of reform projects designed to improve economic performance or to democratise politics may produce new forms of corruption and self-dealing. Reformers seek to control these new types of malfeasance.
- International efforts may be focused on reducing the willingness of multinational businesses to pay bribes and on enlisting them to help the developing world carry out reforms.
- International programmes to control the flow of illicit funds can help check corruption by making it more difficult to transfer secret funds abroad, where they cannot be traced. Other types of cooperation in the control of international criminal activity can help check corruption.

## **Controlling Corruption in Project Loans and Grants**

Aid organisations, concerned with the success of the projects they support, will obviously be troubled by endemic corruption. For example, suppose that 20% of aid funds are lost because of corruption. The 20% may not represent bribes per se, but inflated contracting costs and the loss of equipment and other inputs from tolerating bribery. A project with a budget of \$100 million could have been completed for \$80 mil-

lion in an honest system. Consider a simple project in which funds invested at time zero earn a return in time one (and only in time one), and suppose that an investment must earn a return of 10% in order to pass muster. Then, an honestly administered project would need to generate benefits of \$88 million. The corrupt project would need to produce returns of \$110 million, a difference of \$22 million. A project that should have cost \$80 million must return \$110 million in order to be worthwhile—a rate of return on productively used resources of 37.5%. Even in the industrial world few projects have such a high return. Thus in the absence of corruption many more projects would be worth initiating.

Furthermore, if corrupt opportunities vary across projects and if a country's corrupt top officials have a say in which projects are sponsored, they will favour those with large opportunities for private gain, thus skewing how projects are ranked. The problem is not just that too few projects will seem worthwhile to aid and lending agencies, but that an inefficient mixture will be supported. One recent buzz word in development circles is "ownership". Projects will fail unless the borrower feels that it "owns", or has a stake in, the project. Unfortunately, one form of ownership is all too common: political figures in borrower countries and firms in lender countries show ownership interest in projects that produce personal benefits for the politicians and profits for the firms. They will oppose projects that spread the benefits more broadly and that assure free competition. Ownership is thus of questionable value in countries whose rulers do not seem committed to poverty alleviation.

UNDP and the World Bank may have no choice but to impose more stringent controls and improve oversight. Until recently, the main focus has been on analytical rigor at the project approval stage and on transparent procurement processes. Some projects with strong support from a country's rulers were not supported because of the concern that they would simply create pools of rents for the powerful. World Bank procurement guidelines sought to assure some level of

competitive bidding on most large contracts, but worries about corruption were implicit. In 1996, however, the Bank revised its procurement guidelines to state explicitly that corruption and fraud would be grounds for canceling a contract if the borrower did not take appropriate action. Companies that the Bank found to be corrupt can be excluded from bidding on future projects. The new rules permit Bank audits of contractors and require contractors to record all payments to agents both before and after bidding, since such payments are frequently the route through which bribes are made.<sup>43</sup> The importance of these changes will depend on how they are implemented in the field. But they represent a promising first step.

The procurement changes might be supplemented by a requirement that potential bidders sign an “integrity pact” under which they pledge to refrain from corruption. Transparency International (1995) has recommended this practice, and Ecuador has experimented with it, but it has never been broadly used. This is a variant of the prequalification processes used by procurement offices in many jurisdictions. The number of bidders might fall, but the selective elimination of corrupt firms will enhance the competitive nature of the process, not reduce it. Although such pledges look redundant since corruption is illegal, they may have the advantage of highlighting the issue in countries that have little respect for formal law. But with such pacts, losers have an incentive to accuse winners of corruption even if none occurred. The international aid and lending community must find a way to make constructive use of the information contractors can provide without becoming enmeshed in investigating the claims of every disappointed bidder. Since bid challenges are often costly and time-consuming, those experimenting with this method must decide how to balance the need for a speedy sale against a process designed to deter corruption.

Other reforms should be considered. For example, projects could be designed keeping the fragility of a country’s procurement processes in mind. Then project officers would favour off-the-shelf items sold in

international markets rather than specialised goods. These standard goods could simply be purchased in the market with no specialised procurement procedures. Another possibility is to develop external benchmarks for certain types of procurement. In such cases the price of comparable products in the private sector can help limit the price inflation that often accompanies payoffs.

The Controllers Office of the World Bank is exploring ways to improve ex-post monitoring so that there is more review of goods and services actually provided. Instead of relying mostly on paper records, Bank auditors are considering more physical inspections and on-site reviews. The Operations Evaluation Division is the World Bank's own inside-outside oversight agency. A study done for its annual evaluation review found that highly corrupt countries were less likely to have successful World Bank projects. This result suggests that the Operations Evaluation Division itself take up the issue as part of its review of Bank priorities. UNDP is also sponsoring a series of projects designed to improve the accountability of aid (UNDP 1996).

Aid and lending organisations must acknowledge the political and organisational dynamics that make corruption difficult to control. They must self-consciously review their own control institutions to isolate areas of deficiency. If they do not carry out the oversight function themselves, they may end up having it thrust upon them by outside observers.

## **Supporting Reform Programmes**

UNDP, the World Bank, the bilateral aid agencies and the regional development banks have a good deal of leverage with their borrowers and grant recipients. They have often been reluctant to use it for fear of being accused of lacking cultural sensitivity or of being heavy-handed advocates of democracy and Western values. This attitude may be changing as the costs of systemic corruption become clear. Citizen surveys and expressions of public outrage suggest that wide-

spread tolerance of corruption is not the rule in most countries. Furthermore, organisations concerned with reducing poverty must remember that even if elites tolerate and benefit from corruption, the intended beneficiaries of aid will seldom do the same.

The international institutions are proving willing to acknowledge the problem of corruption in transition countries of Eastern Europe and Asia, and to consider how aid projects might provide constructive help in alleviating corruption's worst excesses. Once such projects are contemplated in Russia and Turkmenistan, it is difficult to argue that they are inappropriate for Brazil, Guinea or Pakistan. In fact, as private capital becomes more important in some traditional areas of World Bank lending, the organisation's role in institutional reform should increase. UNDP is basically a grant-making organisation that is already in the business of providing technical support for governments. It, too, can do more in this area.

These institutions already support public sector management and governance projects in a wide range of areas. UNDP has also provided aid for the development of democratic institutions (UNDP 1996, 1997a). Some World Bank projects began as part of the structural adjustment lending carried out in the 1980s and, at a somewhat reduced level, through the 1990s. This is an awkward vehicle for effecting institutional reform, and free-standing projects are now being carried out. Other loans aiming to reform regulatory authorities, taxation agencies, the judiciary and other public institutions are being considered or implemented. The Bank frequently advises countries on the privatisation process. Aid agencies such as UNDP and the bilateral donors have led the development of institutional reform projects. All of these initiatives require a long-term commitment of funds and expertise, and a realisation that "output" measures will not be easy to formulate precisely. Nevertheless, the development community can play a role in providing a framework within which development can proceed as a partnership between the public and the private sectors.

Sometimes the problem is not just reducing corruption in existing institutions, but preventing it from arising in new ones. A privatisation auction can be tarnished by payoffs and insider deals. A new regulatory agency established to oversee privatised firms can be corrupted. A fledgling democratic process can be undermined by illegal campaign contributions and vote buying. Thus reform programmes supported by outside aid must assess the opportunities for corruption and self-dealing that can arise as a result of reforms that are otherwise beneficial.

The previous section of this paper outlined the steps that a reform minded government can take to reduce corruption. International aid and lending agencies can start with such a framework and work with individual countries to develop a realistic programme. The priorities for reform will differ across countries, but the basic factors that must be considered include substantive reform of the law to reduce corrupt incentives in particular sectors, reform of the legal framework and improvements in the integrity of monitoring, reform of law enforcement and of the civil service, and the strengthening of checks and balances.

Greater success in improving the institutional environment for development would be likely if both international lenders and borrower governments took a more straightforward approach to controlling corruption and other forms of malfeasance. UNDP and the World Bank try to maneuver between the economic interests of poor and wealthy states, and to manage the tensions between charitable goals and the politics of aid and lending. The issues are complex, but a place to start is with an acknowledgment of the problem of corruption and self-dealing and with concerted efforts to limit its impact on growth and poverty reduction. The goal should not be to insulate aid projects from a country's corrupt climate or from the payoffs that have become routine in some areas of international business. Instead, the goal should be to seek fundamental changes in attitudes and institutions where corruption and governmental ineffectiveness go together.

## Limiting Corruption in International Business

Multinational business firms face a dilemma when they deal with corrupt regimes. Each believes it must pay bribes in order to do business, but each knows that they all would be better off if none paid. The playing field is tilted towards unscrupulous but less-efficient firms that would not fare well in an honest system. This realisation has fed recent international attempts to limit corruption in international business. Such efforts could complement the solutions outlined above. Current activity includes multinational efforts, especially at the Organisation for Economic Co-operation and Development (OECD) and at the Organisation for American States (OAS), to constrain corruption and efforts by the business community to promulgate voluntary codes of conduct (box 12). In addition to measures currently under way, another proposal merits discussion—establishing an international tribunal to resolve disputes.

Some have recommended the creation of new international capacities to deal with global corruption. The involvement of the World Trade Organisation (WTO) has been proposed, but worries over tying trade policy to other issues, such as labour conditions, human rights and corruption, suggest that this will not be the first line of action. Within the WTO the most feasible possibility is to revise the Agreement on Government Procurement, focusing on anticorruption aspects, so that more countries will join. The present agreement was entered into force on January 1, 1996, but only a few countries, mostly in the industrial world, have adopted its provisions.

Alternatively, some have proposed an international treaty. The OECD is pursuing this goal for its member states, and the OAS's Convention Against Corruption is open for ratification (see box 12). The idea of a dispute resolution body to hear complaints by firms claiming to have lost business to rivals because of corruption deserves further scrutiny. In establishing a general forum for resolving disputes, there are clearly some difficult problems of proof and decision stan-

dards. Nevertheless, there are some models in the international legal arena that may provide ideas about how to proceed. For example, the World Bank Group's International Center for the Settlement of Investment Disputes (ICSID) resolves disputes under contracts that specify ICSID as the forum of choice to resolve contractual difficulties (Shihata and Parra 1994). ICSID panels are not formal courts, and their use is based on the prior consent of the parties, but they do occasionally deal with issues that are indirectly related to corruption. The process has difficulties though, because the review mechanism lacks finality and sometimes takes an overly technical and formalistic approach. Nevertheless, these problems have eased somewhat in recent years (Reisman 1992, pp. 46–106). The ICSID has not, however, heard disputes arising at the contract-awarding stage, and it may not have jurisdiction in such matters. It is also an expensive and time-consuming process that is not able to handle a large volume of cases.

There are also tribunals in the fields of human rights, international labour standards and nuclear energy that could be models (Barratt-Brown 1991). Non-governmental organisations can bring complaints before them and present evidence. Each of the existing bodies has its own problems, and none is a perfect model for those concerned with anticorruption efforts. Nevertheless, a more careful examination of the possibilities for some kind of international tribunal needs further exploration.

The international community could also establish a forum to review cases of suspected corruption in privatisation or contracting, perhaps in connection with an integrity pact mechanism. Cases brought by disappointed bidders or defrauded lenders would require that the country involved make a transparent accounting of its behaviour. The actual payment of bribes would not necessarily need to be documented. Instead, the focus would be on the terms of the deal. If they seem to diverge significantly from what would have been expected in an honest process, the remedy could be to require that the project be rebid. One difficulty in making the process operational,

### **Box 12 International Efforts to Control Corruption**

International efforts include those that focus on the industrial world and those that involve a broader range of countries. The most important recent international initiatives are those taken by Organisation for Economic Co-operation and Development (OECD) and the Organisation of American States (OAS).

In 1994 the OECD Council adopted a Recommendation calling on Member countries to combat illicit payments in international trade and investment with a particular focus on criminal and tax laws [C(94)75]. Progress since then has been steady, and on May 23, 1997 the 29 members of the OECD Council adopted a Revised Recommendation on Combating Bribery in International Business Transactions [C(97)123]. It commits the members to draft and ratify a convention on the criminalisation of bribery under a strict timetable. The aim is to have the treaty in force by the end of 1998. Members also pledged to pass national legislation making foreign bribery a crime by the same date. National laws can take different approaches but must conform to a list of "common elements". For instance, laws must not permit companies to offer "local custom" as a defence. The OECD would establish a monitoring programme to assure effective and consistent implementation of the Recommendation (OECD 1997).

The Council also urged prompt implementation of its May 1996 Recommendation that Member states "re-examine the tax deductibility of bribes to foreign public officials, with the intention of denying this deductibility in those Member countries which do not already do so" [OECD, Meeting of the Council at the Ministerial Level, Paris, May 21–22 1996, Communiqué, SG/COM/NEWS(96)53, section 9(x)]. Most OECD countries permit the tax deductibility of illicit overseas payments. As of the spring of 1997 only Norway and the United States forbid the tax deductibility of bribes, although several other countries have draft legislation in preparation (OECD 1997).

The OECD has also been concerned with corruption in foreign aid. In 1996 the Ministers requested that the organisation "follow up on the effect given to the recommendations on anticorruption proposals for bilateral and multilateral aid procurement endorsed by the Development Assistance Committee [OECD 1996, 15(xviii)]. This committee recommended that Members require anticorruption provisions governing bilateral aid and that they urge international aid organisations to be similarly vigilant [DCD/DAC(96)11].

An Inter-American Convention Against Corruption has been negotiated under the auspices of the OAS (OEA/Ser.K/XXXIV.1; CICOR/

*(Box 12 continues next page)*

**Box 12 (continued)**

doc.14/96 rev.2, 29 March 1996). The Convention is now open for ratification, and seven countries have done so. The Convention requires a good deal of cross-border cooperation and calls for strengthening national laws. It demands that countries prohibit and punish transnational bribery subject to their own constitutions and legal systems (OAS 1996, VIII). Under the Convention states agree to deny favourable tax treatment for expenditures that violate the anticorruption laws of Member States (OAS 1996, III.7). Subject to domestic law, signatories may take people into custody whose extradition is sought by another state (OAS 1996, XI.7). The Convention is distinctive in including both industrial countries, a number of middle-range countries and several poor countries in a single region.

Some international professional and business organisations have put anticorruption initiatives on their agenda. The International Chamber of Commerce (ICC) issued a recommendation in March 1996 urging its members to adopt rules of conduct designed to limit bribery in international trade. The rules prohibit bribery for any purpose, not just to obtain or retain business. Thus they are more stringent than the earlier 1977 ICC code (International Chamber of Commerce 1996). The Council of the International Bar Association (IBA) adopted a complementary resolution in June 1996 (IBA 1996). The UNDP Programme for Accountability and Transparency is considering working with the International Organisation of Supreme Audit Institutions and the International Federation of Accountants to develop projects to strengthen accountability in developing countries (UNDP 1996, p. ii).

Activity by private international organisations is complemented by the actions of individual companies. In the United States the presence of the Foreign Corrupt Practices Act has spurred companies to develop and enforce strict codes of conduct. The American Bar Association has a Task Force on International Standards for Corrupt Practices that is considering the issue, and the Business Roundtable has taken up the question of corruption, particularly as it affects government procurement processes throughout the world. The US branch of Transparency International has sponsored an effort to compile existing codes and to help companies without such codes to develop them (Transparency International-US 1996). This initiative is also part of the agenda of the international headquarters of Transparency International.

*Sources:* International Bar Association 1996, International Chamber of Commerce 1996, OECD 1997, Transparency International-US 1996 and UNDP 1996.

however, is that the new bid will not simply be a more transparent and honest rerun of the old one. All the players will have new information as a result of the first round that will affect their behaviour in the second round. The strategic aspects of this proposal need to be carefully analysed to avoid creating an even more unfair system.

Such a process would, of course, discourage some projects from proceeding. That might not be such a bad thing. When an inside deal appears inevitable, privatisation should be delayed, since a public firm is much easier to monitor than a private one. Also, a public works project may have been designed with bribes in mind, not economic development. Further, unlike the arbitration processes carried out under the ICSID, the cost of the proceeding might be subsidised by the international community if a developing country emerges victorious from a challenge. The jurisdiction of the tribunal could be limited to countries that volunteer to establish an Integrity Pact system in return for World Bank or UNDP technical advice and other support for the process of carrying out a privatisation or a contract. This proposal is an example of the more general principle that one way to fight corruption is to give losers a means of lodging a complaint (Alam 1995).

The international business community is beginning to recognise the costs of corruption to the global investment environment, suggesting another approach to reform. Perhaps international businesses themselves could provide funds and technical assistance to countries interested in reform. This is already being done through professional associations like the American Bar Association, but UNDP and other aid organisations might explore the possibility of collaborative projects. Businesses that have been enmeshed in corrupt networks may provide useful advice on how to eliminate them. Of course, reforming countries might be reluctant to accept help from those who have corrupted them in the past, but UNDP might be able to establish a neutral forum in which the experience of these companies could be tapped and their suggestions for reform canvassed. If this suggestion looks a bit like asking the safe cracker for advice on how to increase the secu-

rity of banks, so be it. Often those with some experience will be the most sensitive to ways to avoid the pitfalls of reform.

Many international efforts are very recent and some have a purely hortatory character. The next few years will indicate whether they have any real meaning in the international business environment. UNDP and other aid and lending organisations, along with non-profits such as Transparency International, can play a monitoring role and can help sponsor programmes to develop practical reform proposals for individual countries and for the business community.

## **Controlling Money Laundering and International Criminal Enterprise**

Another facet of the international efforts against corruption are efforts to make it more difficult for corrupt rulers to hide their gains. The problem is not only that bribe receipts are easy to hide in offshore accounts, but that, being illegal, they are especially likely to provide capital to illegal businesses worldwide.

Efforts to crack down on money laundering are a useful way to increase the costs of organised crime and to make corruption more risky. The UN Vienna Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances adopted in 1988 and the 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of Proceeds of Crime are the main international agreements (Scott 1995). The Vienna Convention calls on countries to criminalise the laundering of drug money. The European Union also issued a directive, in 1991, that obligates member states to require that financial institutions maintain systems to prevent money laundering. The main international body engaged in ongoing efforts to control money laundering is the Financial Action Task Force set up in 1989. It includes representatives from the OECD, Hong Kong, Singapore, the Gulf States and the European Commission (Scott 1995). It has developed 40 recommendations for appropriate counter-measures, including the prohibition of anonymous accounts.

But as emerging markets and small financial paradises become increasingly used for money laundering, the problem of control is becoming more serious. Keeping the industrial world pure is of little relevance. At issue is both the ease with which corrupt officials in one country can hide their gains in another and the possibility that money laundering activities can undermine the credibility of a country's financial structure (Scott 1995).

Money laundering controls are only negative sanctions, which are unlikely to be an effective means of increasing investment in capital-poor countries. A highly corrupt country is generally one with an uncertain and arbitrary business environment. Such an environment encourages local elites to invest abroad and discourages FDI. Thus although actions designed to check international money laundering can play an important subsidiary role, they are not likely to have much of an impact on poor countries unless combined with more direct efforts to improve government performance and accountability.

International efforts to control illegal businesses are a second important option. In addition to other negative effects, such businesses often have a corrupting influence on government. When corruption is combined with organised crime, the problem for international aid organisations is especially difficult. If the entire state is permeated with crime, there is probably little outside organisations can do except wait in the wings and hope for the best. In less extreme cases the experience of industrial countries in fighting organised crime may be useful. Developing countries, not used to confronting organised crime, will likely need a combination of training and law reform. Such reform is unlikely to be sufficient unless the economy is strong and competitive. The state may need to make more direct efforts to reduce the excess profits available to criminal entrepreneurs in legitimate businesses. One solution is to promote the entry of well-capitalised legitimate businesses that, with some state help on the law enforcement side, can compete with mob-dominated firms. Although it is too early to judge the success of the effort, this is what a large

multinational waste management firm is doing in the trash hauling industry in New York City.<sup>44</sup>

A country's links to the broader world can either limit or expand the scope for organised crime. On the one hand an open trading and investment regime will make it easy for both contraband and the profits of crime to flow across borders. The existence of numerous financial paradises where black money can come to rest makes domestic criminal activity less risky since money can be easily hidden abroad. To counteract the negative impact of openness requires international efforts to "follow the money", and isolate those countries willing to provide safe havens for black funds. This suggests that international organisations ought to focus on international banking disclosure standards that make it more difficult to hide illicit funds.

On the other hand open borders facilitate the investment by outsiders in a country. If these outsiders are not part of the domestic criminal body and are not associated with such groups elsewhere, they may challenge entrenched groups. Of course, if such investments are costly and dangerous, few may make the effort, a country's openness to foreign investment at least makes them thinkable.

The control of international criminal behaviour is an important matter, but the lesson of this review is that a criminal justice approach to corruption is not sufficient. Limiting money laundering and controlling illegal businesses clearly require international cooperation, but these efforts cannot by themselves have much of an impact on the level of corruption when the underlying incentives arise, not from illegal business activity, but from the benefits of controlling the state.



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## Conclusions

Corruption cannot be expected to wither away just because a reform government has taken power or because economic growth is vigorous. As long as officials have discretionary authority, corrupt incentives will remain and can be especially harmful to fragile new states. Reformers will have to take concrete action, not just assume that entrenched habits will disappear with a change in top personnel. Those who benefited from the corrupt regime must not be permitted to hold back change.

Corruption is not a problem that can be attacked in isolation. A criminal law approach that simply searches for bad apples or big fish and punishes them is not sufficient. Of course, the state may need to establish credibility by punishing highly visible corrupt officials, but the goal of such prosecutions is to attract notice and public support, not solve the underlying problem. Klitgaard (1988) recommends “frying a big fish” for just this reason. Structural and procedural reform requires a set of credible anticorruption laws that outlaw whatever types of payments are viewed as illegal and establish punishments. If some types of payments are viewed as acceptable tips or gifts to public officials, they should be legalised and made subject to reporting requirements. One test of the cultural justification for payments is the acceptability of proposals to make such payments public. The possibility that payoffs may motivate officials to work more efficiently suggests that in particular cases illegal bribes might be converted into legal incentive-pay schemes.

The cases in which corruption enhances the efficiency of agents and improves the allocation of public services are limited. The theoretical

and empirical evidence does not support wide-spread tolerance of corruption. The difficulty with tolerance in some areas is that it undermines efforts to reduce corruption in areas where it is clearly harmful.

Both theory and practice suggest that there is no simple response that should be adopted across the board once the basic anticorruption statutes are in place. There are two different but related types of corruption—corruption involving high-level officials that often implicates multinational corporations or large domestic firms and corruption that is endemic to how the government carries out routine activities such as tax collection, customs, licensing and inspections. Within each of these categories, some payoffs facilitate illegal activities and some enable access to benefits to which one is legally entitled. Special efforts may also be needed to maintain the integrity of independent institutions inside and outside government that play an important role in oversight, prosecution and judgment.

Because of the interrelated character of corrupt systems, it is difficult to know where to begin a reform programme. It is clear, however, that efforts to keep aid projects clean while ignoring the rest of a government's activities will be ultimately ineffective as corrupt officials and private individuals and firms seek opportunities elsewhere. Clearly, international organisations should not abandon efforts to keep their own projects free of corruption, but the more serious that effort becomes, the more they will need to help countries reduce domestic corruption. UNDP's Programme for Accountability and Transparency effort recognises this fact, given its emphasis on improving overall financial accountability in aid-dependent countries (UNDP 1996).

Countries that are serious about fighting corruption will require detailed country-specific assessments. But a few general remarks can be made. The first step is to discover where corruption is imposing the greatest cost. There are several common possibilities:

- Tax and customs revenues may be far below the level needed to carry out basic government services, and the pattern of payments may be very inequitable because of payoffs. The response should be

to both simplify the tax laws to reduce bureaucratic discretion and reorganise the bureaucracy to improve oversight and incentives for good performance.

- Regulation of business may be so complex, time consuming and intrusive that it affects the development of a healthy private sector. Here the answer is to take a hard look at tax and regulatory laws to see which can be eliminated, which can be simplified and which require better enforcement. Many countries have pointless business regulations that generate bribes along with ineffective regulations in socially beneficial areas such as environmental protection.

- Another costly practice is state sponsorship of massive infrastructure projects. The cost of corruption is not the bribes themselves, but the inefficiency that they encourage. Even if direct evidence of corruption is not available, evidence of the inappropriate scale and design of projects should be sufficient to cancel them. Such a change in direction must, however, be combined with improved procedures for future project approvals, else the pattern may repeat.

Basic institutional reforms may be needed before particular sectors can be reformed. Especially important is improving the checks and balances in a political system. Without changing a nation's constitutional structure, there are a range of reforms that may be politically difficult to implement, but are not particularly expensive. The problem is to institutionalise such reforms so that they can endure changes in personnel and changes in political leadership. These include policies that increase the transparency and accountability of government operations and facilitate the organisation of independent watchdog groups.

Even if the problems of substantive policy and institutional structure have been tackled, most corrupt countries must face the difficult task of civil service reform. This will be either financially expensive or politically painful, but it is necessary. If civil service wages are allowed to deteriorate relative to private sector wages and if pay differentials within the civil service are too small to give officials an incentive to seek promotions, then efforts to control official corruption are unlikely

to succeed. Reform policies must reduce the size of the civil service, pay decent base salaries and establish effective carrots and sticks that give officials incentives to be honest and perform efficiently. The experience of UNDP and the World Bank in helping countries reform their civil services ought to be made broadly available, even when the outcomes were less successful than had been hoped at the outset.

- The lack of credible institutions capable of hearing complaints and enforcing the law is a weakness of many developing and transition countries. Thus one area for reform should be to improve existing institutions, such as the courts, or to create new bodies, such as independent inspectors general or anticorruption commissions. The experience of other countries should be documented. The problem of anticorruption campaigns being used to undermine political opponents and discipline those who are otherwise troublesome must be acknowledged when new institutions are proposed.

Fundamental change requires commitment from the top and a willingness to follow through as the anticorruption effort unfolds. Even if a state's basic constitutional framework is not open to change, serious reform can be carried out within any existing government structure. Governments that make it very difficult for independent voices to be raised in criticism, however, will have an especially difficult time establishing a credible commitment to honest and transparent government. Such governments may be able to move quickly in the short run, but always pose the risk that their policies will be reversed in the future. The priorities for international aid and lending organisations facing their own budgetary constraints are difficult to establish in the abstract. A few observations are possible:

- International organisations need to make it much clearer than in the past that corruption will not be accepted and cancel projects where corruption is uncovered or where cost overruns suggest that either venality or incompetence is pervasive. They need to be skeptical of supporting projects that make it easy for public officials to hide private gains.

- International organisations should actively support international efforts to limit corruption. These include efforts to reduce the willingness of international businesses to pay bribes and support for international efforts to establish budgetary, accounting and procurement standards—and to train officials to use them.

- Grant and loan projects should focus on creating an environment favourable to shared growth and poverty alleviation. Both UNDP and the World Bank have experience in government reform, but it must be scoured for the lessons it can provide. Projects should be designed so that country officials work with international organisations to isolate the most serious problems and to design solutions. This will involve identifying sectors in which corruption imposes severe costs and redesigning programmes to reduce incentives. International organisations must use their leverage to push civil service reform as a basic background requirement. Finally, they need to help countries find ways of opening government to outside scrutiny and strengthening legal institutions of oversight and control. This sounds like a large order. But piecemeal efforts are unlikely to do much lasting good. Aid agencies might select a few countries with supportive governments and work with those governments to design programmes that will serve as examples for the future.

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## Notes

1. United Nations General Assembly, "Resolution 51/59: Action Against Corruption", A/RES/51/59, January 28, 1997. The Resolution adopts the International Code of Conduct for Public Officials for the UN and recommends it to Member States.

2. Current UN thinking on governance policy is contained in UNDP (1997a). More background material is in UNDP (1995, 1997b). An overview of the Hague seminar including three background papers is in United Nations (1990). UNDP work on improving the accountability of aid is found in UNDP (1996). The Latin American meetings are summarised in Zwanikken (1996). Electoral reform projects have been carried out in a number of countries, including Brazil, the Gambia, Guyana, Liberia, Mozambique and Sierra Leone.

3. Data are from the Price Reform Group of the Finance and Trade Institute of China's Academy of Social Science. Printed in *Zhongguo Wujia* (China Price), Beijing, October 1990. On corruption in China see Gong (1993), Hao and Johnston (1995) and Johnston and Hao (1995).

4. "Camel Through the Needle's Eye", *Newswatch*, February 3, 1991. Excerpts reprinted in World Bank (1993b, Annex 26).

5. "South African Economy in Global Firing Line", *Financial Times*, March 13, 1995, and "Strong Debut for Unified Rand", *Financial Times*, March 14, 1995. According to the first article, however, South Africans still face tough controls on taking funds abroad—a situation that could encourage illegal attempts to circumvent the controls.

6. "Bribe Index", *Sunday Times of India*, December 17, 1995.

7. Legal and regulatory uncertainty is frequently mentioned by business people in the developing world. See, for example, Economisti Associati (1994); Webster (1993a); Webster and Charap (1993).

8. GATT (1991, 1995); "Airport Customs Harnesses 3 Billion Mexican Pesos Per Year", *El Economista*, February 13, 1992.

9. The Oxford Analytica (1996) authors conclude that: "If assumptions that some state bureaucracies are inefficient are made, and that the degree of regulation or taxation that they impose is excessive, three possible benefits of corruption emerge". The benefits are as follows. Bribes can speed up processing for profitable projects by permitting them to get to the head of the queue (Lui 1985). Bribes can overcome excessive regulation, and bribes can reduce tax payments. The authors conclude that given the costs of prevention, corruption "may offer a 'second best' alternative [to more fundamental reforms]".

10. Bribes paid to enact favourable laws by a democratic legislature are a particularly good example of the often large gap between the size of the bribe paid and the impact of corruption on society. If legislators cannot coordinate their actions, they may be inexpensive to bribe since no one lawmaker has much bargaining power (Rose-Ackerman 1978). Rasmusen and Ramseyer (1994) develop an interesting model of this case.

11. Integrity workshops organised with the help of Transparency International and the World Bank's Economic Development Institute are one option that was tried in Tanzania. See Langan and Cooksey (1995).

12. Johann Graf Lambsdorff, a scholar working with Transparency International, has prepared a cross-country index of corruption that is a compilation of others' rankings based on perceptions of the level of corruption in business dealings. New Zealand and Singapore are at the top of his list. The index and an accompanying explanation is in *Transparency International Newsletter*, September 1996, pp. 5-8.

13. "Roh's Former Security Advisor Arrested on Graft Charges", *Agence France Presse*, December 13, 1995; "Seoul Shaken as Ex-

Presidents Are Charged with Insurrection”, *Jane’s Defense Weekly*, January 10, 1996; “S. Korea’s Daewoo Head Faces Bribe Charges”, *Reuters North American Wire*, January 17, 1996.

14. “Singapore Exposes Tip of Corruption Iceberg”, *Financial Times*, February 15, 1996.

15. “German Airport Corruption Probe Deepens: Five Jailed and 20 Companies Under Investigation”, *Financial Times*, July 2, 1996; “German Corruption Wave Prompts Action”, *Reuter Business Report*, September 25, 1996.

16. *Transparency International Newsletter*, June 1996 reporting on a story in *Le Monde*, March 19, 1996.

17. “Tentacles of Defense Scandal Reach Out for Claes”, *Financial Times*, October 19, 1995; “Belgians Seek to Arrest Dassault”, *Financial Times*, May 10, 1996.

18. *Transparency International Newsletter*, December 1995, reporting on a story in *Saturday Nation*, October 14–20, 1995.

19. *Transparency International Newsletter*, June 1996, reporting on a story in *Daily Nation*, May 3, 1996.

20. Lien (1990b) canvasses these difficulties and shows that a corrupt official who discriminates in favour of some bidders will frequently select an inefficient contractor. See also Rose-Ackerman’s (1978, pp. 121–32) model of corruption in public contracting.

21. See Coolidge and Rose-Ackerman (1997). For an example of the short-run orientation of corrupt timber concessionaires in Malaysia see Vincent and Binkley (1992). Deacon (1994, p. 415) reports studies showing that security of tenure is negatively associated with deforestation rates, and he points to case studies showing that when property rights are poorly enforced, deforestation is more rapid. Of course, corruption is only part of the reason why firms might have a short-run orientation. Deacon (1994) shows that deforestation rates are associated with political variables reflecting insecure ownership, but the explanatory power of his model is low.

22. For example, in Malaysia firms involved in the privatisation of both electricity and telecommunications have complained that the government admitted numerous additional competitors with strong political links. See “Malaysian Privatisation Loses Allure”, *Financial Times*, October 13, 1995.

23. Lui (1990, p. 124), for example, worries that young Chinese will fail to build up their ordinary human capital and will instead focus on developing “directly unproductive human capital”, including such talents as “skills in power struggles, understanding the preferences of one’s superiors and ways to flatter them, knowledge about the intricate connections among some powerful officials, and so on”.

24. New York Times, November 19, 1996; *Far Eastern Economic Review*, November 28, 1996. For background on Thailand see Phongpaicht and Piriyanarangsana (1994).

25. A historical example from Egypt under Muhammed Ali in the 1820s illustrates the problem. According to Edward William Lane, an Englishman living in Egypt at that time, judges’ decisions were influenced by the rank of the plaintiff and the defendant or a bribe from either. “On some occasions, particularly in long litigation, bribes are given by each party, and a decision is awarded in favour of him who pays the highest”. Quoted by Johnson (1991, p. 686).

26. According to the Russian government 269 business people and financiers were murdered in 1995 in execution-style slayings. See “Mr. Tatum Checks Out”, *The Economist*, November 9, 1996.

27. Mauro uses a subjective index of corruption compiled by Business International from its correspondents throughout the world. The Economist Intelligence Unit, a proprietary firm that now owns Business International, provided him with data from the early 1980s that it judged as no longer of commercial value. The index, which covers 67 countries, omits Eastern Europe, China and the Middle Eastern oil countries. The Business International data also include numerous other measures of the climate for business. The data set is published as an appendix in Mauro (1995).

28. The two indices are very highly correlated ( $r = 0.81$ ). When both were available, Mauro averaged them together. Otherwise, he used the value of the single available index.

29. An overall index of the riskiness of investing in a country based on 11 factors from the Business International index (one of which is the corruption index) was associated with both lower investment rates and lower growth rates (Mauro 1995).

30. The second index is from the *World Competitiveness Report*, published by the EMF Foundation in Geneva. It covers only 32 countries and excludes Africa, Eastern Europe (except Hungary) and Latin America (except Mexico and Brazil).

31. Rose-Ackerman (1978, p. 163); "Bribes and Publicity Mark Fall of Mexican Drug Lord", *New York Times*, May 12, 1996; "Mexican Connection Grows As Cocaine Supplier to U. S.", *New York Times*, July 30, 1996; "Popular Revulsion Is New Factor in Chronic Colombian Drug Scandal", *Washington Post*, January 28, 1996.

32. "Airport Customs Harnesses 3 Billion Mexican Pesos Per Year", *El Economista*, February 13, 1992.

33. "Mexico Fine-Tuning Customs Area Ahead of NAFTA", *Reuters News Service*, February 24, 1993.

34. For examples of debarment see, "Singapore Blacklists Scandal-Tinged Firms", *Nikkei Weekly*, February 19, 1996; Thacher (1995), who describes the practices used by the New York City School Construction Authority.

35. "Court Removes Rao as Head of Political Bribes Investigation", *The Times*, March 2, 1996.

36. "Indonesia Magazine Ban Overruled", *Financial Times*, May 4, 1995; "Jakarta Court Reverses Ban on Tempo Magazine", *Business Times*, May 4, 1995.

37. "Spanish Court Overturns Ruling on Secret Funds", *Financial Times*, February 22, 1995.

38. United Nations (1990, pp. 23–24). See also Antoniou (1990) and Pope (1996, pp. 73–78).

39. Thacher (1995); “New York City Builds a Better Watchdog”, *New York Times*, March 14, 1996.

40. Cadot (1987). Dey (1989) and Rose-Ackerman (1978, pp. 170–79) note that interactions may also occur between officials with no formal hierarchical connections. For example, a person trying to build a house may need to obtain the permission of several different government offices. Dey suggests that networks of corrupt officials can develop under such conditions.

41. “Informant’s Revelations on Cali Cartel Implicate Colombian Officials”, *Washington Post*, January 28, 1996.

42. Fort Lee, New Jersey, across the Hudson River from New York City was one example. The wealthy organisers of illegal gambling games, however, made one mistake—they invested in Fort Lee condominium projects. These projects soon filled up with young, reform-minded professionals who voted in a reform mayor and city council committed to closing down the gambling industry in their town (Amick 1976, p.89).

43. On July 23, 1996 the World Bank Executive Directors approved changes in the Bank’s General Conditions Applicable to Loan and Guarantee Agreements. Section 6.03 was expanded to include corruption or fraud by representatives of the borrower or by the beneficiary of the loan as grounds for canceling the part of the loan affected. The borrowing country can, however, defend itself against cancellation by taking “timely and appropriate action satisfactory to the Bank to remedy the situation”. Furthermore, the *Guidelines for Procurement under IBRD Loans and IDA Credits* has been amended to add a new paragraph (1.15) stating that the Bank will reject a proposal for an award “if it determines that the bidder recommended for award has engaged in corrupt or fraudulent practices in competing for the contract in question”. In other words it is not sufficient to know that the bidder engaged in corruption to obtain other contracts. The Bank will also cancel a contract if corrupt or fraudulent practices are revealed later on. Firms found to

have engaged in corrupt or fraudulent practices with respect to Bank-financed projects will be declared ineligible for further contracts “either indefinitely or for a stated period of time”. The Bank will have the right to require that it be able to inspect the records of suppliers and contractors relating to their Bank contracts. The Bank also requires that all commissions paid to agents, both before and after the contract is signed, be disclosed to the Bank. For an overview see Shihata (1996).

44. “Judge Backs Competition in Trash-Hauling Industry”, *New York Times*, February 28, 1994; “The Garbage Wars: Cracking the Cartel”, *New York Times*, July 30, 1995; “Monitors Appointed for Trash Haulers”, *New York Times*, December 23, 1995.

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