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Removing Impediments to Sustainable Economic Development

The Case of Corruption

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Abstract

This paper examines causes and consequences of corruption within the process of economic development. It starts by reviewing some of the factors that, over the past couple of decades, have transformed corruption from a subject on the sidelines of economic research to a central preoccupation of policy makers and donors in many countries. Drawing on a vast treasure trove of experiences and insights accumulated during the postwar period and reflected in a growing body of academic research, the paper analyzes many of the institutional mechanisms that sustain corruption and the impact of corruption on development. This paper argues that many forms of corruption stem from the distributional attributes of the state in its role as the economy's central agent of resource allocation. What is the impact of corruption on public finances and on the characteristics and performance of the private sector? What distortions does corruption introduce in the allocation of resources and in the relationships among economic agents in the marketplace? The paper also addresses the question of what can be done about corruption and discusses the role of economic policies in developing the right sorts of incentives and institutions to reduce the incidence of corruption. Particular attention is paid to business regulation, subsidies, the budget process, international conventions, and the role of new technologies. The paper concludes with some thoughts on the moral dimensions of corruption.

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1. Introduction

The past 20 years or so have witnessed a remarkable shift in our understanding of what are the factors that matter for creating the conditions for sustainable economic growth and development. While perhaps it would be a slight exaggeration to say that a revolution has taken place, there is little use denying that the focus of the economics profession has broadened in major ways, as we have come to comprehend better the role of such factors as education and skills, institutions, property rights, technology, transparency and accountability. On the whole this broader outlook has been beneficial, an implicit recognition that promoting inclusive growth will be a multidimensional undertaking and that those concerned with assisting policy makers everywhere in implementing more successful policies will have to address an expanding set of non-traditional concerns.

This paper deals with one of these concerns. It examines the role of corruption and its multifaceted interactions with the process of economic development. In section 2 we begin by examining some of the factors which, over the last couple of decades, may have contributed to confer issues of corruption a certain legitimacy within the economics profession, that have transformed it from a subject very much in the sidelines of economic research into a central preoccupation of the donor community and policy makers in many countries. Section 3 provides some working definitions of corruption and explores some of the principal sources of corruption. We argue that many forms of corruption stem from the distributional attributes of the state in its role as the economy's central agent of resource allocation.

Section 4 examines the impact of corruption on development, drawing on a vast treasure throve of experiences and insights accumulated during the postwar period and reflected in a growing body of academic research. We look at the impact of corruption on the public finances, and on the speed and characteristics of private sector development. We examine the distortions that it introduces in the allocation of resources and the various insidious ways in which it vitiates the nature of relationships among economic agents in the marketplace. Section 5 addresses the question of what can be done about corruption and the role of economic policies in creating an environment that provides the right sorts of incentives and institutions to reduce the incidence of corruption. We pay particular attention to business regulation, subsidies, the budget process, international conventions, and the role of the new technologies. We conclude with some thoughts on the moral dimensions of corruption.

2. Changing Perspectives

A taboo subject

It was not so long ago that formal discussion about corruption at international financial institutions such as the International Monetary Fund and the World Bank was taboo. The subject was not mentioned in policy papers prepared by the staffs of either organization or at meetings of the Executive Board and it was not alluded to in the context of the intense policy dialogue between the staffs of either institution and country authorities. Though it would have been impossible not to notice that corruption was rampant in many parts of the world, there was a conscious choice to sidestep the issue, considering it a form of interference in domestic politics, something that neither organization was willing to do. Article IV of the World Bank's Articles of Agreement, for instance, clearly warns: "The Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions, and these considerations shall be weighed impartially in order to achieve the purposes stated in Article 1." This had been fairly narrowly interpreted by the Bank's Legal Counsel, in case any Bank employee entertained thoughts about any possible connection between the prevalence of corruption and the Bank's primary purpose, as stated in Article 1, which referred to the "reconstruction and development of territories of members…and the encouragement of the development of productive facilities and resources in less developed countries."[2]

I was told in the late 1980s—as part of the folklore that was passed on to young economists soon after they joined—that a deputy director in the African Department of the IMF had had the temerity to mention corruption at a meeting of the Executive Board and been forced into early retirement. I had no way to confirm whether the story was real or apocryphal, but it certainly rang true and was fully consistent with the virtually zero attention given to corruption and its implications in the everyday work of the organization, even in countries with long traditions of widespread corruption at the highest levels of government.

2 The IMF's own Articles of Agreement do not contain a specific prohibition against interference in political affairs. Article I, which lays out the purposes of the organization, refers to the promotion of international monetary cooperation and exchange rate stability, the facilitation of international trade, "the establishment of a multilateral system of payments," and the provision of loans to support the countries' balance of payments. It is not clear why the founders chose to make this prohibition explicit in the case of the World Bank and to sidestep it altogether in the case of the Fund. One possible interpretation is that given the narrower and more technical focus of the Fund, they could not imagine that issues of political interference would ever arise in the day-to-day work of the organization.

A gradual shift in attitude

Sometime in the late 1980s and early 1990s there was a shift in thinking within the development community and at the international financial institutions about the role of corruption in the development process.[3] The shift was tentative at first, with increasing references in the speeches of the heads of both organizations to the role of "good governance" in encouraging successful development. It is perhaps not possible to pinpoint a single factor which may have precipitated a change of heart and a growing recognition of the role of institutional and other factors—beyond economic stabilization—in promoting economic growth and development. One that comes to mind stems from the falling of the Berlin Wall and the associated collapse of central planning as a supposedly viable alternative to free market capitalism. It was obvious that it was not inappropriate monetary policies that led to the collapse of central planning but rather widespread institutional failings, including a lethal mix of authoritarianism (therefore, lack of accountability) and corruption.

The collapse of central planning in the late 1980s and the need for the international community to assist these countries in making a successful transition to democratic forms of governance and economies based on market principles made it glaringly clear that it would take far more to do so than "getting inflation right" or reducing the budget deficit. Literally overnight, the economics profession was forced to confront a much broader set of issues beyond conventional macroeconomic policy. This was particularly intensely felt in countries such as Russia, given the economic collapse that followed the dissolution of the Soviet Union and the decision to abandon the mechanisms of central planning, given their utter failure to deliver anything that one might call sensible economic development. Related to the demise of central planning, the end of the Cold War had clear cut implications for the willingness of the international community to recognize glaring instances of corruption in places where ideological loyalties had led to episodes of collective blindness. Michaela Wrong (2009, p. 184) puts it thus: "the cynical realities of the Cold War required loyalty payments, and if those had to be made to military dictators and autocrats with blood on their hands in the knowledge that little would reach the poor, so be it." By the late 1980s, Mobutu was cut off by the donor community, no longer willing to quietly reward him for his persistent loyalty to the West during the Cold War.

A second factor which had the same effect was growing frustration with the plight of people in Africa and other parts of the developing world. Gains in the global fight against poverty had began to bear some fruit but these were largely concentrated in China, with Africa actually seeing further increases in the number of poor, both in absolute numbers and as a proportion of the population. I was an economist in the Development Issues Division of the IMF during the late 1980s and early 1990s and distinctly remember efforts by the IMF staff—particularly in Africa—to look beyond macroeconomic stabilization to issues of structural and institutional

3 For a review of the role of international institutions in anti-corruption policy, see Rose-Ackerman (2011).

reforms. The focus may not have been exactly right, the organization may have had a powerful inertia in its conditionality and other internal practices and in relying on conventional formulations about credit growth and the budget deficit. Thus, it may not have been ready yet to confront issues such as the impact of pervasive corruption. But there is little doubt in my mind that it tried to broaden the limits of debate to include a broader array of non-traditional concerns.

A third factor surely had to do with developments in the academic community. In particular, research on the importance of property rights, education and training, and institutions, including some empirical work which began to suggest that differences in institutions appeared to explain an important share of the growth differential between countries, and therefore have an influence upon countries' growth performance, well beyond simply getting inflation right or addressing other macroeconomic weaknesses. It is no exaggeration to say that in respectable academic circles, corruption began to be seen as an *economic* issue—whatever the Articles of Agreement of the World Bank might hint to the contrary—and this led to a better understanding of the economic effects of corruption, a topic to which we will turn our attention shortly.

Also playing an important role was the intensification, beginning in the 1980s, of the pace of globalization. I remember accompanying my friend Jonathan Schell, who was visiting Moscow in 1993, to a meeting with Gennady Burbulis, a top adviser to Russian President Boris Yeltsin. Schell's book *The Fate of the Earth*, published in 1982, had, according to prominent Russians I met in Moscow, been instrumental in precipitating a major shift in the thinking of senior Russian officials, from Mikhail Gorbachev down to key members of the military establishment, about the economic sustainability of the Cold War. The Soviet Union had been on a Cold War footing for decades and the collapse of oil prices in 1986 persuaded them that the arms race was likely to end in penury and economic collapse, if it did not lead to a nuclear holocaust. In either case the *status quo* was no longer a rational choice. In response to a question from Schell about the causes for the demise of the Soviet empire, Burbulis noted the opening up begun by Gorbachev and, in particular, the sudden access to vast amounts of information about life in the capitalist West. Suddenly, the myth that central planning was a legitimate and efficient alternative to heartless Western-style capitalism was shown for the lie that it was. As Soviet citizens began to travel abroad in greater numbers and as the restrictions on freedom of the press were relaxed, the misery of life in the Soviet Union became fully, painfully evident.[4] Not only did citizens in the West enjoy a much higher standard of living than in the Soviet Union, but they did so in the context of democratic forms of governance and respect for individual freedoms.[5]

4 For an eloquent portrayal of the plight of Russian women during this period, with particular reference to the medieval quality of the Soviet Union's health services and other such facilities, see, for instance, Francine Plessix Gray's 1989 book, *Soviet Women: Walking the Tightrope*.

5 Of course, there was plenty of misery in the developing world but, to most Russians, this was not the relevant comparison. The Soviet Union's adversaries (and, therefore, relevant benchmark for purposes of comparison) were not the Islamic Republic of Iran or Bolivia, but the United States and its NATO allies.

Globalization and its supporting technologies have clearly led to a remarkable increase in transparency and to people's demand for openness and greater scrutiny. Friedman (1999) calls this process the democratization of information. The multilateral organizations were not immune to these influences. How could one ignore or fail to see the stashing away of billions of dollars of ill-gotten wealth in secret bank accounts by the world's worst autocrats, many of them long-standing clients of these organizations? One implication of this was that sometime in the early 1990s, the IMF—the content of whose reports had always been regarded as strictly confidential—began to be far more open and, with some exceptions, started to put large numbers of country staff reports on its website. Of course, the moment it began to do so, it significantly expanded the perimeter of permissible debate. Old habits die hard and the decision to make country reports publicly available did not immediately lead to a quantum leap in candor in staff assessments. But there was little doubt that the environment had changed and corruption could no longer be swept under the carpet.

In parallel to these developments and further raising international public awareness of corruption, the 1990s witnessed a large number of scandals involving major political figures in some form of bribery or corruption. In India and Pakistan the prime ministers were defeated largely because they were dogged by corruption charges. In South Korea two presidents were jailed following disclosures of bribery, while in Brazil and Venezuela bribery charges resulted in the presidents being impeached and removed from office. The president in Colombia survived impeachment but his reputation was tarnished as a result of campaign financial contributions from a drug cartel and his party lost the next election; the president of Ecuador was less fortunate, forced to quit and leave the country under a cloud of scandal. The credibility of the president of Mexico suffered, when it was revealed that his brother had accumulated vast sums in questionable dealings. In Italy, Italian magistrates sent to jail a not insignificant number of the political class, who had ruled the country in the post-war period, and exposed the vast web of bribery that had bound together political parties and members of the business community. There was less progress in Africa but, without question, corruption became harder to hide and the new technologies of communication proved a useful ally of increasing openness and transparency.

A related development that comes to mind in thinking about why corruption became a legitimate concern for the development community pertains to changes in the global economy, which significantly boosted the perceived importance of productivity as a primary engine of prosperity. Globalization highlighted the importance of efficiency. Countries could not hope to maintain their presence in the global economy and compete in an increasingly complex marketplace, unless they used scarce resources effectively. And the prevalence of corruption definitely detracted from this. Furthermore, business leaders began to speak more forcefully about the need for a level-playing field and the costs associated with doing business in corruption-ridden environments.

There seems to be little doubt that in the 1990s the United States government made efforts to keep the issue of corruption alive in its discussion with OECD partners, further raising international awareness. The Foreign Corrupt Practices Act of 1977 had forbidden American businessmen and corporations from bribing foreign government officials, imposing stiff penalties, including prison terms, on those engaged in the paying of illegal bribes. Because other OECD countries were not subject to such restrictions—in fact, the payment of bribes continued to be tax deductible in most other OECD countries, as a cost of doing business abroad—American companies began to complain that they were losing business to France, Germany, Japan and others. Those who had pushed for the U.S. anti-bribery legislation had argued that it would discourage corruption and thus remove a bias against those American firms that did not engage in bribery. Instead, academics sifted through the data and showed that following passage of the Act, U.S. business activities abroad declined substantially, as the Act had actually helped to undermine the competitive position of American firms.[6] Foreign direct investment, joint venture activity, and aircraft exports, for instance, had all contracted sharply in amounts that were equivalent to something like a 30 percent reduction in GDP in the host countries. These developments gave considerable impetus to U.S. government efforts to persuade other OECD members to ban bribery practices. In 1997, the OECD adopted the Anti-Bribery Convention, with members committing themselves to "take such measures as may be necessary to establish that it is a criminal offense under its law for any person intentionally to offer, promise or give any undue pecuniary or other advantage, whether directly or through intermediaries, to a foreign public official."

Also contributing to this shift in attitude was the work of Transparency International (TI) and the publication, beginning in 1993, of its now well-known *Corruption Perceptions Index* (CPI). That corruption existed everywhere was a well-known fact. What TI showed was that some countries had been more successful than others in curtailing it and that it was possible to build a simple index that would attach a corruption score to each country. The work of TI, including the formulation of anticorruption initiatives in such areas as public procurement, conflict of interest, and freedom of information laws, as well as the formation of an extended network of national chapters in more than a hundred countries, helped greatly to focus public attention on the issue of corruption. Many governments disliked the CPI and severely criticized it, a sure sign of its effectiveness. I believe TI contributed to legitimizing public discourse on issues of corruption and thus eased the transition by the multilateral organizations into doing the same. It would be some time before these organizations would actually begin to do anything serious about it—such as, for instance, withholding loan disbursements in the presence of serious shortcomings in the use of public resources—but at least staff members were no longer being forced into early retirement for raising the issue. More important, economists began to broaden the debate as to the elements of a more integrated approach to economic development, one that went beyond the

6 See Hines, James R. "Forbidden Payment: Foreign Bribery and American Business After 1977", NBER Working Paper 5266, September 1995.

narrow confines of macroeconomic stabilization and an overwhelming focus, in the case of the IMF, on inflation and the budget deficit.

Transparency International was soon assisted in its efforts by the international organizations themselves. At the IMF/World Bank meeting in 1996 the Bank president, James Wolfensohn, gave a speech in which he did not mince words, saying that there was a collective responsibility to deal with "the cancer of corruption." In country after country—he said—"it is the people who are demanding action on this issue. They know that corruption diverts resources from the poor to the rich, increases the cost of running businesses, distorts public expenditures, and deters foreign investors. They also know that it erodes the constituency for aid programs and humanitarian relief. And we all know that it is a major barrier to sound and equitable development." Recognizing that the Bank "cannot intervene in the political affairs of our member countries," he nevertheless promised that the Bank would "not tolerate corruption in the programs that we support." More important, Mr. Wolfensohn invited Transparency International to assist the Bank in the development of its anticorruption strategies and gave strong backing to Bank staff efforts to develop a broad range of governance indicators, including those specifically capturing the extent of corruption. This was an extremely important development because it made it possible for the Bank, through the use of quantified indicators and data, to focus attention on issues of governance and corruption while at the same time not appearing to interfere in the political affairs of its members. The Bank's Governance Indicators shifted the nature of the debate on corruption, from abstract (and necessarily controversial) discussions about the widespread incidence of corruption in, say, Kenya's public sector, to evidence-based analysis of internationally comparable composite indicators drawn from a large number of credible sources. (See Table 1.)

Table 1. World Bank: Control of Corruption for Selected Countries 2000 and 2012

	2000	2000	2012	2012	Corruption Perception Index 2012	
Country	Point Estimate	Percentile Rank	Point Estimate	Percentile Rank	Score	Ranking
Denmark	2.52	100	2.39	100	90	1
New Zealand	2.36	99	2.32	100	90	1
Sweden	2.40	99	2.31	99	88	4
Norway	2.29	97	2.24	99	85	7
Finland	2.59	100	2.22	98	90	1
Switzerland	2.21	95	2.15	98	86	6
Singapore	2.29	97	2.15	97	87	5
Australia	1.96	94	2.00	96	85	7
Canada	2.23	96	1.92	95	84	9
Germany	1.90	93	1.78	94	79	13
United Kingdom	2.24	96	1.64	92	74	17
Japan	1.23	86	1.61	92	74	17
Chile	1.54	92	1.56	91	72	20
United States	1.66	93	1.38	89	73	19
Spain	1.33	87	1.05	82	65	30
Estonia	0.65	75	0.98	80	64	32
Taiwan	0.75	78	0.72	74	61	37
Poland	0.55	72	0.59	72	58	41
Korea	0.25	65	0.47	70	56	45
Lithuania	0.19	64	0.31	66	54	48
Hungary	0.69	76	0.28	65	55	46
Czech Republic	0.08	62	0.23	64	49	54
Turkey	-0.33	47	0.17	63	49	54
Latvia	-0.29	48	0.15	63	49	54
Italy	0.72	77	-0.03	58	42	72
Brazil	0.02	60	-0.07	56	43	69
South Africa	0.61	73	-0.15	54	43	69
Bulgaria	-0.21	52	-0.24	52	41	75
Zambia	-0.85	21	-0.36	46	37	88
Mexico	-0.24	51	-0.41	43	34	105
China	-0.24	51	-0.48	39	39	80
Argentina	-0.34	47	-0.49	39	35	102
Algeria	-0.95	14	-0.54	36	34	105
India	-0.37	46	-0.57	35	36	94
Egypt	-0.39	44	-0.57	34	32	118
Ethiopia	-0.49	38	-0.60	32	33	113
Indonesia	-0.89	19	-0.66	29	32	118
Iran	-0.57	32	-0.82	24	28	133
Uganda	-0.85	21	-0.95	18	29	130
Russia	-0.92	17	-1.01	16	28	133
Ukraine	-1.07	8	-1.03	16	26	144
Pakistan	-0.82	22	-1.06	14	27	139
Kenya	-0.95	14	-1.10	12	27	139
Nigeria	-1.13	6	-1.13	11	27	139
Venezuela	-0.53	35	-1.24	7	19	165
Angola	-1.52	2	-1.29	5	22	157
Congo, Dem. Rep	-1.57	1	-1.30	4	21	160

Sources: World Bank Governance Indicators, Control of Corruption 2012. Control of corruption scores range from -2.5 to +2.5. Transparency International, Corruption Perception Index 2012.

An episode that may have helped significantly to change people's perceptions about the potentially destructive effects of widespread corruption was the unraveling of Indonesia in 1997-98. Asian economies had had the best growth performance during the post-war period compared to all other regions in the world and Indonesia was a star performer among them, growing at roughly twice the average rate for the region for extended periods of time and more than three times the average for the world as a whole. Not surprisingly, given this excellent growth performance and the success in poverty reduction, increases in average life expectancy and reductions in adult illiteracy in Indonesia also tended to outpace the average for the rest of the world. By the mid-1990s there was broad consensus among development professionals that a combination of sound macroeconomic management, the existence of a thriving entrepreneurial class, and political stability had all been key factors in explaining the impressive evolution of Indonesia's economic and social indicators.

This all unraveled with impressive speed during the Asian financial crisis of 1997, when the full extent of corruption under the Suharto regime emerged in the context of efforts by the multilateral organizations to assist the government to restore confidence in the country's economy and its institutions. In his account of the Asian crisis, Paul Blustein (2001, p. 91) notes: "By the 1990s the Suharto family's avarice was so pervasive that almost any foreign firm investing in, say, a power plant or phone system or petrochemical factory had to hand over lucrative partnership rights to one presidential relative or another to grease the project's way through the country's bureaucracy. Bambang Trihatmodjo, Suharto's second-eldest son, headed the Bimantara Group, which was granted a television license, special concessions for overseas distribution of the state petroleum company's products, and high tariffs to protect a $2.2 billion plastics plant built jointly with German and Japanese multinationals. Suharto's daughters also became multimillionaires thanks to government-granted contracts to build power plants and toll roads, among other ventures."

Furthermore, the rot extended to the banking system where a World Bank mission had found extensive evidence of Suharto pressure on banks to funnel loans to favored companies, with banks cooking their books to give the appearance of improving balance sheets. According to Blustein, bank loan officers were approving new loans to clients who were in arrears on old loans and the loan documentation was so poor as to suggest a combination of incompetence and bribery on a large scale. Weak lending standards, heavy exposure to the property market, heavy government involvement in the banking sector and high levels of "connected lending"—coupled with widespread expectation that if banks failed, the government would bail out depositors, creditors and shareholders—eventually led to the collapse of the Indonesian banking system in a drama that, a decade later, would play itself out in the United States in a fascinatingly similar fashion. While Indonesia was clearly the more extreme case of unraveling during the Asian crisis, corruption was also endemic in South Korea, Thailand and Malaysia and some of the same factors played a central role in these countries' own crises during 1997-98.

Tanzi (1998) makes an interesting additional point in explaining the increased attention given to corruption in policy making circles. The incidence of corruption, he claims, has been on the rise over the past several decades and by the 1990s had become so ubiquitous as to be no longer possible to ignore.[7] In a paper published in the *American Economic Review* in 1997 Tanzi showed the extent to which government operations had expanded during the twentieth century. Looking at a set of 13 industrial countries, he noted that total government spending in relation to GDP had been about 12 percent on average in 1913, but had risen to 43 percent by 1990, with some countries having levels of spending closer to 55-60 percent of GDP. Revenues, of course, had risen accordingly. Higher taxes and higher spending reflected a substantial transformation in the role of the government in the economy, with governments by the 1990s heavily involved in education, health, social security, unemployment compensation, research and development, and numerous other activities. With this significant expansion in the scope of government activity and in the actual numbers of people engaged in carrying out or delivering a broader set of government goods and services, there was, he argues, a corresponding increase in the degree of government regulation and intervention in the economy, a development which created new opportunities for corruption. The expansion in the size and the role of the government also affected the developing countries, but these typically did not have long traditions of good governance and strong institutions, leading to a proliferation of opportunities for bribery and malfeasance. Two other factors which are also likely to have contributed to rising corruption are the rapid growth of international trade in the post-war period—again, vastly expanding the scope for the payments of bribes and "commissions"—and, more recently, the privatization process, particularly in transition economies. One might add to these two factors the rapid growth of foreign direct investment, pari passu with the growth of international trade. Tanzi believes these factors to have contributed to the spread of corruption as "a contagious disease," further raising public awareness.[8]

3. Corruption and Its Sources

For the reasons outlined above the 1990s witnessed the appearance of a large number of academic studies examining different dimensions of corruption: its causes, impact, and the institutional mechanisms that sustained it, often with a particular focus on the developing world

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7 The World Bank indicator called "control of corruption" shows that for a group of 47 countries accounting for the lion's share of world GDP, corruption was worse in 2012 than in 2000 for 30 countries and was unchanged or slightly better in the remaining 17, not a very encouraging picture for the global fight against corruption.

8 Daniel Kaufmann (2005, pp. 96-98) uses survey data for a large number of countries in which households and firms report on average bribery payments as a share of sales (for companies) to provide an estimate for the total annual worldwide bribery payments. His figure, which excludes leakages from budgets and theft of public assets, amounts to US$600 billion -US$1.5 trillion per year. Kaufmann's methodology—described in detail in his 2005 paper—is conservative and actual bribery figures are likely to be higher, nearer the upper limit of his range estimate, and possibly higher.

where its costs were assumed to be highest. In addition to insights derived from the academic community, the greater willingness on the part of the international financial organizations to look at corruption in the context of their overall mandate for promoting economic development also provided a significant body of knowledge based on on-the-ground experience. It will be useful to review briefly what, in fact, we have learned about the sources of corruption in the past thirty or so years.

What do we mean by corruption? For many development practitioners it has generally meant the "abuse of public office for private gain." Andrei Shleifer and Robert Vishny (1993) defined *government* corruption as "the sale by government officials of government property for personal gain." Nathaniel Leff, a Harvard researcher who wrote one of the earliest pieces in the academic literature on corruption—at a time when it was not on the radar screen of either the IMF, or the World Bank, or bilateral donors—said that "corruption is an extra-legal institution used by individuals or groups to gain influence over the actions of the bureaucracy."[9] Joseph Nye (1967, p. 418) said that corruption is "behaviour which deviates from the formal duties of a public role because of private-regarding (personal, close family, private clique) pecuniary or status gains", and includes bribery, nepotism and misappropriation. In his review of the literature on corruption Bardhan (1997, p. 1321) says that in most cases "corruption ordinarily refers to the use of public office for private gains, where an official (the agent) entrusted with carrying out a task by the public (the principal) engages in some sort of malfeasance for private enrichment which is difficult to monitor for the principal." Klitgaard (1988, p. 22) draws on the principal/agent formulation to say that corrupt behavior occurs when "the agent is betraying her role as a public servant for her own private interests." Banfield (1975, p.587) establishes an interesting distinction between *personal corruption*, in which the agent "sacrifices his principal's interest to his own, that is, he betrays his trust" and *official corruption* in which the agent violates a law and "acts illegally or unethically albeit in his principal's interest." More recently, the principal/agent formulation has been adopted by Banerjee, Mullainathan and Hanna (2012) to develop a new theoretical framework for analysing corruption. In their model, corruption is a consequence of the interaction between the task being performed by the bureaucrat, his/her private incentives and what the principal can observe and control.

Daniel Kaufmann (2005) makes a strong case for a broader definition of corruption, not necessarily restricted to an exclusive concern with illegal acts involving the public sector. In his view corruption generally involves collusion between two or more parties, at least one of which operates in the private sector, as when a transnational company pays bribes to the president of an African country to obtain an oil concession. Furthermore, some forms of corruption may be legal in some countries, such as when certain mechanisms of political party funding are artfully used

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9 Nathaniel H. Leff's paper "Economic Development Through Bureaucratic Corruption" was published in 1964 in *The American Behavioral Scientist*. It was fairly controversial in tone and content and we shall later examine some of its claims.

to exert critical influence in the shaping of policies and institutions in ways that provide benefits to the contributing private parties at the expense of the broader public welfare, a process akin to the "privatization of public policy." Such instances of undue influence may not involve the payment of bribes but, on the whole, are conceptually indistinguishable from more conventional forms of corruption involving the abuse of public power for private benefit. The public sector bias in the conventional definitions of corruption may reflect the sense that corruption is more damaging in the context of developing countries, where the claims on scarce resources are more pressing—these countries will often have high levels of poverty and many unmet social needs, including weak institutions—and where the evidence suggests that it is often the government that bears the primary responsibility for its prevalence. As an example, an empirical study by Bhattacharyya and Hodler (2012) shows that higher rents from natural resources lead to a higher level of corruption, but only if the quality of the democratic institutions is relatively poor.

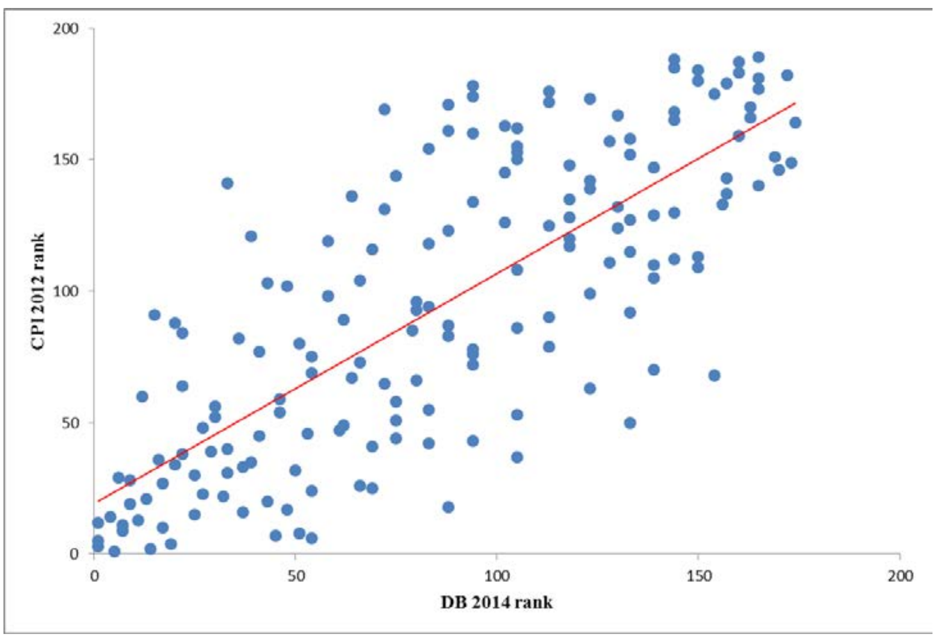
The state as regulator and rationing agent

Economists seem to be agreed that an important source of corruption stems from the distributional attributes of the state. For better or for worse, the role of the state in the economy has expanded in a major way over the past century and this has led to the proliferation of benefits under its control and also in the various ways in which the state imposes costs on civil society and the business community. While a large state need not necessarily be associated with higher levels of corruption—the Nordic countries have the highest levels of public spending in the world but are also the least corrupt—it is the case that, at least in principle, the larger the number of interactions between officials and private citizens, the larger the number of *opportunities* in which the latter may wish to illegally pay for benefits to which they are not entitled, or avoid responsibilities or costs for which they bear an obligation. A recent empirical paper by Fan, Lin and Treisman (2012), using survey data from 80 countries, provides evidence that firms are more likely to report bribery in countries with more government tiers, or with a larger number of local government employees.

In those countries where the state is involved in the distribution of social benefits, but in ways that are not transparent, and which may involve corruption, these will not be equitably distributed and the poor—less able to pay/bribe—will be at a disadvantage. In such cases, the intent of social policy will be distorted and, if the problem is serious enough, perverted.

Governing often translates into the issuing of licenses and permits. From the cradle to the grave, the average citizen has to enter into transactions with some government office or bureaucrat to obtain a birth certificate, to get a passport, to pay taxes, to open up a new business, to drive a car, to register property, to engage in foreign trade, to sell a good or service to the government, to hire an employee, to use the publicly provided health services, to be allowed to build a house, among countless others. The World Bank's *Doing Business Report* (DBR) has become an excellent annual compendium of the burdens of business regulation in 183 countries. The picture that emerges from the report for a large number of countries is not a pleasant one.[10] For instance, it takes 18 procedures in Equatorial Guinea to start a new business and an average of 135 days to fulfill them. It takes 1,442 days to enforce a contract in Bangladesh and 1,300 in Greece. In Argentina it takes 24 procedures to get a construction permit and 365 days to actually receive it. In fact, the data in the report eloquently highlights the extent to which many countries *discourage* the development of entrepreneurship in their own private sectors. The sobering irony of the DBR is that those countries with the greatest need for entrepreneurship and private sector development are those that generally create the greatest obstacles for the creation of new enterprises, or that otherwise intervene in ways that retard the emergence of entrepreneurial capacities which are so central to the development of an enabling environment for innovation. Not surprisingly, the prevalence of corruption is highly correlated with the incidence of red tape and excessive regulation. The figure below shows the country rankings for Transparency International's *Corruption Perceptions Index* and the rankings for the World Bank's DBR for a total of 172 countries. The figure speaks for itself: the greater the extent of bureaucracy and red tape, the greater the incidence of corruption—the correlation coefficient is close to 0.80.

Figure 1. 2012 Corruption Perceptions Index vs. 2014 Ease of Doing Business Ranks



Sources: Transparency International (2012) and World Bank 2014 Doing Business Report.

10 The *Doing Business Report* is available free of charge, at: www.worldbank.org

A number of surveys have shown that businesses allocate considerable time and resources to dealing with the demands of red tape. Often, they may feel that the paying of bribes is a way to save time and enhance efficiency and, in many countries, possibly the only way to get business done without undermining the firm's competitive position vis-à-vis those who pay bribes routinely. Obviously, the more dysfunctional the economic and legal system are and the more onerous the regulations, the greater the incentives for individuals and businesses to short-circuit it through the paying of bribes. In his 1964 paper, Nathaniel Leff made this point in a number of ways, expanding the argument beyond purely cumbersome regulations, but also with reference to damaging policies. He gave the example of poor harvests in Brazil and Chile in the early 1960s, resulting in upward pressures on food prices. Both governments decided to freeze food prices, ordering the bureaucracies to enforce price controls. In Chile, a reasonably honest bureaucracy was quite successful in maintaining price controls, with a correspondingly adverse effect on food supplies. In contrast, in Brazil, a combination of inefficiency and bribery was very effective in sabotaging the enforcement of price controls, but the result was increased food production. Or, as Leff put it: "we see the success of entrepreneurs and corrupted officials in producing a more effective policy than the government" (p. 12). Nye (1967, p. 420) provides similar examples; the absurdities of central planning in the Soviet Union induced "corruption" on the part of the factory managers, to add a degree of flexibility to a system that made a mockery of efficiency in resource allocation.[11]

In East Africa, active discrimination against Asian minorities forced them to find accommodation with their oppressors through bribery and corruption. Leff argued that those who viewed corruption as an unremittingly bad thing were implicitly assuming that governments were well-motivated and committed to the implementation of policies that advanced the cause of economic development. In reality, however, Leff thought that in many countries policies were largely geared to advancing the interests of the ruling elite. Carried away by his arguments, he questioned whether the internal revenue bureaucracy should be unduly criticized for unenthusiastic tax collection efforts if the government, for instance, was not particularly committed to economic development but showed a weakness for, say, new jet aircraft for the air force. In such a case "the money saved from the tax collector may be a gain rather than a loss for development" (p. 12).[12] Without stating so explicitly, Leff, and somewhat later Nye (1967)

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11 The more insane the rules, the more likely will participants in the system find themselves breaking them.

12 Noonan (1984, p 646) relates the story of the philosopher Ludwig Wittgenstein who, while living in England, learned that the annexation by Germany of Austria would mean that his two sisters living in Vienna would be subject to the Nazi laws on race. Wittgenstein travelled to Germany and arranged for the Nazi authorities to leave his sisters alone in exchange for the payment of a sum of money deposited at the Reichsbank from the family fortune in Switzerland. Noonan adds: "when you have a right to a civil good—property, fair treatment, peace—you have a right to prevent its unjust denial. To use effective and necessary means of securing the right is not unjust. These means include an exchange with the power holder who is unjustly denying you your due." Noonan argues that when conditions in society have deteriorated to such an extent that they approach warfare against the oppressed—the Germany into which Wittgenstein made his appearance—then it is justified to "buy back harassment" (*redimere*

seemed to be suggesting that corruption was a response to market distortions, to red tape, excessive and unreasonable regulation and bad policies but these, in turn, were also themselves affected by the levels of corruption prevailing in the country, in a symbiotic two-way form of causality that turned corruption into an intractable social and economic problem. Reading these two early papers one is tempted to ask: How does a reform-minded government get started? This is a question to which we will turn shortly. While it is clear that bribes and corruption may in some cases be responses to the existence of distortions in the economy, we will see that far from enhancing efficiency, in general they imply heavy costs for society, across a broad range of fronts.

Tanzi (1998) argues that the tax system itself is often a source of corruption, particularly in those cases where the underlying legislation is unclear or otherwise difficult to understand, presumably giving tax inspectors and auditors considerable leeway in interpretation. Unclear tax laws will give rise to unwholesome "compromises" between tax inspectors and taxpayers. More generally, there are numerous ways in which various features of government organization and policy create incentives for the emergence of corrupt behavior. As noted above, the imposing presence of the government in the economy and, in particular, the provision of goods and services at below market prices create fertile ground for corruption. Invariably, they give rise to the creation of some form of rationing mechanism to manage excess demand, requiring the exercise of discretion on the part of some government official(s). One of the first projects engaging the IMF in early 1992 was assisting the Russian government in unifying the exchange rate. The Soviet Union had operated under a highly complex system of multiple exchange rates. I remember a meeting at the Central Bank of Russia in the spring of 1992 in which we were shown an annex running into several pages with the exchange rates that applied for the importation of various items, from luxury cars, to medications to baby carriages. Some bureaucrats had managed to come up with some mysterious criteria establishing dozens upon dozens of prices for foreign exchange, depending on the item to be imported. Needless to say, the list allowed considerable latitude for interpretation and discretion.[13]

The Russian government in 1992 operated under a system of export quotas, for which licenses were needed. Since the difference between the export price and the domestic price was often enormous (a ratio of 50 to 1 was not at all unusual), securing an export license was a key to vast riches and, indeed, fortunes were made during this period, sometimes by government officials themselves who found the system just too tempting to scrap. The IMF pressed hard for the elimination of these quotas and the meetings where the case was raised were often hostile—it

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vexationem). However, "the existence of exceptions does not disprove a moral value. The exception is admissible only when the social order and attendant trust are seriously impaired."

13 With considerable trepidation, the authorities did abandon the system of multiple exchange rates in July of 1992 and moved to a system based on a single market-determined exchange rate, possibly one of the more important reforms introduced during the first year of Russia's transition to a market economy.

was obvious that powerful vested interests would hold out as long as possible and, indeed, it took two years to begin to remove them. Another legacy of the Soviet Union was a system of directed credits, essentially highly subsidized loans to agriculture and industry. At rates of interest that were absurdly negative in real terms, the demand for them was unusually strong and, of course, the criteria for allocation opaque in the extreme. Another example that comes to mind was a meeting I attended with senior social security officials in Spain in the late 1980s, when the Spanish government was engaged in a program of ambitious economic reforms as part of which they were trying to improve the administration of various social benefits. One issue of particular concern to the authorities was the unusually high number of individuals who were being granted invalidity pensions, made possible by false certifications being provided from doctors who were either being bribed or were doing friends favors.

While it is easy to see the incentives for bribes provided by such examples, the resulting losses in economic efficiency are likewise evident. Directed credits in Russia did not end up with farmers who might have helped in some way to boost food production. Rather they ended up with the highest bidder who then used the proceeds to buy foreign exchange and finance capital flight (the credits themselves were never paid back or were paid in deeply depreciated rubles). Export quotas resulted in massive losses for the Russian budget, at a time when the country was going through the severe economic contraction associated with the collapse of industrial production, particularly in the military industrial complex and when, therefore, there were enormous pressures for increased social spending. In Spain, an unusually large number of disability pensions were putting a heavy financial burden on the pension funds and were also unfair to those who opted for honest behavior. Susan Rose-Ackerman (1998), one of the leading experts on corruption, calls the above kind of bribery, bribes that clear the market or that equate supply and demand.

Privatization

Rose-Ackerman (1997b) highlights the ample opportunities for corruption provided by efforts, over the past two decades, to divest public assets. Interested parties may bribe to be included in lists of those authorized to bid. It may often be difficult to value appropriately the companies selected for privatization. This was particularly the case in Eastern Europe and the former Soviet Union because the privatization process coincided with periods of macroeconomic instability, with exchange rates under pressure, inflation high and relative prices subject to considerable volatility. This gave officials considerable discretion. Insider dealing may be poorly regulated. In Argentina "several officials who designed the highway privatization bidding process were on the staff of companies that acquired the highways."[14]

Officials may—with the intent to favor a particular bidder—deliberately misstate the company's true financial situation, making it look weaker than suggested by the real data. Insiders, however,

14 Rose-Ackerman, 1997b, p. 54.

aware of the company's true finances, will make a higher bid and prevail. Later on, the privatization will be judged a great success because the (real) finances will look excellent with respect to the false figures presented ahead of the auction. Bidders of public utilities will have great incentives to bribe officials to preserve the monopoly status of the privatized enterprises. More generally, because the value of assets being privatized can be very large (sometimes amounting to several percentage points of GDP) the temptation for illicit profits will be great and considerable creativity will be displayed to capture a share of the rents.

Bribes for every taste

Rose-Ackerman provides a useful classification of other forms of bribery. Some bribes are offered as incentive payments for bureaucrats. These can take a variety of forms, such as "speed money," ubiquitous in many parts of the world, and typically used to "facilitate" some transaction, to jump the queue, and so on. Some economists have argued that this could improve efficiency since incentives are provided to work more quickly and those who value their time highly can move faster. Gunnar Myrdal (1968), however, has pointed out that, over time, incentives could work the other way: bureaucrats will deliberately slow things down or, worse, will find imaginary obstacles or themselves create new obstacles, in order to attract facilitation fees. So, in the end, "speed money" is not paid to speed things up but rather to avoid delays artificially created by corrupt bureaucrats. Indeed, some of the regulations enforced in many parts of the world are so devoid of rationality that one can only infer that they were introduced to create opportunities for discretion and corruption. Far from being a way to enhance efficiency, paying bribes is a way to ease them, to preserve and strengthen the bribery machinery.

Other bribes are aimed at lowering costs, the typical example being the payoff to a customs official so that goods can clear customs more rapidly, more cheaply, or without intrusive inspections or, more generally, to a tax official to reduce tax liabilities. Kaufmann (2005), using survey data collected by the World Economic Forum, has shown that OECD firms operating in other OECD countries tend to behave more or less as they would in their home country. However, once they move to non-OECD countries, their behavior is much more similar to that of domestic firms, exhibiting a proclivity for bribery and other illegal practices (particularly in the area of public procurement), the OECD's Anti-Bribery Convention notwithstanding.[15] There are also bribes to obtain contracts for the sale of goods and services to the state, bribes to gain preferential access to public enterprises that might be in the process of privatization, bribes to buy political influence and votes, to say nothing of bribes to shape public policy, although these

15 According to the *Financial Times* (March 24, 2010) "the US Justice Department accused Daimler of having 'engaged in a long-standing practice of paying bribes to foreign officials' in at least 22 countries between 1998 and 2008, according to a document file in a US district court yesterday." According to the FT, the court document indicates that "Daimler's deals involved hundreds of payments worth tens of millions of dollars to help win contracts worth hundreds of millions of dollars to provide vehicles to governments." Experts are reported to say that a settlement "might involve a fine of several hundred million dollars." Daimler is not alone. "In 2008, German engineering group Siemens settled a bribery scandal with US and German authorities in a €1 billion deal."

might be in some countries disguised as campaign contributions and the like. Bribes can also be used to buy judges and favorable court decisions. Tanzi (1998) notes the very interesting case of the financing of political parties in Italy and Bardhan (1997) does the same for Japan's Liberal Democratic Party, in both of which bribery appears to have played a central role. There are also intra-government bribes, such as when the executive bribes members of a parliament to vote favorably for some piece of legislation; these can either be paid in cash—sometimes financed via some extra-budgetary (slush) fund—or in-kind. In Russia, the distribution of apartments to members of the Duma was often used to secure support for a critically important law, such as the annual federal budget.

Bribery can also be centralized or decentralized. In 1996, at the height of Suharto's power in Indonesia, the levels of corruption in Indonesia, India and Russia were broadly similar: their rankings in the *Corruption Perceptions Index* were 45, 46, and 47 respectively. However, without doubt, the economic performance of Indonesia over the previous decade had been much better than that of India or Russia. A plausible argument can be made that, whereas in Indonesia the ruling family collaborated with certain military leaders and selected member of the business community (Suharto's cronies), serving as a centralized bribery-collection machine, in India and Russia corruption was far more dispersed and, hence, more unpredictable. A kind of "lump-sum" system of corruption is less likely to distort economic decisions than one in which there are many players, no clearly laid out rules, unenforceable "contracts," where there is a constantly changing universe of potential bribees. Bardhan (1997) makes a similar point in relation to South Korea, arguing that corruption there largely consisted of "lump-sum contributions by the major business leaders to the president's campaign slush fund, without taxing economic activity at the margin" (p. 1325).

Decentralized systems are potentially more damaging to economic efficiency because the uncertainty is much higher, the demands from officials for bribes can permeate all levels of government and separate systems can develop involving particular government agencies, from fire inspectors to itinerant tax collectors, to the police. The Soviet Union had a highly centralized system of control, with the Communist party establishing and enforcing the rules and punishing those who engaged in corrupt practices that went beyond permissible limits. With the loss of control in the 1990s, corruption flourished and decentralization spurred innovation, across a broad range of economic transactions. Banfield (1975, p. 602) quoted Wolfinger, who argues that "decentralized political systems are *more* corruptible, because the potential corrupter needs to influence only a segment of the government, and because in a fragmented system there are fewer centralized forces and agencies to enforce honesty."

4. Why Is Corruption So Damaging?

The damage caused by corruption is pervasive. At an extreme, "corruption kills", as eloquently made clear by Ambraseys and Bilham (2011) in a comment published in *Nature*, where they demonstrate that 83% of all deaths from building collapse in earthquakes over the past 30 years occurred in countries that are anomalously corrupt. This section examines some of the ways – less dramatic but not necessarily less damaging – in which corruption corrodes the foundations of a stable society and economy.

Impact on public finances

Corruption undermines government revenue and, therefore, limits the ability of the government to invest in productivity-enhancing areas, such as education, infrastructure and health. Not surprisingly, where corruption is endemic, individuals and citizens will view paying taxes as a questionable business proposition, often a way to indulge the government in some of its worst excesses. There is always a delicate tension between the government in its role as tax collector and the business community and individuals in their roles as tax payers. The system works reasonably well and the budget becomes an important mechanism of distribution when those who pay taxes feel that there is a good chance that they will see a future payoff, in terms of improvements in the country's infrastructure, enhanced services, better schools and a better-trained and healthier workforce, and so on. Corruption sabotages this implicit contract.

When government officials allow corruption to flourish they contribute to the creation of an environment in which those who pay taxes are either morally outraged at having to do so or, more likely, feel entirely justified in finding creative ways to avoid paying them or, worse, become bribers themselves. In some cases, lobbying and influence-peddling become relatively attractive alternatives to paying all taxes due, a natural response to the signal sent to the private sector by government bureaucrats or legislators: "we are for sale." To the extent that corruption undermines revenue, it adversely affects government efforts to reduce poverty. According to the World Bank (2012) in 2010 (the latest year for which figures are available), there were 1,274 million people living on less than $1.25/day, the definition of extreme poverty. There were 2,472 million living on less than $2.00/day, equivalent to 41 percent of the population of the developing countries. Moneys that leak out of the budget because of corruption are moneys that will not be available to lighten the burden of the poor; bribery thus interferes with the fulfillment of basic human needs. Of course, corruption also undermines the case of those who argue that foreign aid can be an important element of the fight against global poverty—why should taxpayers in the rich countries be asked to support the lavish lifestyles of the kleptocrats in failing states?

Corruption, as we shall see below, distorts public investment and boosts overall spending, leading, other things being equal, to a larger government deficit than would otherwise be the case. A larger deficit will generally mean a larger accumulation of public debt, higher debt-service payments and, inevitably, constraints on other areas of expenditure which could more directly contribute to improved productivity and growth. So, corruption, by undermining revenue, increasing the effective tax burden and boosting expenditure is highly damaging to the public finances. Or, to put it in another way: when corruption depresses revenues, governments will be forced—to sustain a given level of expenditure—to increase tax rates and/or to forego the benefits of programs which cannot be financed because of lack of resources. Often, because they are easy to collect, governments will opt for increasing consumption taxes, which tend to be regressive, disproportionately affecting the lower-income groups. To give another example: in Russia the minimum pension—received by some 37 million people—fell by 70 percent in real terms between 1991 and 1996 because the government had "lost" several billion dollars in annual budget revenue through tax exemptions extended to cronies and favored companies.

Johnson, Kaufmann and Zoido-Lobatón (1998) used cross-country data to establish that the higher the level of corruption in a country, the larger the share of its economic activity that will go underground, and, hence, will be beyond the reach of the tax authorities. Not surprisingly, studies have shown that corruption also undermines foreign direct investment since it acts in ways that are indistinguishable from a tax; other things being equal, investors will always prefer to establish themselves in less corrupt countries. Wei (2000) reviewed FDI data from 14 source countries to 45 host countries, and concluded that: "an increase in the corruption level from that of Singapore to that of Mexico is equivalent to raising the tax rate by 21-24 percentage points."

Undermining private sector development

Corruption undermines the investment climate, discourages private-sector development and innovation and encourages various forms of inefficiency; the more widespread it is, the more damaging its effects. Budding entrepreneurs with bright plans and ideas will be intimidated by the bureaucratic obstacles, financial costs and psychological burdens of starting new business ventures (including dealing with corrupt officials to obtain permits and licenses) and will either opt for taking their ideas to some other less corrupt country, if they can afford to do so, or, more likely, may desist altogether, or opt for early departure from the market, quickly shutting down newly created companies. So, corruption is either a barrier to entry into the market or a factor in precipitating early departure; in either case, economic growth is adversely affected. The high incidence of corruption will imply an additional financial burden on businesses, imposing heavy costs on them, thereby undermining their international competitiveness. Unlike a tax, which is known and predictable and can be built into the cost structure of the enterprise in an orderly fashion, bribes are necessarily unpredictable and random and will undermine cost control, reduce profits and undermine the efficiency of those who must pay them to stay in business. Paulo Mauro (1995) used some indices of corruption and institutional efficiency to show that corruption lowers investment and, hence, economic growth. He offers the following example: "if Bangladesh were to improve the integrity and efficiency of its bureaucracy to the level of that of Uruguay (corresponding to a one-standard deviation increase in the bureaucratic efficiency index), its investment rate would rise by almost five percentage points, and its yearly GDP growth rate would rise by over half a percentage point" (p. 705).[16]

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16 Rose-Ackerman (1997b, p. 91) gives an interesting illustration of the effects of corruption on the viability of development projects. Assume that 20 percent of the funding for a particular project is lost to corruption—this could be because of over-invoicing of costs, losses due to theft of equipment and so on; the details themselves are not essential. Assume a rate of return of 10 percent. Because of corruption, a US$100 million project could have been

Corruption is particularly devastating for small and medium-sized enterprises—often the engines of economic growth and job creation in the developing world—which may not have the clout of big companies to protect themselves from a proliferation of requests for bribes. Corruption also contributes to a misallocation of human resources. To sustain a system of corruption, officials and those who pay them will have to invest time and effort in the development of certain skills, nurture certain relationships, and build up a range of supporting institutions and opaque systems, such as off-the-books transactions, secret bank accounts, and the like. But these "assets" will not be easily transferable to the non-corrupt part of the economy later on, for by its very nature, corruption is not about boosting productivity and the country's potential wealth; it is fundamentally about the redistribution of rents which, of course, do not add to economic growth. Surveys have shown that the greater the incidence of corruption in the country, the greater the share of time that management has to allocate to dealing with ensuring compliance with regulations, avoiding penalties, and dealing with the bribery system that underpins them, activities that draw attention and resources away from production, strategic planning, and so on. In fact, a paper by Bentzen (2012) finds cross-country evidence that corruption does exert a significant and negative impact on countries' productivity levels. And, of course, the more the time is spent by officials either building up systems to control corruption—or, in the case of corrupt officials, ensuring that the bribery machinery in place remains operational, appropriately flexible and secret—the less time is devoted to governing and adding value, without doubt a net reduction in the government's administrative capacity.

Distortion of incentives

Research done at the IMF has established that corruption "distorts the entire decision-making process connected with public investment projects" (Tanzi and Davoodi, 1997). Large capital projects provide tempting opportunities for corruption. Governments will often undertake projects of a larger scope than necessary or of greater complexity than warranted by the needs of the country. Public investment will thus be higher—the developing world is littered with the skeletons of white elephants, often built with external credits, and representing a heavy burden on meager budgets. Moreover, the productivity of the investment will be lower and, in the context of scarce resources, governments will find it necessary to cut spending elsewhere, sometimes in socially vital areas, or in operations and maintenance. Tanzi (1998) plausibly argues that corruption will also specifically reduce expenditure on health and education because these are areas where it may be more difficult to collect bribes.

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implemented with US$80 million. An honest project would need to generate benefits of US$88 million, but the corrupt project would need to produce a return of US$110 million. So, a project that should have cost US$80 million, must generate US$110 million to be viable—this is a rate of return of 37.5 percent on productively used resources, extremely high by any measure. If one assumes a 30 percent loss, then the required rate of return rises to 57.1 percent, and so on. The point is that if you are Bill Gates and you are approached to fund this project, you would be well-advised to say no.

Indeed, it is possible to generalize the results of Tanzi and Davoodi's work and to suggest that corruption risks creating perverse incentives, whereby governments will tend to resist economic reforms which, if implemented, would eliminate harmful (but profitable) distortions. So, economic reforms are no longer examined on their merits, but rather in terms of the extent to which they might eliminate bountiful sources of economic rents, a perversion of the legitimate aims of public policy. So, you withhold approving the elimination of export quotas as long as possible, because doing so will push your friends and cronies off the rich trough of illicit profits. Or, as in Indonesia, you sabotage proposals to eliminate monopolies because your children's billion-dollar businesses will be jeopardized. This is by no means a problem limited to developing countries. Lobbying in the United States and other industrial countries is a multi-billion dollar industry. Were it limited to enlightened public discourse on the merits of proposed pieces of legislation through which interested parties, in a spirit of consultation, aim to assist legislators to better understand the full ramifications of various courses of action, "lobbying" would actually fulfill a beneficial public purpose. The reality, however, is often one where (to paraphrase Paul Krugman) corporate cash greatly degrades the ability of the political system to address real problems. So, to give an example, financial sector reform and the need to strengthen the regulatory role of the state—a glaring need, given the origins of the 2008-2009 global financial crisis—is delayed and watered down under the onslaught of "campaign contributions" to politicians for whom re-election is always a priority over the public interest. Some would argue that well-documented lobbying with tough disclosure requirements is better than bribing, but the impression that aggressive lobbying sometimes creates is that it is a more sophisticated mechanism to achieve the same ends sought by those engaged in outright bribery: to obtain some government special dispensation in exchange for some favor.

Worsened income distribution

Corruption has disturbing distributional implications. Empirical work done at the IMF shows that corruption actually contributes to worsening income distribution. Gupta, Davoodi and Alonso-Terme (1998) have shown that corruption, by lowering economic growth, perceptibly pushes up income inequality. It also distorts the tax system because the wealthy and powerful are able to use their connections to make sure that the tax system works in their favor (e.g., tax cuts for the well-off). It also leads to inefficient targeting of social programs, many of which will acquire regressive features, with benefits disproportionately allocated to the higher income brackets, an issue we will examine more closely below. Corruption is associated also with lower social spending, unequal access to education, and the "use of wealth by the well-to-do to lobby governments for favorable policies that perpetuate inequality in asset ownership (p. 4)."

Uncertainty and short-term focus

Corruption creates uncertainty. There are no enforceable property rights emanating from a transaction involving bribery. The firm that obtains a concession from a high-placed bureaucrat as a result of bribery cannot know with certainty how long the benefit will last. In a competitive market others may appear and be willing to pay more for it. The terms of the "contract" or arrangement may have to be constantly renegotiated to extend the life of the benefit or to prevent its collapse. Indeed, the briber, having flouted the law, may fall prey to extortion from which it may prove too difficult to extricate himself. Rose-Ackerman (1998) observes that in Malaysia companies that had secured illegal logging rights had incentives to cut as many trees as possible as fast as possible, as there was no certainty that these rights would not soon be revoked. There are similar examples with oil and mining concessions in other countries. Of course, in an uncertain environment with insecure property rights, the firm will be less willing to invest and to plan for the longer-term. Thus, a short-term focus to maximize short-term profits will be the optimal strategy, even if this leads to deforestation or the rapid exhaustion of non-renewable resources. The structure of production for the firm paying bribes will thus be potentially distorted.

This uncertainty is partly responsible for a perversion in the sorts of incentives that prompt individuals to want to seek public office. Where corruption is rife, politicians will want to remain in office as long as possible, not because they are necessarily (or even remotely) serving the public good, but merely because they will not want to yield to others the pecuniary benefits of high office—hence the prevalence of "presidents for life" in a large number of countries, particularly in Africa. Where long stays in office are no longer an option, then the new government will want to steal as much as possible as quickly as possible, given a relatively short window of opportunity. Michaela Wrong's *It's Our Turn to Eat* (2009) provides an excellent case study of the latter, as applied to the case of Kenya following the departure of Daniel arap Moi in 2002, after 24 corruption-ridden years in power.

Secrecy and deceit

Corruption encourages secrecy, which makes it difficult to have informed debate about the incidence and effects of corruption. Stiglitz (1999) notes that government officials may engage in secrecy and secretive practices for a variety of reasons. For instance, secrecy is often a convenient way to hide mistakes or to diminish the probability of being accused of making mistakes. Public policy is inherently difficult and officials, fearing public criticism, may find it more convenient to act in ways that are opaque, which protect their actions from potentially tough public scrutiny. With little information disclosure, governments can portray the results of policies and decisions in a way that casts a more favorable light on their performance. It is widely acknowledged, for instance, that Greece "qualified" for participation in the euro area by cooking the data, by disguising the true state of the public finances (particularly as regards defence spending), something that would not have been possible in a system with full and open disclosure of all relevant fiscal data.

A second incentive for secrecy according to Stiglitz (1999, p. 11) is that "secrecy provides the opportunity for special interests to have greater sway." The United States invested trillions of dollars during the Cold War to build up a fearsome military establishment. But this was based on a wild overestimation of the economic and military might of the Soviet Union which, as events subsequently demonstrated, was a terminally ill patient suffering from severe elephantiasis. Had much of the information about the alleged power of the Soviet Union not been shrouded in a cloud of secrecy, the military-industrial complex might have found it much more difficult to make a credible case supporting the vast expansion of the defense industry. Instead, more resources might have gone into education, infrastructure, research and development—more productive expenditures. The need for secrecy in connection with the payment of bribes has an additional damaging effect on the internal system of checks and balances which societies have developed to guard against the abuse of power and without which corruption can grow without restraint. Secrecy will, in turn, force officials and business executives to keep others in the dark, undermining morale within the organization. According to Brademas and Heimann (1998, p. 21), in Italy "payoffs to political parties started at 5 percent of the price of government contracts, then escalated to 8, 10, and finally 15 percent. As the amounts involved shot up, the funds were no longer restricted to political parties. Instead, they went increasingly to the personal accounts of leading politicians. The more egregious the system, the more inevitable the ultimate explosion."

Betrayal of trust

Because corruption is a betrayal of trust it greatly diminishes the legitimacy of the state and moral stature of the bureaucracy in the eyes of the population. While efforts will be made to shroud such corrupt transactions in secrecy, often, particularly when the opportunities for bribery are linked to some government-inspired initiative, the relevant details will leak out and will tarnish the reputation of the government, thereby damaging its credibility and limiting its ability to become a constructive agent of change in other areas of policy. Corrupt governments will have a much tougher time—without resorting to repression—to continue to be credible enforcers of contracts and protectors of property rights. According to Bardhan (1997, p. 1341) the loss of respect associated with corruption will often degenerate into "disloyalty and thievery among public officials." And, as noted earlier, they will have difficulties in persuading individuals and businesses to pay their taxes. With trust betrayed, what often follows is popular discontent. Evidence from the Gallup World Poll was recently used by Clausen, Kraay and Nyiri (2011) to prove that there is a strong negative correlation (with a causal explanation, at least in part) between corruption and confidence in political institutions.

This can sometimes be used by unscrupulous politicians to fan political passions, it has often led to pronounced shifts in the relative strength of ruling parties and contributed to greater political instability; in more extreme cases, as noted by Noonan (p. 700) it can precipitate coups and violent revolutions. During the Cold War, instances of corruption in the capitalist West were used by Communists to cynically lure converts into the Communist cause. Of course, pervasive corruption in the Soviet Union and its satellites was itself a precipitating factor in explaining Communism's ultimate and final collapse.

In Russia, Ukraine and other transition economies, corruption did much to weaken and slow down the transition to more democratic forms of governance. During my years in Moscow I met with many liberal-minded Russians who had found Gorbachev's indecisiveness on economic issues deeply frustrating, who felt that the future of Russia would ultimately depend on the extent and the speed with which the country moved away from the utter failures of communist dogmas, and who were aware that this process would be very painful. Given the deep roots stemming from more than 70 years of communism and the mental habits and attitudes which this had engendered, they were horrified at some of the excesses brought about by the move to the market. Whether in the form of tax breaks and other privileges extended to well-connected operators, or the transfer/plunder of state assets under the protection of barely disguised "market" schemes, they were appalled by what they saw. An eloquent indicator of the profound feelings of rejection which extensive corruption elicited in the Russian population was the fact that by the mid 1990s, the Communist party was enjoying the wind-fall of a political revival and was thought of by many as a possibly viable political alternative for governing Russia, a shocking reversal of fortune and a denial of history.

A contagious disease

Corruption inevitably creates inequity. Honest businessmen who pay import duties and excise taxes are at a great competitive disadvantage with respect to dishonest ones who bribe customs officials. And the longer the honesty endures, the tougher is likely to be the competition provided by the bribers. Often, for the honest enterprise, the alternative to bribing will be going out of business. But this type of corruption also has an impact on the *supply* of corruption. As honest government officials see that their peers are taking comfortable early retirement or leaving government to set up prosperous new businesses financed by the bribes they collected, huge pressures are created “to enter the market” and become part of the fraternity. These pressures may be internal—such as perceptions of relative income losses by the honest official with respect to his unscrupulous colleagues—or external as, for example, in Hong Kong SAR, China, in the 1960s, when the corrupt police officers would harass younger policemen who refused to take bribes (Banfield, p. 28). In some cases, as needed and to tap into the potentially rich veins of opportunity provided by the powers of discretion, the tax authorities may *find* tax liabilities where none existed before.

One of the most egregious examples of the way in which corruption can rapidly metastasize in the economy concerns a tax exemption granted by the Russian government to the National Sports Foundation in 1993. Allegedly introduced to encourage preparations by athletes for the 1996 Atlanta Olympics, the foundation rapidly turned into the largest importer of tobacco, alcoholic beverages, and various luxury items in Russia. The loss of several billion dollars of tax revenue to the budget should have been enough to warn the government about the dangers of permissiveness in the area of tax exemptions, but within a year the Afghan War Veterans’ Union had managed to secure similar treatment. Not to be outdone, the Humanitarian Aid Commission followed quickly in succession; the Commission actually approved the tax-free importation of alcoholic beverages by religious and other organizations on the understanding that the proceeds of the sale of these beverages would be used for humanitarian ends. Tax-exempt imports through the commission amounted to several hundred million dollars a month and there were no mechanisms in place to ensure that sale proceeds were actually used for humanitarian ends. In the above examples, tax exemptions created a huge demand for additional tax exemptions from those who had not received them and whose business interests had, therefore, been adversely affected.

The spread of crime

Finally—and this list is by no means exhaustive—the sorts of bribery and corruption noted above also helped to increase other forms of crime. Because, as we have argued above, corruption breeds corruption, it tends soon enough to lead to the creation of mafias and organized criminal groups who use their financial power to infiltrate legal businesses, to intimidate, to create protection rackets and, in extreme cases, a climate of fear and uncertainty that will undermine the quality of the investment climate. Where the stakes are high, rival groups may resort to contract killings and the like, pushing the homicide rate way up, as has happened recently, for instance, in Venezuela and countries in Eastern Europe and the former Soviet Union. In states with weak institutions, the police may be overwhelmed, reducing the probability that criminals will be caught. This, in turn, encourages more people to become corrupt, further impairing the efficiency of law enforcement, and risking the creation of a vicious cycle that will affect the investment climate in fairly noxious ways, further undermining economic growth. In many countries, as corruption gives rise to mafias and organized crime, the police and other organs of the state may themselves become criminalized. By then, businesses will not have to deal only with corruption-ridden bureaucracies, but they will also be vulnerable to attacks from competitors who will pay the police or tax inspectors to harass and intimidate.

In fact, there is really no limit to the extent to which corruption, once it is unleashed and escapes the control of the authorities, can undermine the stability of the state and organized society. Tax inspectors will extort businesses; the police will kidnap innocents and demand ransom; the prime minister will demand payoffs to make himself available for meetings, aid money will disappear into the private offshore bank accounts of senior officials; the head of state will demand that particular taxes be credited directly to his personal account. Investment will come to a standstill, or, worse, capital flight will lead to disinvestment. Corruption will also interact in lethal ways with other country-specific structural features, such as ethnic or religious diversity, income disparities, tribal politics, and so on, as is made abundantly clear, for instance, in Michaela Wrong's (2009) account of corruption in Kenya. In countries where corruption becomes intertwined with domestic politics, separate centers of power will emerge to rival the power of the state. At that point, the chances that the government will actually want or be able to do anything to control corruption will disappear and the state will mutate into a kleptocracy, the eighth circle of hell in Dante's *Divine Comedy.* Alternatively, the state, to preserve its power, may opt for total war, engulfing the country in a cycle of violence. In any case, corrupt failed, or failing, states become a security threat for the whole international community, "because they are incubators of terrorism, the narcotics trade, money laundering, human trafficking, and other global crime—raising issues far beyond corruption itself."[17]

5. Reducing Corruption

Having looked at some of the more prevalent ways in which corruption damages the social and institutional fabric of a country, in the pages that follow I would like to review briefly some of the options open to governments wishing to implement reforms to reduce it and mitigate its effects.[18] Rose-Ackerman (1998) recommends a two-pronged strategy aimed at increasing the benefits of being honest and the costs of being corrupt, a sensible combination of reward and punishment as the driving philosophical force of reforms. In her view, incentives for corruption will be influenced by a variety of factors. These will include such things as the extent of discretion exercised by officials in the carrying out of their duties; as we have argued in the previous sections, the greater the scope for discretion, the greater the opportunities to engage in corrupt activities.

Whether civil servants are appropriately compensated for their work or are grossly underpaid with respect to positions of equivalent responsibility in the private sector will clearly affect motivation and incentives. If public sector wages are too low, employees may find themselves under pressure to supplement their incomes in "unofficial" ways or, worse, the public sector will attract opportunists and bribe takers, eager to tap into existing rents. Van Rijckeghem and Weder (2001) did some empirical work showing that in a sample of less developed countries, there is an inverse relationship between the level of public sector wages and the incidence of corruption. Others have pointed out that Singapore, one of the countries that has been most successful in reducing corruption in the public sector, has some of the highest paid public servants in the world. Countries where citizens are able to scrutinize government activities and where there is scope for debate on the merits of various public policies will also make a difference. In this respect, press freedoms and levels of literacy—allowing the majority of the population to access relevant sources of information to be able to better assess politicians' performance and the content of their policies—will, likewise, shape in important ways the context for reforms. Whether the country has an active civil society, with a culture of participation in various civic organizations could be an important ingredient supporting various strategies aimed at reducing corruption. The presence of an active political opposition will also be key, as it tends to be

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17 Heineman and Heimann 2006, p. 79.

18 Some economists would argue that as average per capita income rises, countries become less corrupt and that, therefore, the best policy in the longer-term to mitigate corruption is to reduce poverty and to implement coherent policies that will contribute to more rapid economic growth. My own view is that we cannot afford to wait 100 years for this to happen. As this section will argue, there are plenty of things that can be done in the short-term to deal with the devastating effects of corruption, potentially providing larger payoffs in the fight against corruption in a cost effective way.

associated with higher levels of public scrutiny of government policies and initiatives. Whether the country has invested adequately in absorbing the latest technologies is also important, as we will argue later on that technology can be a powerful tool to eliminate or greatly reduce some traditional sources of corruption, such as public procurement. To this list one might add whether the country has credible law enforcement institutions whose activities are guided and supported by an adequate legal framework.

Business regulation

The very high correlation between the incidence of corruption and the extent of bureaucratic red tape, as captured by the *Doing Business* indicators (see Figure 1) suggests that one possible fruitful starting point would be to eliminate as many needless regulations from the books as is compatible with safeguarding essential regulatory functions of the state. The sorts of regulations that are on the books of many countries—to open up a new business, to register property, to engage in international trade, to hire or fire an employee, and a plethora of other certificates and licenses which citizens have to acquire in the normal course of routine interactions with the state—are quite often a legacy of the past. Governments have typically not paused to examine their merits and whether the purpose for which they were introduced, sometimes decades ago, is at all relevant to the needs of the present. Neither have they given much thought to ways in which bureaucracy and red tape could be lightened and made more efficient. Instead, having lost their raison-d'être they have metamorphosed into potential sources of economic rents, luring officials into corruption and illegality. Dreher and Grosser (2013) provide empirical evidence that a high number of procedures required to start a business not only reduces firm entry, but also provides an incentive for corruption, because corruption facilitates firm entry in highly regulated economies.

My own experience in talking about this issue with government officials in many countries is that the elimination of red tape can better be promoted as a reform which is an element of a process of modernization of the state. The most competitive economies in the world are those that have managed to lighten the regulatory burden as a way of enhancing the efficiency of the economy, and this is essential if the country is to be able to compete abroad. There is no need to be ideological about regulation. There will always be scope for a minimum set of rules, in such areas as consumer protection, management of the environment, prudential requirements related to the operations of the banking system, and so on. The issue is one of efficiency, the need to do away with rules and procedures that no longer fulfill any useful role, other than create employment and rents for the bureaucrats that manage them. Rose-Ackerman (1998, p.45) suggests that "the most obvious approach is simply to eliminate laws and programs that breed corruption." She gives the example of Prohibition in the United States during the period 1919 to 1933, which spawned a vast web of corruption, including within law enforcement agencies.[19]

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19 There is an interesting debate at present about the failure of efforts to control the drug trade through criminal law. In early 2009, the Latin American Commission on Drugs and Democracy—headed by three former heads of state—

Appalled by the unintended results of the Eighteenth Amendment to the Constitution, it had become clear by the early 1930s that repealing it would be the better option.

It is possible to extend the above arguments to make a more general point that applies not just to regulations and red tape and other administrative controls that become sources of potential rents, but to all policies that help in some way to undermine competition and efficiency in the economy. One of the bitter lessons from decades of central planning was that a system in which prices reflect relative scarcities in the market place, providing a decentralized system of signals and incentives, is much better for the allocation of resources than one based on administrative controls. Economies will be more dynamic and flexible, better able to cope with external shocks, when decision-making is decentralized and greater scope is given to market forces. During the 1980s and 1990s price liberalization and an easing of bureaucratic controls become a key feature of many programs supported by the international financial organizations and bilateral donors and I believe that the implementation of such policies, to the extent that they contributed to eliminate distortions, did much to eliminate long-standing sources of corruption. The freeing up of prices can also be a spur to entrepreneurial creativity; this became clear in the early phase of the transition in Central and Eastern Europe when, for instance, millions of Russians—no doubt partly out of necessity—found employment as retail traders, ready to supply markets previously characterized by persistent shortages, which were, hence, themselves sources of rents and corruption.

During much of the post-war period many developing countries, particularly in Africa, relied on state-run enterprises to market their agricultural products, using administratively determined producer prices to set the levels of compensation to farmers. By and large, these enterprises were unable to maintain producer prices in real terms, discouraging agricultural production in favor of urban employment, and ended up instead promoting illicit trade at the expense of legal export activity. Often, middlemen in league with corrupt officials would secure monopolies over certain activities (e.g., a transport monopoly in Bolivia, forcing farmers in a particular region to get their products to market using a single carrier), to the detriment of small-scale producers. Reforms of agricultural marketing systems and the setting of producer prices at competitive levels became, thus, another mechanism through which governments could contribute to

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published a report in which it argued that: “Prohibitionist policies based on the eradication of production and on the disruption of drug flows as well as on the criminalization of consumption have not yielded the expected results. We are farther than ever from the announced goal of eradicating drugs. Over the past decades we have witnessed: a rise in organized crime caused both by the international narcotics trade and by the growing control exercised by criminal groups over domestic markets and territories; a growth in unacceptable levels of drug-related violence affecting the whole of society and, in particular, the poor and the young; the corruption of public servants, the judicial system, governments, the political system and, especially the police forces in charge of enforcing law and order.” According to *The Economist* (January 25, 2009) the Commission “called for a public debate on alternatives, including treating drug use as an issue of public health rather than criminal law.”

eliminating incentives for corruption and simultaneously improve efficiency. The need for price flexibility applies also to those prices which have a direct bearing on the macroeconomic environment, such as the exchange rate and interest rates. The past several decades are littered with examples of countries unwilling to adjust official exchange rates, notwithstanding evidence of overvaluation and the development of often large-scale parallel (i.e., black) exchange rate markets. Such overvaluation impeded the development of the tradable sectors in many countries and contributed to the weakening of these countries' balance of payments, impairing their ability to import much-needed machinery and adopt new technologies from abroad.

Mindless subsidies

Subsidies are another example of the way in which government policy can distort incentives and create opportunities for corruption. While there may be instances in which governments will want to support certain vulnerable groups within the population through the provision of well-targeted income support, in practice governments provide much of their subsidies irrespective of the level of income of the recipient. For example, according to an IMF study (2013), consumer subsidies for petroleum products, electricity, natural gas and coal, factoring in the cost of negative externalities from energy consumption, amount to some $1.9 trillion per year, equivalent to about 2.5 percent of global GDP or 8 percent of total government revenues. The study notes that the benefits of gasoline subsidies are the most regressively distributed, with over 60 percent of total benefits accruing to the richest 20 percent of households. For diesel and liquefied petroleum gas (LPG), respectively, 42 percent and 54 percent of benefits go to these income groups. The authors argue further that "removing these subsidies could lead to a 13 percent decline in CO_2 emissions and generate positive spillover effects by reducing global energy demand" (p. 1).

More importantly, for the purposes of our discussion here, subsidies often lead to smuggling, to shortages, to the emergence of black markets and corruption. The mechanisms are generally trivially simple: to take an example: substantial subsidies on LPG in Bolivia lead to a thriving smuggling business on the border with Peru, as Bolivians respond to the incentives provided by a three-to-one price difference between the two markets. Putting aside the issue of the opportunity cost associated with wasteful consumer subsidies (how many schools could be built with the cost of one year's LPG subsidy?), and the environmental implications associated with high (and often wasteful) consumption because of artificially low prices, subsidies can often put the government at the center of corruption-generating schemes, hardly a desirable outcome. Initially intended to cushion the impact of high international prices, subsidies mainly help to boost consumption, to weaken the budget, distort incentives and in many countries end up perverting public policy. Because subsidies accustom the public to low prices, governments are often unwilling to eliminate them because of (at times violent) public protest and riots. They, therefore, have a tendency to become entrenched and greatly diminish the ability of the government to spend in more productive areas.

The above highlights an important point raised by Tanzi (1998, p. 587) when he writes that “to a large extent it is the state that through its many policies and actions, creates the environment and incentives that influence those who pay bribes and those who accept or demand them. It is the state that influences the relationship between briber and bribee.” It is as difficult to argue with this observation, as with his conclusion that much of the discussion about ways to reduce corruption has to necessarily focus on ways to enhance the efficiency of the state and its underlying policies and institutions. Rose-Ackerman (1997b, p 40) goes further in suggesting that “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.”

A better budget process

Subsidies, tax exemptions, public procurement of goods and services, soft credits, extra-budgetary funds under the control of politicians—all are elements of the various ways in which governments manage public resources. Governments collect taxes, tap the capital markets to raise money, receive foreign aid—and, increasingly, in many countries growing amounts of humanitarian assistance—and develop mechanisms to allocate these resources to satisfy a multiplicity of needs. Some countries, particularly in the developed world, do this in ways that are relatively transparent and make efforts to ensure that resources will be used in the public interest. New Zealand is a pioneer in this area, having approved in 1994 the Fiscal Responsibility Act, providing a detailed legal framework for transparent management of public resources. It is no coincidence that New Zealand is consistently one of the top performers in Transparency International’s *Corruption Perceptions Index*. Organizations like the IMF have acquired vast expertise in identifying good practices that have proved to be successful in promoting better management of public funds.

For instance, in terms of the mechanisms that are used by governments every year to approve the budget, there is broad consensus that the draft budget should provide detailed explanations of fiscal targets and priorities, that there should be free and open legislative debate and authorization, and that execution of the budget should be transparent, with public disclosure of performance and audits. There is also agreement that the use of extra-budgetary funds should be strictly limited and that the budget should be comprehensive in scope, capturing all sources of revenue and all items of expenditure. Taxes and tax collection should be based on established laws and provisions and not be left to the discretion of the tax authorities or to be negotiated on an ad hoc basis. Many countries have tax codes that clearly lay out the taxpayer’s rights and obligations, that regulate the imposition of penalties to ensure that they are not used by unscrupulous politicians against political opponents and that establish independent review agencies with the authority, as needed, to investigate government operations.

Countries which have followed New Zealand’s lead have also sought to establish clear lines of responsibility among various levels of government (e.g., federal/national, local), to reduce the possibility of discretion and to diminish uncertainty. The importance of these issues cannot be underestimated. Lack of clarity in the budget process or ambiguity in delineating responsibilities and boundaries provide ripe opportunities for corruption.[20] How governments manage the budget will clearly have a considerable bearing on the incidence of corruption, as the budget represents the single largest pocket of resources in a country's economy, sometimes equivalent to almost half of a country's annual GDP. The more open and transparent the process, the less opportunity it will provide for malfeasance and abuse. Collier (2007, pp. 66, 150) provides a distressing example of the impact of ineffective systems of budget control: in Chad a 2004 survey tracking the funds released by the Ministry of Finance for rural health clinics established that less than one percent actually arrived at its intended destination—more than 99 percent was "lost" along the way. In Uganda, a similar survey showed that only 20 percent of budget allocations for primary schools (other than teachers' salaries) were getting through to the schools. However, once the Ministry of Finance started providing information on monies released to the media and informing individual schools directly about the allocations made, compliance rose to 90 percent.

Improving the interrelated processes and mechanisms underpinning the preparation and execution of the budget may well be one of the potentially most fruitful areas in which multilateral organizations could assist in the fight against corruption. Again, given their reluctance to wade into "political" waters, there is no need to frame such reforms from a corruption-reducing vantage point per se. It is quite enough to see the benefits in terms of gains in efficiency and better resource allocation. The IMF, in particular, with its vast expertise on fiscal issues, could be a particularly important player, given the ample leverage it has due to its ability to quickly disburse resources. And yet, it is not unfair to say that these organizations—having abandoned their state of denial about the relevance of corruption for resource allocation and its centrality on any debate about economic development—are still reluctant to use their leverage more energetically to tackle corruption in the countries where they have lending programs.

Other reforms

Rose-Ackerman (1998), and others provide a useful overview of other measures or reforms which will help to better control corruption. Among them: "a viable legal framework that enforces the law without political favoritism or arbitrariness" and that is buttressed by a credible system of penalties for offenders; improving the pay for judges and giving them greater independence from the executive; efforts to improve the clarity of laws, to reduce the scope for disputes and abuse; the creation of "a tough, independent anticorruption agency can be a potent tool—as long as it represents a credible long-term commitment and includes checks on its ability to be misused for political ends;" ensuring that civil service pay is competitive with respect to

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20 For a detailed discussion of the Russian budget process in the 1990s and the ways in which the system afforded countless opportunities for corruption see Lopez-Claros and Alexashenko (1998, pp. 29-34). Jack Diamond (2006) has an extensive discussion of budget system reform issues, providing an extremely helpful international perspective.

comparable positions in the private sector. A variant of this involves the payment of generous pensions which can be drawn upon only in the event that the employee retires in good standing, a good example of the potential benefits of increasing the opportunity cost of corruption.

Obviously, this latter proposal, to be effective, must also involve streamlining the civil service, since in many countries governments use public sector employment as a form of fiscal stimulus or, worse, as a refuge for the ruling party faithful. Excessive levels of employment in the government bureaucracy will clearly curtail the ability of the authorities to compensate civil servants adequately. This may also require, in parallel, good economic management more generally, to expand the perimeter of job opportunities in the private sector and to avoid having to use the government as the employer of last resort. The appointment of credible ombudsmen to help businesses and individuals facing bribery requests can also be an element of efforts to protect citizens from the impact of corruption. The way in which governments formulate and execute their budgets—including how they manage public procurement of goods and services—is so important that we have dealt with this issue separately above. Kaufmann (1997) makes a case for government attention to the financial sector, given that "fraud-driven financial crises" can be extremely costly. Abuses of an otherwise flawed regulatory system for the financial sector in the United States are now universally acknowledged to have been a primary cause of the 2008-2009 global financial crisis.

Reluctant donors

There would appear to be ample scope for the donor community to bring the elimination or mitigation of corruption much closer into the heart of its aid programs. If, for instance, excessive regulation, tax exemptions and subsidies have become important sources of rents for government bureaucrats, it would appear to make eminent sense to tackle them as a matter of priority. The issue does not even need to be framed in moral or ethical terms—which could awaken latent sensitivities with roots in the colonial era—but can be justified simply in terms of gains in efficiency and the ways in which the elimination of distortions will contribute to the modernization of the state. Unfortunately, my own personal experience and interactions with others who have dealt with these issues, has convinced me that donors are often reluctant to confront these issues head on and bring them into the center of their aid policy agendas. As has been noted by many, including, for instance, William Easterly (2006, p. 181), in the case of the international financial institutions, there is often an internal culture that rewards lending and that predisposes international civil servants to go out of their way to give governments the benefit of the doubt, lest tough scrutiny derails loan programs by exposing extensive corruption.

An undue focus on eliminating sources of corruption might make loans less attractive to governments (whose officials will often be the largest potential losers of the reforms) and jeopardize the donor's lending operations. So, corruption issues (or reforms aimed at indirectly cutting off its sources) will be swept under the carpet and the money flows will continue. International civil servants will pretend that limited reforms will be better than no reforms, or will (unrealistically) persuade themselves that they can ring-fence or protect certain projects from pervasive corruption elsewhere, or will say to each other that it is important to keep open lines of communication with the authorities in the recipient country, to "engage" and try to prop up the few reform-minded ministers who can always be found, even in the most corruption-ridden places.

Some donors will feel vulnerable to accusations of cultural insensitivity, the idea that Western countries are trying—through the multilateral institutions— to impose their own values on the developing world, or, worse, that they are hypocrites, judging by the considerable evidence of corruption in the donor countries themselves, to say nothing of the skeletons in the dusty closets of the colonial era. In such situations, of course, it does not help that the international financial organizations may have a conflict of interest at the heart of their operations. The IMF, for instance, finances its administrative expenditures (the salaries of its staff, the upkeep of its comfortable headquarters, and so on) out of the interest charged on the loans it makes to its members. Other things being equal, the organization will not be indifferent between lending and not lending. The mission head who successfully negotiates a program with a client country will be in a stronger position vis-à-vis his/her peers than one who argues that there is no basis to make a loan because the country is run by crooks or, more likely, because the authorities, while ready to agree to the Fund's conditions on paper, actually have no intention of implementing them or will do so only haphazardly and with considerable delays. In Russia in the 1990s, for instance, the IMF strongly opted for focusing on assisting the government to bring inflation down and to rein in the budget deficit, all very worthy macroeconomic objectives, which, of course, should have been part of any program of external support. But the organization greatly underestimated the considerable leverage it had because of the quick disbursing nature of its resources, which could have been used more proactively to help dismantle an extensive and corruption-ridden web of tax exemptions and other mechanisms which were being actively used by many for personal enrichment.

Corruption is not nice, to be sure. It is awkward to raise these issues, however delicately, in the middle of program negotiations. Government officials will often lie—particularly when someone is paying them to keep an exemption or some other distortion in place—putting the donor in the ungrateful situation of having to raise the matter, however discreetly. To give a real-life example, I remember being approached by a Deputy Finance Minister in Moscow, who confided that the government had just issued a list of tax exemptions for certain luxury imports. With considerable courage—he was going over the head of his boss—he shared with me the long annex specifying the goods that would be subject to the tax exemption. The list included fur coats, jewelry, yachts and other motor boats, light aircraft, and so on—the typical consumption basket of the richest of the rich. Since we were in the middle of negotiating the next package of financial support it would have been logical to press hard for the removal of the exemptions, particularly at a time when, for various reasons, budget revenues were under huge downward pressure. With great reluctance, the mission head from Washington raised the issue with the First Deputy Finance Minister (the whistle blower's boss), who, with a straight face, issued a denial. It did not matter much that this First Deputy Finance Minister was widely alleged to be corrupt; his denial effectively ended further consideration of the matter and, of course, the exemptions remained firmly in place and the program negotiations were eventually concluded successfully, awarding the Russian government some US$6 billion over a one-year period.[21] Bringing inflation down to "low single digits"—an obsession at the IMF at that time, and a goal that, a decade later, was still elusive—lost out to economic efficiency and transparency in a way that prevented the IMF from aligning itself more closely with equity, fairness and openness in the management of public resources, a central element of its mandate. It is difficult to disagree with Easterly when he says that "aid critics have to persuade the rich-country public and politicians not to reward agencies for how much money is mobilized; what matters is results."[22]

International conventions

The international legal framework for corruption control has improved significantly over the past decade. We have already referred to the OECD's Anti-Bribery Convention. There are regional conventions covering Africa, Europe and the Americas, the latter in the form of the Inter-American Convention Against Corruption, or the OAS Convention. In addition, in December of 2005 the United Nations Convention Against Corruption (UNCAC) entered into force, and by late 2009 had been ratified by 137 of its 140 signatories. According to Heinemann and Heimann (2006), the UNCAC is a very promising instrument because, unlike the OECD Convention, it creates a global legal framework involving developed and developing nations and covers a broader range of subjects, including domestic and foreign corruption, extortion, preventive measures, anti-money laundering provisions, conflict of interest laws, means to recover illicit funds deposited by corrupt officials in offshore banks, among others. Since the UN has no enforcement powers, the effectiveness of the Convention as a mechanism to deter corruption will very much depend on the establishment of adequate monitoring mechanisms to assess government compliance with respect to its provisions. It is also felt that the UNDP, the World Bank and other international organizations could be more proactive in providing useful technical assistance to countries willing to develop the capacity to comply with the Convention's provisions. However, because the UNCAC has a more ambitious scope and country coverage, it may well be some time before the benefits of its various provisions are fully realized.

In the meantime, Heinemann and Heimann (2006) argue that a more workable approach in the fight against corruption may consist of more robust implementation of the anticorruption laws in the 36 states that have signed the OECD's Anti Bribery Convention. Ala'i (2000, p. 924) makes

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21 According to Goldman (2008, p. 114), years later this First Deputy Finance Minister (now no longer in government but an active member of Russia's top business community) "was charged in a Russian court of having committed fraud by selling shares in an oil company (Northern Oil) that he did not own." Not only did he not serve time in jail but, in early February of 2009, *The New York Times* reported that he had signed a contract to buy two penthouse apartments at New York's Plaza Hotel for $53.5 million. For further details see: http://cityroom.blogs.nytimes.com/2009/02/04/financier-buys-plaza-penthouse-after-all/

22 Easterly, 2006, p. 183.

a broadly similar point: “The aim is that the signatories, by national implementation, will provide clear and detailed rules that are functionally equivalent to one another in punishing and deterring bribery by international business.” This will involve many elements. First, governments will need to be more pro-active in cracking down on OECD companies that, contrary to the Convention’s provisions, continue to bribe foreign officials. This is a serious problem, as the recent cases against Siemens and Daimler make clear. In their efforts to protect the commercial interests of national companies, governments have at times been tempted to shield companies from the need to comply with anticorruption laws, in a misguided attempt not to undermine their position vis-à-vis competitors in other countries. Trade promotion should not be seen to trump corruption control. As we have noted earlier on, the OECD Convention notwithstanding, governments continue to be afflicted by double standards, criminalizing bribery at home but often looking the other way when bribery involves foreign officials in non-OECD countries.

This is a sad legacy of the colonial era, when governments in developed countries tended to justify bribery abroad by seeing it as part of the cultural landscape of the developing world, a cost of doing business in alien (and presumably more corrupt) settings.[23] The idea that bribery of foreign officials in non-OECD countries is good for business has a long history and it will take energetic and concerted efforts to change the underlying cultural mindset. The virtues of an arms-length relationship between governments and national companies that does not undermine the responsibility of governments, as signatories to the Convention, to enforce it should be underscored. Second, to add credibility to their announced commitment to the goals of the Convention, governments need to develop an effective centralized machinery to investigate and prosecute cases of corruption.

But the responsibility for corruption control does not rest with governments alone. The business community and, in particular, the multinational corporations, as originators of bribery and frequent victims of extortion, also has a key role to play. “Effective compliance also requires robust systems that can educate and train staff, detect problems through internal auditors and an honest ombudsman system, investigate allegations of corruption quickly and thoroughly, sanction guilty parties regardless of where they are on the corporate ladder, and fix the practices that caused the problem” (Heineman and Heimann, p. 84). Given what we now know about the damage caused by corruption worldwide, no self-respecting multinational corporation with

23 Lord Young, the former Secretary of State for Trade and Industry of the United Kingdom and Chairman of Cable & Wireless PLC, said the following in a BBC radio broadcast aired in April of 1994: “The moral problem for me is simply jobs. Now when you’re talking about kick-backs, you’re talking about something that’s illegal in this country, and that, of course, you wouldn’t dream of doing. I haven’t even heard of one case in all my business life of anybody in this country dong things like that. But there are parts of the world I’ve been to where we all know it happens. And if you want to be in business you have to do—not something that is morally wrong, because in some parts of the world…that’s not immoral or corrupt. It is very different from our practice and would be totally wrong in our environment but wasn’t wrong in their environment; and what we must be very careful of is not to insist that our practices are followed everywhere in the world” (quoted in Ala’i, 2000, p. 930).

credible long-term strategies for growth and brand development will want to be associated with bribery and other forms of malfeasance. In any case the potential for damaging revelations and multimillion dollar fines would suggest that bribery is not cost effective. In fact, it is a completely senseless business strategy.[24]

Technology to the rescue

Just as government-induced distortions provide many opportunities for corruption, it is also the case that frequent, direct contact between government officials and citizens can open the way for illicit transactions. In his fine book *Controlling Corruption*, Robert Klitgaard described an extremely promiscuous environment at the Philippines' Bureau of Internal Revenue in the mid-1970s with employees "buying and selling jobs and transfers in the bureau,…collecting and embezzling tax money…accepting bribes from taxpayers for lower assessments….Some officials went so far as to extort money from taxpayers, threatening them with high assessments and the prospect of costly litigation unless the victims paid a bribe" (p. 13). A common feature in these transactions was the direct, personal contact between tax inspector and taxpayer. The "arreglo" (arrangement) had evolved into an essential institution of the Bureau, a negotiated tax settlement with clearly defined shares for the government, the inspector and the taxpayer. Obviously one way to address this problem is to use readily available technologies to encourage more of an arms-length relationship between officials and civil society. The Internet has been proved empirically to be an effective tool to reduce corruption (Andersen *et al*., 2011), and its potential can be even better understood by looking at its application to public procurement and other forms of interactions between citizens and the public sector.

Few countries have been as successful in promoting e-government as Chile. Chile ranked 8th in the UN *E-Participation Index 2012*, a rank that put it as one of the top world leaders. The country is recognized as a pioneer and global leader in the use of technologies aimed at enhancing transparency and efficiency in government.

In Chile, the use of online platforms to facilitate the government's interactions with civil society and the business community has been particularly successful in the areas of tax collection, public procurement, and red tape. The Internal Revenue Service (IRS)[25] was the first government agency to adopt the Internet as a tool to enhance the quality of client services, to improve tax administration, and add a degree of transparency to interactions between the agency and taxpayers. Through its Website, the Chilean IRS processes the delivery of annual and monthly income tax statements, electronic invoicing and fee billing, and electronic start-up application forms. It also has a service which provides assistance to small businesses with accounting and

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24 There would appear to be an enormous amount of work ahead for the business community. According to Heineman and Heimann (2006, p. 76) the sharply critical report by Paul Volcker on the UN oil-for-food program also showed that nearly half of the 2000 companies that participated in it "may have been involved in kickback schemes."

25 See www.sii.cl

electronic invoicing. The Chilean IRS is one of the most modern tax administrations in the world. Indeed, its success has spurred other public and private agencies in Chile and abroad to use similar electronic platforms to deal with clients. High levels of compliance have shown not only that technology can help eliminate corruption in the payment of taxes, but contribute to improve overall efficiency. The statistics are impressive: over 99 percent of Chilean tax-payers state and pay their income taxes through the Internet, amounting to over 2,9 million statements filed during 2013.

Perhaps one of the most fertile sources of corruption in the world is associated with the purchasing activities of the state. With the increasing presence of the state in the economy, alluded to earlier, purchases of goods and services by the state can be sizable, in most countries somewhere between 5-10 percent of GDP, or equivalent to somewhere between US$ 3-6 trillion on an annual basis worldwide, a huge sum. Because the awarding of contracts can involve a measure of bureaucratic discretion, and because most countries have long histories of graft, kickbacks, and collusion in public procurement, more and more countries have opted for procedures that guarantee adequate levels of openness, competition, a level playing field for suppliers, fairly clear bidding procedures, and so on. Of course, there is a wide variety of country practice. Often, the poorer the country is, the more archaic—and hence the more vulnerable to corruption—the rules governing public procurement. Klitgaard (1988, pp.134-155) offers a fascinating case study on procurement in Korea in the 1960s and 1970s and the impressively creative ways in which suppliers—through highly imaginative schemes involving a combination of collusion, kickbacks and physical intimidation—were able to extort massive and illicit profits from the procurement process.

As with tax collection, Chile has used the latest technologies to create one of the world's most transparent public procurement systems in the world. ChileCompra was launched in 2003, and is a public electronic system for purchasing and hiring, based on an Internet platform. It has earned a worldwide reputation for excellence, transparency and efficiency. It serves companies, public organizations (including universities, hospitals, schools, the military, government ministries, and Congress, among others) as well as individual citizens, and is by far the largest business-to-business site in Chile. Involving 850 purchasing organizations, in 2012 registered users completed 2,100,000 purchases issuing invoices totaling US$9.1 billion. It has also been a catalyst for the use of the Internet throughout the country. The third area in which Chile has spearheaded the use of technology to improve the efficiency of the state is in the area of red tape. ChileAtiende is a government site coordinating the work of over 150 government agencies and private institutions, and managing close to 2000 administrative processes online, including birth certificates, identity documents, pension fund payments, trademarks/patents, housing subsidies, university credits, and so on. The site receives an average of more than 1 million visits per month.

In all these areas, there is ample scope for technical assistance from the international financial institutions. Chile was able to implement the above reforms because it had the financial means, the human capital resources, and the strong backing of its politicians to use technologies to improve the efficiency of public services. Many developing countries may have the will to implement similar reforms, but often lack the funding or the technical means to put such systems in place. Over the past several decades, we have tended to underestimate the relative importance of technical assistance in foreign aid programs. Often the *knowledge* gap—the inability to tap into best practices because countries do not have adequate human resources to run programs like ChileCompra—is far more insurmountable than the *financial* gap, which donors can fund.

6. The Moral Dimensions of Corruption

In his erudite and all-encompassing study of bribery through the ages, Noonan (1984, p. 700) observes that “the common good of any society consists not only in its material possessions but in its shared ideals. When these ideals are betrayed, as they are betrayed when bribery is practiced, the common good, intangible though it be, suffers injury.” Bribery and corruption—however much the experts may wish to disguise them in the language of costs and benefits and economic choices—have a moral dimension. We ignore it at our own risk and at considerable cost to society in terms of the effectiveness of measures taken to limit or ameliorate their corrosive effects. Noonan gives several reasons to support the thesis that bribery has a strong moral dimension. By now, it has been criminalized in virtually every country in the planet, although enforcement of the laws condemning it may be weak. As we have seen, corruption itself may have weakened the state and its capacity to punish violations of the law, but there is little ambiguity that bribery is regarded everywhere as a perversion, hence the need for secrecy, for deception, and the use of euphemisms (gifts, contributions) by the guilty when it explodes into the open.

Bribery interacts with power. He who is willing to pay the most will be granted the exemption, will shut out the competitor, will gain the advantage. A plutocracy, a world in which wealth and money rule, is not a system likely to capture the popular imagination. Bribers understand this, and for that very reason they do not advertise their actions and are condemned to act behind the scenes, on the margins of legality and morality. Of course, bribery and corruption are betrayals of trust. Noonan (p. 704) puts it elegantly when he says: “the social injury inflicted by breaches of trust goes beyond any material measurement. When government officials act to enrich themselves they act against the fabric on which they depend, for what else does government rest upon except the expectation that those chosen to act for the public welfare will serve that welfare?” Equally important, bribery and corruption are deeply at odds with the moral basis of most of the world’s great religions, which have often provided the moral underpinnings of the modern state, as is clear, for instance, by reading the U.S. Constitution and other such founding documents.

In many of the measures discussed in the previous sections aimed at combating corruption, the underlying philosophy is one of eliminating the opportunity for corruption by changing incentives, by closing off loopholes and eliminating misconceived rules that encourage corrupt behavior. If, for instance, the budget is formulated, approved and executed in an environment of clear rules and transparent procedures, it is far less likely to be a mechanism for abuse and personal enrichment. But an approach that focuses solely on changing the rules and the incentives, accompanied by appropriately harsh punishment for violation of the rules, is likely to be far more effective if it is also supported by efforts to buttress the moral and ethical foundation of human behavior. A strategy in the struggle against corruption that is based solely on the design of better rules and harsher punishment for offenders is likely to be expensive and inefficient: expensive because of the need to build an infrastructure of enforcement that is credible and which catches and deals with offenders, but inefficient because it immediately pits the regulators/enforcers against the offenders in a cat-and-mouse game. And we have seen that the mice are often well-equipped to win, because the stakes are so high and the cat (regulator) is underpaid, overstretched, and outsmarted. The 2008-2009 global financial crisis revealed huge gaps in the regulation of the "shadow" banking system (hedge funds, investment banks, other off-balance sheet vehicles), but also showed that poorly-paid regulators are no match for the creativity of bankers willing to stretch the rules in an effort to disguise reality and boost short-term profits.

This means that in the long-term perspective, anticorruption strategies have to be supported by moral education and the strengthening of the ethical principles underpinning society.[26] This may mean reinforcing the civic responsibility component of secular education. It may require religious leaders—who bear such heavy responsibility for the decline of religion as a force for social cohesion—to set aside narrow doctrinal differences and return to the spiritual roots of their respective faiths to revitalize their ability to lead individuals and societies to a stronger identification with the spiritual rather than the material dimension of human nature. In particular, it will involve partnerships with all the organizations and social forces that have a strong ethical foundation. In a society with stronger ethical standards, the struggle against corruption will gain a new source of strength that will complement the progress made in recent years in improving the legal framework designed to combat bribery and corruption.

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26 Some international organizations are coming around to the view that anticorruption strategies cannot neglect the moral dimension. A fine example of this is the World Health Organization's attempt to create a framework for better governance in the pharmaceutical sector of its member countries. The global pharmaceutical market is worth some US$600 billion per year and the medicine chain is laden with opportunities for abuse and corruption, from the conduct of clinical trials to the filing of patents, licensing of establishments, sale and distribution, public procurement, prescriptions, to name just a few. The WHO's programme aims to "reduce corruption in pharmaceutical systems through the application of transparent, accountable administrative procedures and *the promotion of ethical practices* (emphasis added)." It identifies four values as underpinning a framework for good governance in the sector: justice, truth, service to the common good, and trusteeship and calls for explicit training of officials with a view to enhancing an understanding of the role of such values in the operation of the sector. (See Anello, 2008).

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