CHAPTER 6

Governance and Corruption

SUSAN ROSE-ACKERMAN

Introduction

All political systems need to mediate the relationship between private wealth and public power. Those that fail risk a dysfunctional government captured by wealthy interests. Corruption is one symptom of such failure with private willingness-to-pay trumping public goals. Private individuals and business firms pay to get routine services and to get to the head of the bureaucratic queue. They pay to limit their taxes, avoid costly regulations, obtain contracts at inflated prices and get concessions and privatised firms at low prices. If corruption is endemic, public officials – both bureaucrats and elected officials – may redesign programmes and propose public projects with few public benefits and many opportunities for private profit. Of course, corruption, in the sense of bribes, pay-offs and kickbacks, is only one type of government failure. Efforts to promote 'good governance' must be broader than anti-corruption campaigns. Governments may be honest but inefficient because no one has an incentive to work productively, and narrow elites may capture the state and exert excess influence on policy. Bribery may induce the lazy to work hard and permit those not in the inner circle of cronies to obtain benefits. However, even in such cases, corruption cannot be confined to 'functional' areas. It will be a temptation whenever private benefits are positive. It may be a reasonable response to a harsh reality but, over time, it can facilitate a spiral into an even worse situation.

'Corruption' is a term whose meaning shifts with the speaker. It can describe the corruption of the young from watching violence on television or refer to political decisions that provide narrow benefits to one's constituents in the form, say, of a new road through the district. In short, speakers use the term to cover a range of actions that they find undesirable. Because my topic includes both corruption and poor governance, I omit both morally corrupting activities, on the one hand, and run-of-the-mill constituency-based politics, on the other. I use the common definition of corruption as the 'misuse of public power for private or political gain', recognizing that 'misuse' must be defined in terms of some standard. Many corrupt activities under this definition are illegal in most countries – for example, paying and receiving bribes, fraud, embezzlement, self-dealing, conflicts of interest and providing a *quid pro quo* in return for campaign gifts. However, part of the policy debate turns on where to draw the legal line and how to control borderline phenomena, such as conflicts of interest, which many political systems fail to regulate. As I outline below, one of the most important debates turns on the issue of 'state capture' or the problem of creating open democratic-market societies in states where a narrow elite has a disproportionate influence on state policy. In those countries outright bribery may be low, but the system is riddled with special interest deals that favour the few over the many.

Researchers at the World Bank estimate that world-wide bribery totals at least \$1 trillion per year, just over 3 per cent of world income in 2002. The Bank staff extrapolated from firm- and household-level data contained in their own country-level surveys so the number represents an

I am grateful to Madiha Afzal and Dionysia-Theodora Avgerinopoulou for very useful research help. In parts of this chapter I draw on Rose-Ackerman (1999). I am grateful to Daniel Kaufmann, David Nussbaum, Benjamin A. Olken, Luccio Picci, Martin Raiser and Jong-Song You for helpful comments and current references.

order of magnitude with a large margin of error.[1] It is an estimate of the volume of bribes, not the impact of corruption on economic growth and global income. If used to measure the costs of corruption, it assumes that the volume of pay-offs is a good proxy for their economic effects. This, of course, need not be true. In economic terms, bribes are transfers from one pocket to another and are not an accurate measure of corruption's impact. Rather, the economic costs are the distortions induced by these transfers. Those costs may be many orders of magnitude higher than the volume of bribes themselves, or they may, under some conditions, be lower. Bribes may be small in some countries because bribe payers have bargaining power and do not need to pay much to get large benefits. In other countries, public officials may be able to extort large pay-offs that represent most of the benefits of the corrupt transaction. The estimate also ignores the role of corruption in increasing inequality and undermining support for democracy. Nevertheless, it provides a starting point from which to develop more fine-grained estimates.

Pointing to the magnitude of the problem, however, does not determine solutions. Because of the diversity of circumstances that produce corruption and poor governance, it is difficult to propose global approaches. Nevertheless, in what follows I make an effort, recognizing that improving governance in individual countries will require carefully tailored policies carried out with the hard work and personal commitment of those on the ground. Estimates of costs and benefits are obviously only rough guesses. However, it is important not to overlook reform possibilities in this area. Some reforms, if well designed and implemented, would have large benefits and very low costs. Unfortunately, they also have serious distributive effects, and those who gain from the status quo are frequently powerful economic and political actors capable of blocking reforms.

Cost-benefit ratios (CBRs) for other types of reforms will be distorted if they do not take corruption, self-dealing and incompetence into account. The risks of corruption and weak administration thus need to be considered in assessing proposals, for example, to limit hunger, reduce violence, or improve education and health.

The options that I discuss fall into five categories: voice and accountability, procurement, revenue raising, regulation of business and efforts to limit high-level corruption in international business.

First, I summarise many successful examples of programmes that *improve accountability at the grass roots*, and argue that these cases provide lessons that can be applied elsewhere. Some cases, such as school financing in Uganda and public works construction in Nepal, suggest that relatively simple, inexpensive reforms can have large benefits if the political will exists.

Second, I recommend efforts to develop *benchmark cost estimates* that can help constrain procurement fraud and corruption. This would require coordinated data gathering efforts, but given the large cost distortions in contracting – sometimes up to 30–40 per cent – the gains could be large. Under some conditions, a state could combine benchmarking and citizen control to constrain waste and malfeasance.

Third, I consider reform of revenue collection through *tax simplification and incentive-based reforms*. Once again the net benefits of a well-designed programme can be large, but the mixed record of past efforts suggests caution.

Fourth, I recommend the *streamlining of business regulations* based on data indicating the economic costs of 'red tape'. However, past work has looked only at the gains to business and has failed to consider the costs to society of eliminating regulations that provide social benefits. Policy must thus balance the benefits and costs of regulations.

Finally, I discuss international initiatives to *increase transparency* in international concession contracts for natural resources and efforts to track down the assets of corrupt officials. The former option is also recommended in Paul Collier and Anke Hoeffler's (2004) chapter 3 in this volume on civil war. They estimate that it could provide multi-billion dollar benefits with minimal costs. Like the other options on my list, however, there is a dearth of actual experience in putting this

[1] Correspondence with Daniel Kaufmann, World Bank Institute, February 2004. The World Bank Institute is preparing a document explaining the derivation of this figure and considering the relationship between the volume of bribes and the social costs of bribery.

idea into practice. One should follow an experimental approach to see what works and what does not.

This chapter focuses on empirical evidence. It does not discuss theoretical work on the causes and consequences of corruption and poor governance. Those who want to pursue these issues further should consult Rose-Ackerman (1978, 1999), a review article by Pranab Bardhan (1997) and the framework presented in Shleifer and Vishny (1993). These sources also include extensive references to the literature. To access current work, the World Bank Institute maintains a website (http://www.worldbank.org/wbi/governance) as does Transparency International (TI), an international non-governmental organization (NGO) committed to fighting corruption (http://www.transparency.org). Several recent literature reviews are at the website of U4 Utstein Anti-Corruption Resource Centre (http://www.u4.no).

Research on the Causes and Consequences of Corruption

Several strands of literature demonstrate the benefits of corruption control and government reform. I begin with cross-country studies that try to explain the consequences of corruption and poor governance for economic growth and well-being. The next section considers firm-level surveys that explore the consequences of corruption for firm behaviour. Next, I summarise surveys that provide a window onto individual attitudes toward and experiences with corruption and dysfunctional government. Then I turn the causal link around and review studies that seek to determine the causes of poor government and corruption. Finally, I introduce distinctions between administrative corruption, 'state capture', and what Michael Johnston calls 'power chasing wealth' (2002).

The Consequences of Corruption and Poor Governance: Cross-Country Research

Cross-country research on corruption and governance is part of a growing body of research that looks for the institutional bases of economic growth. Measures of corruption and poor governance are correlated with *per capita* income and with the United Nations Human Development Index (HDI). Richer countries, on average, have less reported corruption and better functioning governments.[2] The same holds true for countries with high levels of the HDI, a measure that includes estimates of health and educational attainment as well as a logarithmic measure of income. Figure 6.1 shows the relationship between the HDI and the index of corruption developed by TI. Very high levels of human development are associated with low levels of corruption (high numbers on the TI index). However, high levels of corruption (between 1 and 4 on the TI index) are associated with a wide range of middle to low levels of human development.[3]

These two stylised facts raise the possibility that policy makers should forget about governance and just focus on stimulating growth though standard economists' prescriptions. Under that view, marginal improvements in governance are of questionable benefit to poor and corrupt countries, and good governance is a 'luxury good' that citizens will demand once they are rich enough to care. However,

[2] Kaufman (2003, annex 2, figures 1A, 1B and IC) presents three figures showing the postive correlations between the log of real GDP *per capita* and corruption, the rule of law, and voice and accountability, respectively. The governance measures are derived from survey evidence mostly based on the perceptions of business people and country experts.

[3] The corruption measure is an ordinal index derived from surveys, not a cardinal measure. Thus, a move from 2 to 3 on the index might imply a greater increase in integrity on some cardinal measure, such as level of bribes *per capita*, compared with a move from 8 to 9. One should not give a cardinal interpretation to indices of corruption. If a country's index fall from 6 to 3, this does not mean that corruption has been halved. However, if one compares countries at any CPI score between 2 and 4 with those between 8 and 9, there is a greater spread in the HDI levels in the former case than in the latter. There is, however, another aspect of the data that deserves mention because it determines the curvilinear shape in figure 6.1. The HDI uses a logarithmic scale for the income portion of the index, a technique that compresses the scale for wealthy countries. A similar graph with *per capita* income on the *y*-axis instead of the HDI shows a more dispersed pattern of income at higher levels of the (somewhat different) corruption index (Kaufmann 2003, figure 1A). However, at low levels of the index (that is, in highly corrupt environments) the data points continue to appear more dispersed than at high levels.

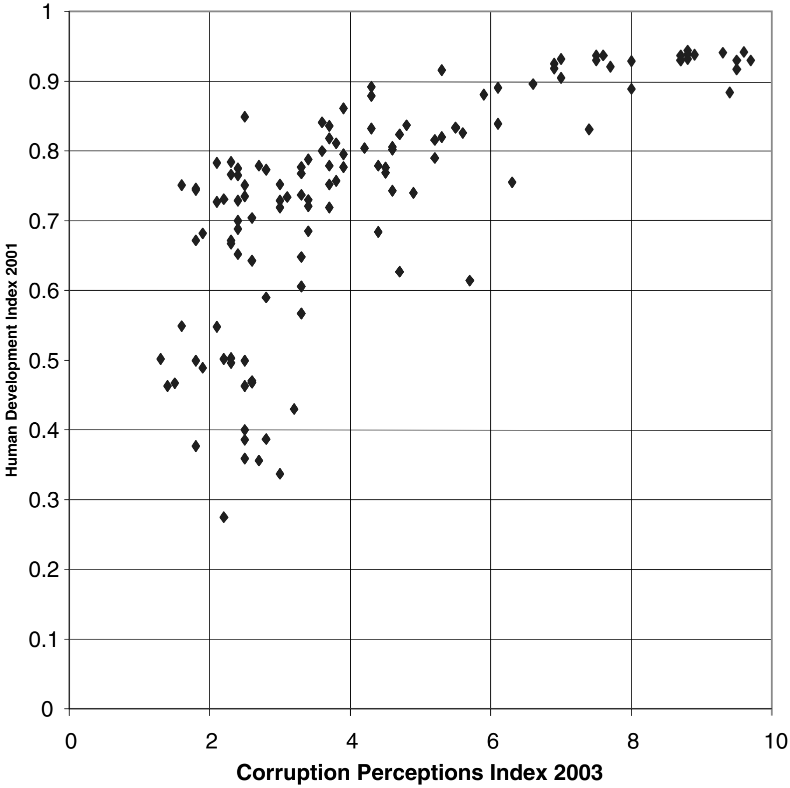

Figure 6.1. *Human development index and corruption perception index*
Source: Calculated from UNDP and TI data.

the available statistical evidence suggests that, correcting for other factors, poor governance is itself one of the reasons that some countries are poor and have low or negative growth rates. Kaufmann and Kraay (2002) confirmed this result and, in addition, found no positive feedback from higher incomes to improved governance. However, the issue remains contested. It seems plausible that both directions of causation hold. Demands for greater democracy, transparency and integrity in government often become more insistent as *per capita* income rises. However, to the extent that corrupt rulers recognise this possibility, they have an incentive to limit prosperity to constrain such demands. Those who benefit from a corrupt status quo will try to impede reform. Improvements in human well-being seldom occur spontaneously but, instead, require government actions to complement private efforts. Governments that waste resources through malfeasance or inadvertence are a drag on growth and undermine the achievement of other goals.

As Mancur Olson (1996) demonstrated, economic measures alone do a poor job of explaining the divergence in growth rates. This finding spurred research on the importance of institutions. At around the time of the publication of that article, cross-country data ranking countries' institutional quality began to be available, and researchers interested in economic development began to use existing political science measures of democratisation. This spawned a large literature showing that 'institutions matter'. I cannot summarise that literature here except to say that I am sympathetic to Dani Rodrik's (2003) view that first-order economic principles do not map onto unique policy packages; furthermore, as he argues, igniting growth and sustaining it over the long term are two different things and may require different polices. I focus here on work that incorporates a measure of corruption, recognizing that these indices reflect not just the level and frequency of bribes but also capture the general quality of state–business–society relations.

TI has published cross-country data on corruption since 1995. It collects data from a number of different surveys that mostly report business and expert perceptions of corruption in various countries. Some of the underlying data sources also include questions concerning the overall business environment – asking about red tape, the quality of the courts, etc. Respondents rank the countries on a scale from 'excellent' to 'poor'. The annual TI indices are a compilation of corruption scores that average three years of data. They are ordinal rankings and do not provide measures of the volume of bribes, the incidence of corruption, or its impact. Because the underlying surveys included in the index vary from year to year, the data can not be used for time series studies. The World Bank has made use of the underlying indices that make up the TI index and has produced its own 'graft' index using a different aggregation method and including more countries. It is highly correlated with the TI index. Most studies use one or the other of these indices. Although some countries change position from index to index and have different rankings in the TI and World Bank datasets, there is an overall stability to the rankings. Furthermore, if a country's score differs from survey to survey, one cannot tell if this is because of the use of different sources, changed underlying conditions, or shifts in perceptions. Thus, these indices are a rough measure of the difficulties of doing business across countries, but they should not be used to make precise bilateral comparisons between closely ranked countries.

Studies using these data have found that high levels of corruption are associated with lower levels of investment and growth and that corruption discourages both capital inflows and foreign direct investment (Mauro 1995; Wei 2000; Graf Lambsdorff 2003a). According to Wei, an increase in the corruption level from relatively clean Singapore to relatively corrupt Mexico is the equivalent of an increase in the tax rate of over 20 percentage points. The statistical result holds for East Asian countries as well as for the others in his sample. Acemoglu, Johnson and Robinson (2001) find that when the risk of expropriation is high, growth rates tend to be low. Most measures of institutional quality are correlated, and in this case, expropriation risk and corruption go hand in hand so that the same association holds for corruption. Countries perceived as more corrupt pay a higher risk premium when issuing bonds (Ciocchini, Durbin and Ng 2003). Corruption lowers productivity, reduces the effectiveness of industrial policies and encourages business to operate in the unofficial sector in violation of tax and regulatory laws (Ades and Di Tella 1997; Kaufmann 1997; Graf Lambsdorff 2003b). Graf Lambsdorff (2003a, 2003b) finds that an improvement in a country's TI corruption score by 1 point increases productivity by 4 per cent of GDP and increases net annual capital inflows by 0.5 per cent of GDP. This means that if a country such as Tanzania could achieve the corruption score of the UK, its GDP would increase by more than 20 per cent and net annual *per capita* capital inflows would increase by 3 per cent of GDP. Of course, such extrapolations are not to be taken strictly literally because the corruption score reflects all sorts of complex underlying conditions, but they do suggest the importance of the institutional environment to the achievement of economic success.

Highly corrupt countries tend to underinvest in human capital by spending less on education, to overinvest in public infrastructure relative to private investment and to have lower levels of environmental quality (Mauro 1997; Esty and Porter 2002; Tanzi and Davoodi 2002a). High levels of corruption produce a more unequal distribution of income under some conditions, but the mechanism may be complex – operating through lower investments in education and lower *per capita* incomes (Gupta, Davoodi and Alonso-Terme 2002; Gupta, Davoodi and Tiongson 2000). One study hypothesises a U-shaped relationship. If corruption is very low or very high, inequality is low. However, in the high-corruption case, everyone is equally poor. The empirical work, which omits the most impoverished countries, suggests that higher levels of corruption lead to increases in inequality, but the effect reaches a plateau at very high corruption levels associated with low levels of *per capita* income. Corruption levels help explain Gini differentials within Latin America, the OECD and Asia, but they do not explain the large Asia–Latin American differences in Gini coefficients or the intercontinental differences in growth rates (Li, Xu and Zou 2000). Corruption can undermine programmes explicitly designed to help the poor. For example, Ben Olken (2003) shows how corruption and theft undermined a rice distribution programme in Indonesia. At least 18 per cent of the rice disappeared; in the one third of the villages that suffered losses, 43 per cent of the rice was missing on average. Under reasonable assumptions, corruption and theft turned a welfare-improving programme to one that was welfare-reducing.

Corrupt governments lack political legitimacy (Anderson and Tverdova 2003). However, political supporters of corrupt incumbent governments, not surprisingly, express more positive views of the government. Presumably, this difference depends upon the individualised benefits that flow to these supporters. Surveys carried out in four Latin American countries (El Salvador, Nicaragua, Bolivia and Paraguay) in 1998 and 1999 showed that those exposed to corruption had both lower levels of belief in the political system and lower interpersonal trust (Seligman 2002). In Nicaragua, respondents were asked if the payment of bribes 'facilitates getting things done in the bureaucracy'. Interestingly, those who agreed that corruption gets things done were *less* likely to believe in the legitimacy of the political system (Seligman 2002, 429). Surveys of firms in countries making a transition from socialism provide complementary findings. Firms with close connections with the government did better than other firms, but countries where such connections were seen as important for business success did worse overall than those where political influence was less closely tied to economic success (Fries, Lysenko and Polanec 2003).

In circumstances of low government legitimacy, citizens try to avoid paying taxes and firms go underground to hide from the burden of bureaucracy, including attempts to solicit bribes. Using data from the World Values Survey and Transparency International, Uslaner (2003) shows that high levels of perceived corruption are associated with high levels of tax evasion, with countries falling into two distinct groups. His survey data from Romania show that those who believe that one has an obligation to pay taxes have more trust in government. Similarly, Torgler's (2003) study of attitudes toward tax evasion in Central and Eastern Europe (CEE) shows that when individuals perceived that corruption was high, they were less likely to say that people have an obligation to pay taxes. Thus, one indirect impact of corruption is to persuade people that it is acceptable not to pay taxes because government has been captured by corrupt officials and those who support them. As a consequence, corrupt governments tend to be smaller than more honest governments, everything else equal (Friedman *et al.* 2000; Johnson *et al.* 2000). Thus in corrupt governments, the individual projects are excessively expensive and unproductive, but the overall size of the government is relatively small.

Business Surveys on the Consequences of Corruption

More nuanced results come from surveys that questioned businesses about the costs of corruption, red tape and other constraints on doing business. The World Business Environment Survey (WBES), carried out between the end of 1998 and the middle of 2000 under World Bank auspices, questioned several thousand enterprises in eighty countries (Batra, Kaufmann and Stone 2003). Figure 6.2 indicates the way that constraints on business differ between OECD members and emerging economies. In the statistical work using firm-level data, a high frequency of corruption, financing difficulties, high taxes and lack of government–business consultation each had significant negative impacts on firms' sales growth over 1997–9. In countries with negative scores on all four measures, the average growth of sales of existing businesses was more than 10 percentage points less than in countries on the positive side on all four. Investment growth was affected by four factors as well, with policy predictability

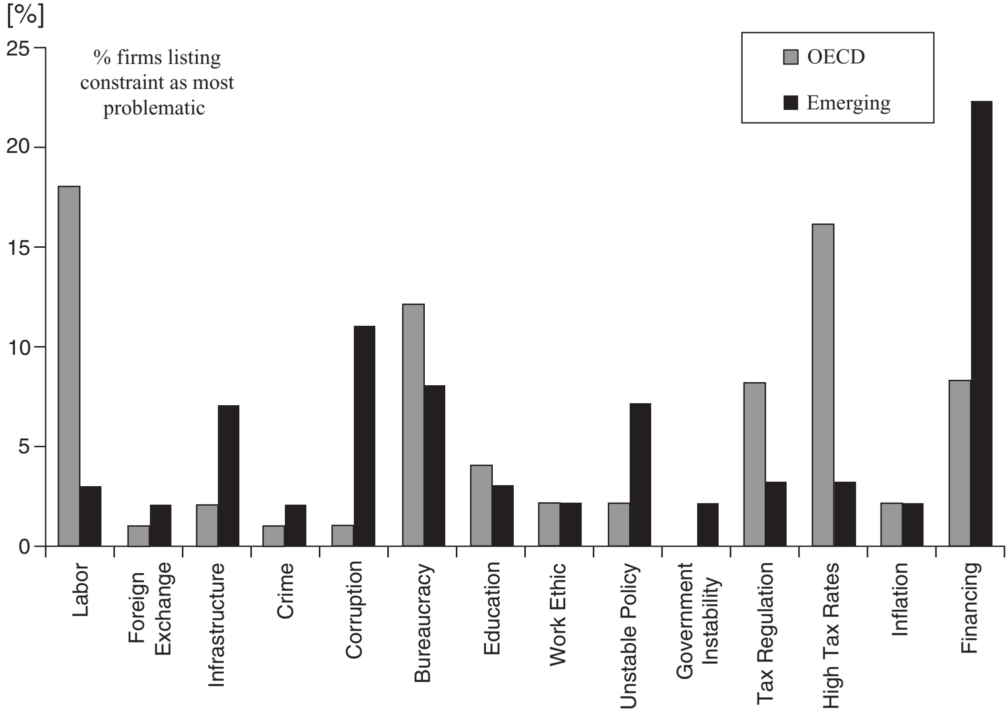

Figure 6.2. *Key business environment constraints to the firm: emerging economies and OECD*
Note: Executive Opinion Survey (2003) – question 13.01: 'From the following list, please select the five most problematic factors for doing business in your country, and rank them between 1 (most problematic) and 5.' Figure 6.2 shows the percentage of firms ranking the constraint as the most *problematic among the fourteen items on the list.*
Source: Kaufmann (2004).

replacing lack of consultation. The same was true for the four significant variables in the investment equation.[4] As the authors conclude: 'While it may be difficult and take years to reform taxes, financing, corruption, and policy predictability, the evidence suggests that higher growth and investment are associated with such improvements.'[5]

Other less comprehensive research studied countries as diverse as those in Asia, SSA, and CEE. Most of this work is broadly consistent with the WBES survey. Survey work in Asia by the World Bank demonstrates the way that government effectiveness affects the investment climate and hence both the level of foreign investment in a firm and the firm's export orientation. In Bangladesh, China, India and Pakistan firm export levels and foreign investment were higher where hassles and delays were low. Given the evidence that endemic corruption is 'sand' not 'oil', that is another way of saying that corrupt pressures are low. To help one understand the magnitude of the effects, the authors report 'that if Calcutta could attain

[4] Neither predictability of bribe requests nor positive views of government on other questions (a 'kvetch' effect) affected that conclusion and no measure of these effects was significant (Kaufmann, Mastruzzi and Zavaleta 2003, 372–7).

[5] Batra, Kaufmann and Stone (2003, 14). The survey results were converted to binary zero/one codings with zero indicating the desirable outcome for business (Batra, Kaufmann and Stone 11). A related study by Fries, Lysenko and Polanec (2003, 40) using only data from Eastern Europe and the Former Soviet Union (FSU) produced similar results. Qualitative perceptions of corruption, crime, judicial quality, regulatory constraints, taxes and financing constraints significantly affected GDP *per capita* in 2001, real GDP growth from 1997 to 2001 and real GDP growth in 2002, all in the expected direction.

Shanghai's level of investment climate, the share of firms . . . exporting would nearly double from the current 24 per cent to 47 per cent, comparable to the coastal Chinese cities. Similarly, the share of foreign-invested firms would increase by more than half, from the current 2.5 per cent of firms, to 3.9 per cent' (Dollar, Hallward-Driemeier and Mengistae 2003, 7).

Svensson (2003) surveyed firms in Uganda. The level and incidence of bribery were positively associated with a firm's contact with the public sector for such matters as foreign trade, tax collection and regulatory compliance. The level of bribes was a function of both a firm's ability to pay and of the expected cost of relocation. More corrupt firms had lower growth rates on average than others. This research suggests how corruption imposes differential costs on different types of firms and demonstrates how it is connected to the underlying policies of the government.

The most comprehensive survey work has been done in CEE. The World Bank's two waves of surveys of the business environment in that region document the specific ways that corrupt officials and intrusive rules affect businesses and show how corrupt environments impose costs (Johnson *et al.* 2000; Hellman, Jones and Kaufmann 2003, 2004). There are broad differences in corruption and protection payments between Russia and the Commonwealth of Independent States (CIS), on the one hand, and Central Europe, on the other. Formally organised firms in Russia and Ukraine are much more likely to admit to hiding sales and salaries than firms in Central Europe (Johnson *et al.* 2000, table 1). Wholly off-the-books enterprises are more common in Russia and Ukraine and such firms hide all of their output from the authorities. Furthermore, firms in Russia and Ukraine reported spending more time on government and regulatory matters than elsewhere (18 per cent and 25 per cent, compared with about 10 per cent for the other countries; Johnson *et al.* 2000, table 2). This may be a rough measure both of the degree of extortion to which firms are subject and of the degree to which firms can be exempted from rules if they curry favour with authorities. In Russia and Ukraine almost all firms that answered the question reported making illicit payments, and they hide a high proportion of their sales. In Central Europe, a group of firms also operates both corruptly and partly off-the-books, but the practice is not so widespread.

Surveys demonstrate how firms manage to cope when the legal system is weak. Informal relationships built on trust and private sanctions exist but cannot easily bear the entire burden of maintaining business deals. Weak states produce widespread corruption, private protection rackets and the flouting of regulatory and tax laws. The CEE countries vary in the security of property rights. Those countries with more secure property rights have higher levels of new investment by established firms (Johnson, McMillan and Woodruff 2000, 2002).[6] The security of property rights is measured by the ability of the state to enforce its own rules impartially. In other words, the benchmark is not a libertarian state but one that provides services, regulates behaviour, levies taxes and operates an impartial court system. Property rights are less secure if bribery and protection payments are common and if the courts do not enforce contracts. Thus, corruption is not a route to a secure relationship with the state but opens up possibilities for extortion. Furthermore, if firms pay for protection, either to private mafias or to the police, this reduces the security of rights as well (Johnson, McMillan and Woodruff 2002, table 1). Trust in the state as a *reliable actor* seems important. Firms appear willing to substitute legal and impartially administered taxes for the uncertainties of bribe payments and the dangers of relying on private protection services (Friedman *et al.* 2000).[7]

Household Surveys

Surveys of individuals sometimes ask about attitudes toward corruption and bribery. The results provide a counterweight to those who claim that

[6] Entrepreneurs with the least secure property rights invest 40 per cent less than those with the most secure property rights. At the time of the survey in 1997, the absence of bank finance did not prevent firms from investing because they were profitable enough to satisfy their investment needs internally (Johnson, McMillan and Woodruff 2002). Although employment growth is unrelated to property rights, high sales growth is significantly associated with more secure property rights (Johnson, McMillan and Woodruff 2000).

[7] See also Graf Lambsdorff (2003a), who concludes, using cross-country data, that legal reform, directed at the improvement of property rights and the maintenance of law and order, is crucial for attracting foreign capital.

Table 6.1. Citizens' Feelings about Giving Money or a Present

Q103 'Suppose people gave money or a present to an official and got what they wanted, would they be most likely to feel . . . '
Q104 'But if they thought very few other people gave such things to officials, would they then be most likely to feel . . . '

	Czech Republic		Slovakia		Bulgaria		Ukraine	
	Q 103 (%)	Q 104 (%)	Q 103 (%)	Q 104 (%)	Q 103 (%)	Q 104 (%)	Q 103 (%)	Q 104 (%)
Happy	50	15	63	18	66	36	55	22
Angry	25	36	23	37	13	20	11	24
Worried	7	15	5	14	11	16	18	34
Ashamed	18	34	8	31	11	29	16	20

Note: 'Don't know', 'Mixed/Depends', etc. answers were recorded if given spontaneously, but never prompted; they have been excluded from the calculation of percentages.
Source: Miller, Grødeland and Koshechkina (2001).

entrenched corruption is acceptable to ordinary citizens. Interviews in a range of countries have found widespread popular disapproval of entrenched corruption (e.g. Pasuk and Sungsidh 1994; Anderson, Kaufmann and Recanatini 2003).

One particularly detailed study of four CEE countries provides some nuance (Miller, Grødeland and Koshechkina 2001, 2002). The research revealed that people disapprove of corruption even if they report engaging in it themselves. The authors conducted surveys and focus groups in four countries that cover the spectrum of transitional democratic and market institutions – from the relatively far-advanced Czech Republic, through Slovakia and Bulgaria, to Ukraine. Although experience with corruption varied markedly across the countries, the public's underlying values and norms did not differ greatly. A majority in each country expressed strong moral disapproval of pay-offs but, at the same time, a plurality of citizens in every country except the Czech Republic said they would pay a bribe if asked. The authors conclude that the basic problem is not a weakness in the underlying values of citizens and public officials but an excess of *corrupt opportunities*. Because of a concentration of corrupt opportunities in some areas of public life, the officials most likely to receive gifts or bribes are hospital doctors, traffic police and customs officials. One hopeful finding – reproduced in table 6.1 – was that people's attitudes toward bribery were affected by their perceptions of others' actions. Attitudes are not deeply entrenched but depend on situation-specific variables, such as one's perception about whether or not others are paying.

A second type of household survey is a part of the International Crime Victimization Survey (ICVS) compiled by the United Nations Interregional Crime and Justice Research Institute (http://www.unicri.it/icvs). Individuals are asked if during the past year any government official had asked them or expected them to pay a bribe in return for services. Naci Mocan (2004) used this data, which is available for 49 countries, to show that both personal and country characteristics determine the risk of exposure. Those of higher wealth and education reported more frequent requests, presumably because they interact more frequently with public officials and have a greater ability to pay. Low levels of reported corruption are related to high levels of institutional quality, uninterrupted democracy, and an absence of war. Poor institutional quality leads to both high perceptions of corruption under the TI or World Bank indices and high levels of victimization. The study confirms the claim that corruption is a symptom of underlying institutional weaknesses. Law enforcement policies that target corruption alone without touching the underlying institutional weaknesses are unlikely to be effective either in changing perceptions or in improving growth. Holding other things constant, 'a one-half standard deviation increase in the quality of institutions (e.g. from the level of Indonesia to the level of India), generates an additional 0.7 percentage point increase in . . . average annual *per capita* GDP growth. For a developing country with $2,500 *per capita* income in 1975 this translates into an additional $500 *per capita* income by 1995' (Mocan 2004, 28).

In diagnostic exercises the World Bank has used household surveys to narrow down anti-corruption efforts to areas of most concern to the population. However, although these surveys isolate pressure points where corruption is widespread, they do not measure the cost of bribery in terms of the inefficient or unfair allocation of public services or burdens. The ICVS does not provide this kind of information either. It simply reports the proportion of people who were asked for a bribe in four areas: The next step in the diagnostic exercise, therefore, should be an estimate of the relative costs of tackling different types of corruption that affect daily life.

Causes of Corruption and Poor Governance

Given the costs of corruption and poor governance, reformers need to isolate the causes of these phenomena. Cross-country data permit one to obtain a broad overview of the underlying causes of corruption and weak governance. I have already mentioned the role of income and wealth as both a cause and a consequence of corruption. However, the simultaneity often is not well handled in the empirical work. Nevertheless, it seems possible to conclude, first, that poor governance contributes to low growth and to the other harmful outcomes noted above, and that weak underlying economic conditions facilitate corruption. The exception is a very poor country with weak institutions that is so badly off that there is little for anyone to steal.

Some studies find that trade openness and other measures of competitiveness reduce corruption (Ades and Di Tella 1999; Sandholtz and Koetzle 2000; Blake and Martin 2002), suggesting that societies with fewer rents to share are less corrupt. However, once again the causation is unclear; countries that do not favour corrupt firms may be able to establish a policy of open and competitive markets. Graf Lambsdorff (2003a), for example, finds that weak law and order and insecure property rights encourage corruption which in turn discourages foreign capital inflows.

Inequality contributes to high levels of corruption. In democracies in particular, inequality facilitates corruption, a result consistent with the state capture variant of corruption. The negative effect of inequality on growth may be the result of its impact on corruption taken as a proxy for government weakness (You and Khagram 2004). Here, too, the causal arrow goes both ways.

Historical and social factors help explain cross-country differences. For example, Acemoglu, Johnson and Robinson (2001) use the mortality rates of European settlers as an instrument for the type of colonial regime put in place by the imperial power and find that it does a good job of predicting expropriation risk (and corruption levels) at the end of the twentieth century. La Porta *et al.* (1999) consider legal origin, religion, ethnolinguistic fractionalisation, latitude and *per capita* income as determinants of a range of features of economic, social and political life. Corruption, as well as other measures of institutional weakness, is worse in countries with higher ethnolinguistic fragmentation, few Protestants, and Socialist or French legal origins. (See also Sandholtz and Koetzle 2000; Treisman 2000.)

Colonial heritage, legal traditions, religion and geographical factors seem associated with corruption and other measures of government dysfunction, but these are not policy variables that present-day reformers can influence. The key issue is whether these historical regularities directly affect government quality or whether they help determine intermediate institutions and attitudes that present day policies can affect. In La Porta *et al.* (1999) the historical variables are not always significant and become entirely insignificant when they add income and latitude. These historical patterns may thus operate through their impact on underlying *institutional structures*, not as direct determinants of corruption. If so, that may be good news for reformers so long as there are alternative routes to the creation of institutions that facilitate economic growth and high income (cf. Rodrik 2003). Latitude and history need not be destiny.

The impact of democracy on corruption is complex. High levels of economic freedom and lower levels of corruption go together, as does an index of democratisation (e.g. Sandholtz and Koetzle 2000; Blake and Martin 2002; Kunicova and Rose-Ackerman 2005). Governments with more female participation in politics are less corrupt and this is consistent with survey evidence suggesting that women are more disapproving of corruption than men (Crook and Manor 1998, 42; Swamy *et al.*

2001). Within the universe of democracies, features of government structure, such as presidentialism, closed-list proportional representation and federalism, facilitate corruption (Treisman, 2000; Kunicova, 2002; Kunicova and Rose-Ackerman, 2005).[8] Presidential systems that use proportional representation (PR) to elect their legislature are more corrupt than other types of democracies. Many parliamentary democracies that elect legislatures by plurality rule have a heritage of British colonial rule, and many PR systems had French or Spanish rulers. Present-day levels of freedom also have historical roots. However, if constitutional form, protection of rights, women's rights and electoral institutions are important determinants in and of themselves, then countries have policy levers available even if they cannot change their histories.

A World Bank survey permits one to see how one country compares with others on a range of different factors (Kaufmann, Mastruzzi and Zavaleta 2003, 363–4). Although measures of corruption, government quality and informal sector activity are strongly correlated, more fine-grained analysis often shows pockets of strength and weakness. For example, a study of Bolivia, using this survey, showed that it ranked poorly on several measures of corruption, judicial quality and property rights, but rather well on standard macroeconomic variables such as inflation, the exchange rate and the quality of the central bank. Because Bolivia has had a low growth rate, the results suggest that getting the macroeconomics fundamentals right is not sufficient. *Institutional reforms* are needed and within Bolivia itself some public institutions score better than others and may provide reform models (Kaufmann, Mastruzzi and Zavaleta 2003, 364–5).

'Crony Capitalism' and the Links between Political and Economic Power

The World Bank distinguishes between administrative corruption and what its calls 'crony capitalism' or 'state capture'. Country-specific research on such countries as Russia, Albania, Indonesia and Malaysia confirms the importance of the distinction. *Administrative corruption* includes the use of bribery and favouritism to lower taxes, escape regulations and win low-level procurement contracts. '*State capture*' implies that the state itself can be characterised as largely serving the interests of a narrow group of business people and politicians, sometimes with criminal elements mixed in. Even if the group with influence changes when the government changes, most of the citizens are left out. Michael Johnston (2002) proposes a richer taxonomy that includes political systems that manipulate private firms for personal gain. He calls this 'power chasing wealth' as opposed to 'wealth chasing power'. The World Bank would probably put both types in the 'state capture' category, but they may have different implications. For example, Russia may be moving from a case where private wealth controlled public power to one where political power dominates private wealth.

Favoured firms may not have secure property rights in the legal sense but may be able to obtain favoured treatment because of their insider status (Hellman, Jones and Kaufmann 2003). This can promote economic growth at least for a period of time. Rock and Bonnett (2004) conclude that between 1984 and 1996 the large East Asian countries (China, Indonesia, Korea, Thailand, Japan) were in a different category from the rest of the world. They argue that, during their study period, these countries were characterised by strong centralised governments with long time horizons that were able to control corrupt networks. Rulers promoted growth by providing privileges to capitalists in return for kickbacks. These are very special cases that appear to store up problems for the future. The main risk is a change in the political leadership. For example, in a study of Indonesia under President Suharto, Fisman (2001) used an index of the political connectedness of firms listed on the Jakarta Stock Exchange, dubbed the Suharto Dependency Index. He demonstrates that rumours about Suharto's health problems between 1995 and 1997 had a more negative impact on the share prices of firms with

[8] Fjeldstad (2003) provides a literature review on decentralisation and corruption that cites studies that contradict the results for federalism found in the sources listed in the text. In any case, it is important to distinguish between federalism and explicit policies designed to empower those at the grassroots. I discuss the latter below.

high levels of this index and that the differential impact was greater the worse the rumours.[9]

Because sustained corruption undermines political legitimacy, corruption can itself undermine the rulers' long time horizon, leading to regime change (Rose-Ackerman 1999, 32). However, the more democratic regimes that emerged in several of the countries studied by Rock and Bonnett (2004, 1101) have had to confront corrupt network that now work to undermine growth.

More detailed research has been done on the former Communist states in Europe and Central Asia. The World Bank and the European Bank for Reconstruction and Development (EBRD) show that, although administrative corruption is a problem throughout the former Communist states, state capture is a particularly serious problem in the countries of the former Soviet Union (FSU). In such situations the firms that do the capturing perform well, but overall economic growth suffers (Hellman, Jones and Kaufmann 2003). Fries, Lysenko and Polanec (2003, 31–2) document the differences between 'captor' firms with insider status and 'non-captor' firms. The former have higher growth rates of fixed capital, revenue and productivity. Slinko, Yakovlev and Zhuravskaya (2004) obtain similar results using data from the Russian provinces.

If top political figures themselves exploit their position for private gain, the effectiveness of government programmes and the impact of foreign aid and lending suffer. Even if those with good political connections are also good economic managers, there is a long-term risk that they will exploit their dominant positions to squeeze out potential competitors (Acemoglu 2003). This inequality of influence can extend beyond special treatment by the executive and the legislature to include the courts as well.

[9] Of course, Suharto did actually resign from office in May 1998 but, as Fisman points out, this is a difficult event to study within his framework because so many other things were happening at the same time: the 'event window' was several months long, the successor was a Suharto ally and trading volumes were exceptionally low by the end of 1997. Perhaps for these reasons, the relationship did not hold in the beginning of 1998 except for steep declines in the shares of firms controlled by Suharto's children (Fisman 2001, 1100, n. 9).

World Bank researchers define 'crony bias' as the difference between the reported influence of one's own firm and business association, on the one hand, and the influence of those with close ties to political leaders, on the other. In a study using firm-level data from the 2002 Business Environment and Enterprise Performance Survey on former socialist countries (BEEPS), Hellman and Kaufmann (2004) find that firm managers who believe that the state is unduly influenced by a narrow set of 'cronies' are more likely to withhold taxes, pay bribes and avoid using the courts. These actions then help keep state institutions weak. Bribery and extortion are mostly a problem for medium-sized businesses. Large dominant firms have close relationships with top political leaders so that mutually beneficial deals are possible. These deals are often harmful to the overall growth and prosperity of the country and undermine efforts to establish the legitimacy and trustworthiness of the state.

In the geographically broader WBES survey of eighty countries there is a marked relationship between this measure of crony bias and survey responses on the size of the unofficial economy and the decree of democratic voice and accountability. A large unofficial economy indicates that the regulatory and taxation powers of government are low and that many firms cannot obtain outside financing because they are off-the-books. Low levels of voice and accountability suggest that the state is not responsive to its citizens' interests. Figures 6.3 and 6.4 present these results.

Reform Proposals

Research on the causes of corruption suggests ways to think about reform. First, the simultaneity between *income* and *poor governance* implies that purely economic prescriptions, taken alone, will not succeed either in promoting growth or in improving government performance. If, as Kaufmann and Kraay (2002) argue, causation flows mostly from corruption to low levels of income and growth, that conclusion is strengthened. Macroeconomic policy prescriptions presuppose a well-functioning government, which is just what is lacking in corrupt

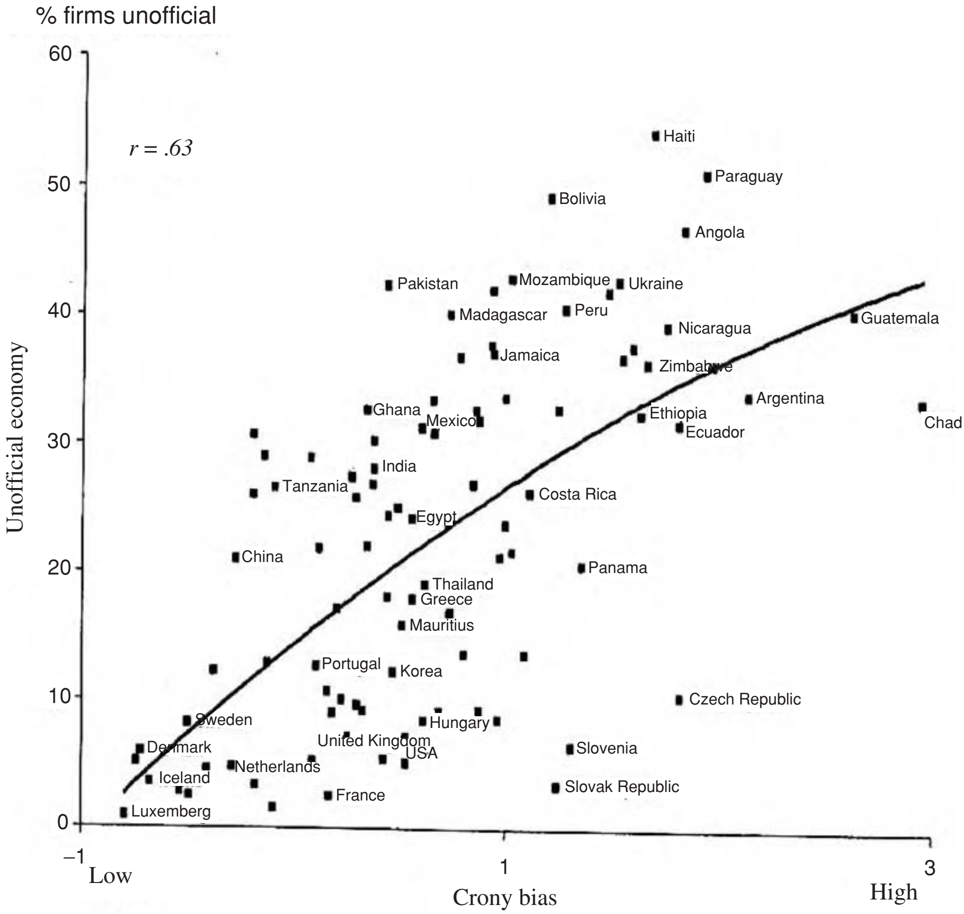

Figure 6.3. *The unofficial economy and crony bias (data from World Bank Worldwide Survey)*
Note: Only selected countries among the 102 in the worldwide survey are labelled, owing to space limitations. Unofficial economy data are drawn from firms' responses to the following question: 'What percentage of business in your country would you guess are [sic] *unofficial or unregistered?' (categorical, converted using minimum within each range). Crony bias is constructed based on data from the 2003 worldwide survey of firms in 102 countries, calculated as the difference between influence by firms with political ties and influence by the firm's own business association.*
Source: Kaufmann (2004).

countries. Similar problems of simultaneity exist for trade openness and inequality. Proposals to improve governance by concentrating on economic growth, trade openness, and reductions in inequality thus beg the question of how weak states could accomplish such fundamental changes. Second, history and latitude may be important, but they are givens, not policy tools. One needs to determine what they are instruments for and whether present-day institutions are subject to reform whatever a country's history. Third, some features of political systems seem to promote honest and effective government: high levels of economic freedom, parliamentary structure, certain types of electoral institutions and avoidance of private capture of the state and of state capture of the economy. Some of these statistical associations could be translated into particular policy proposals, but most of them

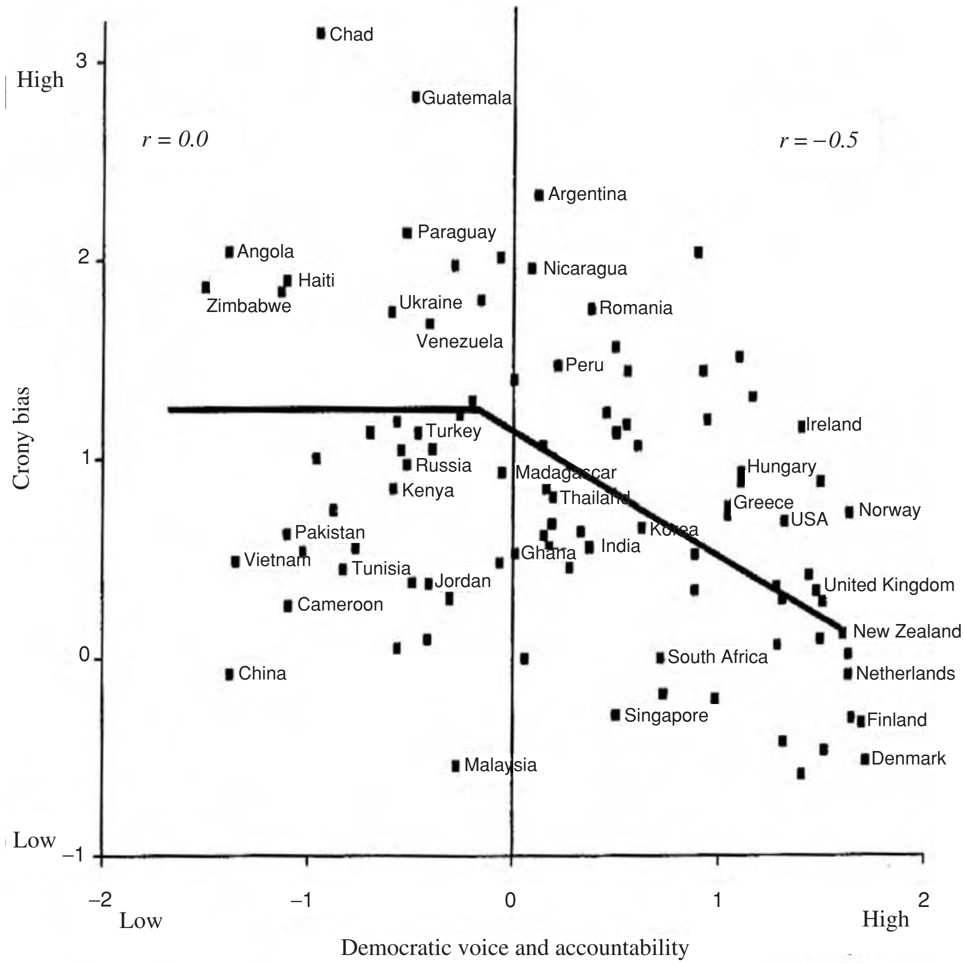

Figure 6.4. *Crony bias, voice and accountability*
Note: Data from Executive Opinion survey (2003) and World Bank Institute's calculations; 'crony bias' is defined in the note to figure 6.3; the voice and accountability variables are from Kaufmann, Kraay and Mastruzzi (2003).
Source: Kaufmann (2004).

are at a level of abstraction that is not easy to operationalise. Because the associations are statistical regularities based on cross-country research, I am reluctant to translate them into concrete proposals. My own emphasis is on middle-range proposals that concentrate on particular sectors and deal with government accountability from the bottom up. They are consistent with the broad empirical regularities outlined above, but they have a more selective focus.

The net benefits from some specific anti-corruption reforms seem to be quite high. Weighting benefits and costs more highly if they are experienced by the poor would only enhance the value of most policies (cf. Olken 2003). The problems are, first, setting priorities for a long-term response and, second, overcoming the resistance of those who benefit from the status quo. Often even if the net benefits are large, the beneficiaries of the status quo are very powerful (Fries, Lysenko, Polanec 2003; Krastev and Ganev 2004).

The priorities I establish are based on my belief in some stylised facts and obviously depend on the truth of the following empirical hunches:

(1) To the extent that low corruption is associated with beneficial outcomes – stronger growth, higher incomes, more equal income distribution – the explanation is not corruption taken in isolation but rather the close correlation between *corruption and other measures of the way government functions*.[10]
(2) From this, it follows that policies to improve government functioning should not primarily focus on enforcing criminal laws against corrupt dealings. These laws are a necessary background condition but will mean little unless accompanied by more *systemic reforms*.
(3) Instead, one must consider the underlying *institutions and habits of behaviour* that make corruption endemic in some countries and in some sectors but not others.
(4) Although norms of behaviour with historical and social roots influence the level of corruption, corruption is also a *crime of opportunity* that requires willing participants on both sides of the transaction. Variations in corruption within a country suggest that this is so. Thus, a country's legacy of corruption and poor governance need not be accepted as somehow determined for all time. The situation can be improved on a case-by-case basis.
(5) Political and bureaucratic corruption occurs where *greed and self-interest interact with government institutions*. However, different factors create corrupt incentives in each case, and hence they need different policy responses.

Corruption, standing alone, is not comparable to hunger, disease and violence among the world's problems. However, if the weak government capacities of which it is a symptom persist, targeted policies will fail in weak and dysfunctional states. This is especially so when a central state is under the control of a narrow group that does not operate in the interest of most of the population. Government may also be dysfunctional because it is excessively decentralised so that lower-level government officials can establish local monopolies free of oversight from higher levels of government. Rather than deal with the problem of concentrated political power head on, my options focus on ways to constrain and limit such power while at the same time acknowledging the value of a competent, well-functioning state.

The largely negative finding of a study of reform efforts in Eastern and Central Europe provides support for my approach (Steves and Rousso 2003). The World Bank and the EBRD carried out surveys of businesses in that region in 1999 and 2002. These are not panel studies, but they do shed some light on changes in the business environment over time. The survey results were matched with country level measures of anti-corruption initiatives that took the form of an index combining: (1) domestic legal reforms designed to increase transparency and accountability, (2) ratifications of anti-corruption conventions and (3) specific anti-corruption actions such as publication of an anti-corruption strategy and action plan and the establishment of an anti-corruption commission. In general, those countries that were least corrupt in 1999 adopted more of these reforms during the time period, partly in response to EU pressure. Scoring high on the index, however, was not a reliable predictor of reductions in reported corruption and, unfortunately, was also associated with a perceived increase in the problem. These results need to be interpreted with caution because they cover only a short period of time and one region of the world. They do, however, suggest that policies that simply raise awareness will not have the desired effect unless they are accompanied by more concrete, substantive changes in state–society relations.

Based on existing research and my own view of the way the parts of the good government puzzle fit together, I have isolated the following policies for further discussion. They are complements, not substitutes. Where possible I discuss studies that highlight successful policies and analyse failures. Some states are so dysfunctional that none of these reforms makes sense. My candidate for the most misguided World Bank project was one designed to improve President Mobutu's tax collection capacity

[10] See, for example, table 2 in La Porta *et al.* (1999, 240–1). High levels of corruption are highly correlated with bureaucratic delays and low levels of tax compliance on a country-by-country basis.

in Zaire. Obviously, such a 'reform' would not have improved social welfare. Leaving such deeply dysfunctional states to one side, the policies I discuss are: (1) improved oversight and participation by citizens and greater government transparency; (2) procurement reform; (3) improved revenue raising capacity; (4) improvements in the business environment by cutting unnecessary red tape; and (5) international efforts involving multinational firms and international organisations with a focus on asset recovery and greater transparency in international natural resource contracts.

Some reforms could, in principle, produce measurable improvements in productivity and economic growth; others, however, enhance government legitimacy and accountability and have no straightforward financial counterpart. However, as I demonstrate below, quantitative studies in individual countries demonstrate that empirical work can provide strong guides to policy. Thus, all of my specific policy proposals are accompanied by ideas for improving the quantitative bases for policy making. This research will usually require primary data gathering efforts, but in highly corrupt environments, the pay-offs can be substantial.

In some countries corruption of the police and the army reflects the role of organised crime in society. That kind of 'state capture' is obviously a major problem for the states involved and for those harmed by illegal businesses such as drugs and trafficking in humans and weapons. However, because it raises a host of issues specific to the control of organised crime and illegal businesses, I will not discuss this type of corruption here.[11]

Oversight, Participation, and Transparency

> [C]orruption is an institutional system in which *rights are dissolved in exchange for gifts*. (Robbins 2000, 440)

Survey data from eighty countries suggest an association between low levels of voice and accountability and low levels of *per capita* income (figure 6.5). Furthermore, as figure 6.4 indicates, when voice and accountability are high, 'crony bias' tends to be low. However, that relationship does not hold when a country moves from very low to low levels of voice and accountability. Thus, if reforms raise expectations through pure participatory strategies, they may produce disillusionment if not coupled with more fundamental changes. At this level of aggregation, however, one cannot make specific policy proposals. Instead, I move down a notch and consider the benefits of a particular type of citizen oversight and government transparency: local citizen involvement both in monitoring programmes and in direct provision of services.

The benefits of moving to more local control depend both on the effectiveness of such control and on how bad things are at present. There are two prongs to the development of a strategy. First, one must find programmes and governments that are very wasteful in providing services or managing aid flows and second, within that universe, one must select countries and projects suitable for managed decentralisation. By this I mean, decentralisation of either monitoring or service provision along with centralised information flows and the enforcement of anti-corruption and anti-fraud laws.

Several detailed studies have examined the way local involvement in public programmes can enhance efficiency and increase benefits. They show that it can be done, but also provide numerous cautionary tales of poorly designed programmes. I concentrate on the conditions for successful decentralised programmes, recognizing the need to guard against the capture of state structures by those seeking illegal enrichment. Careful studies of individual programmes suggest that the benefits of improved integrity in local aid projects and public service delivery ranged from 100 per cent to 400 per cent in the cases studied. However, the more anthropologically informed work suggests limits to participatory models in hierarchical rural societies. Decentralisation can be an invitation to local corruption and self-dealing if not managed effectively.

In Latin America reformers have made numerous attempts both to involve rural people in the design and monitoring of agricultural development programmes and to increase the participation of city

[11] For an excellent collection of articles that focus specifically on failed states see Rotberg (2003, 2004). For more on the establishment of the rule of law in weak states see Rose-Ackerman (2004, in Rotberg 2004).

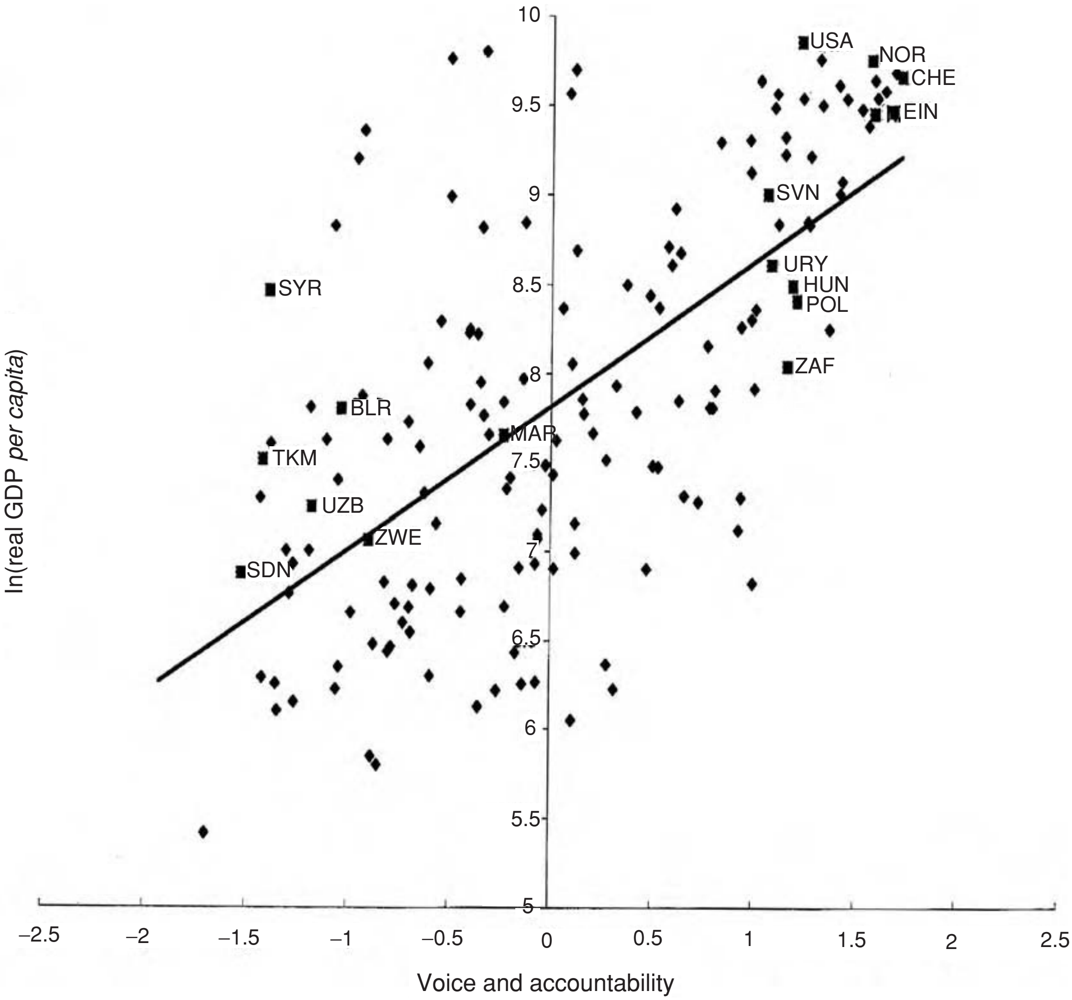

Figure 6.5. *Voice, accountability and* per capita *income*
Note: Figure 6.5 plots a measure of voice and accountability in 2000–1 (horizontal axis) against real per capita *GDP in 1995 (vertical axis). The governance ratings on the horizontal axis are based on subjective assessments from a variety of sources and are subject to a substantial margin of error.*
Source: Kaufmann (2003).

dwellers in government decision making. The rural development programmes sought to improve the targeting of programmes to the needs of farmers and to increase accountability to beneficiaries (Parker 1995; Das Gupta, Grandvoinnet and Romani 2000). The urban cases, of which the most famous is Porto Alegre, Brazil, had the explicitly political goal of increasing democratic participation in opposition to existing clientalistic structures (Abers 1998; de Sousa Santos 1998). The successful cases in both settings gave citizens better information about what to expect from government and developed their capacity to hold public officials to account. The result was a reduction in corruption and self-dealing.

The World Bank's surveys of public officials in Bolivia provide some statistical backing for the view that low corruption and high levels of transparency and 'voice' are beneficial to the actual

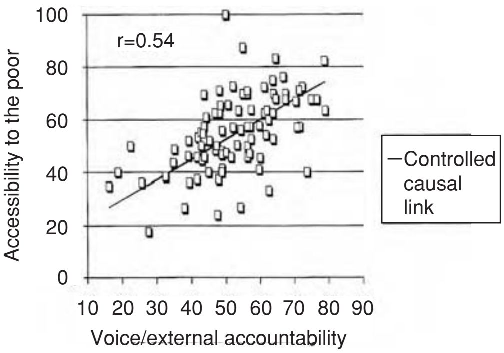

Figure 6.6. *External accountability and feedback improve access of the poor to public services (Bolivia GAC diagnostic)*
Note: Based on Kaufmann, Mehrez and Gurgur (2002). The sample of institutions includes forty-four national, departmental and municipal agencies that provide services to the poor. Each point depicts an institution.
Source: Kaufmann (2003).

performance of government and help the poor (Kaufmann, Mastruzzi and Zaveleta 2003, 380–8). A study based on 1,200 interviews with public officials in many different national agencies and local governments demonstrated wide interagency and intergovernment variation. Using simultaneous equation techniques, the study found that public service delivery is negatively associated with corruption and positively associated with the external voice of users and with transparency. Bribery and corruption are higher in more politicised units of government and in those with lower transparency and less meritocracy. Transparency is affected positively by voice and negatively by corruption and politicisation. Municipal governments perform worse than central government agencies on average but do sometimes provide better access for the poor. Measures of civil service management and individual ethical commitments had no independent impact although they may obviously be associated with some of the other variables (Kaufmann, Mastruzzi and Zaveleta 2003, 383). Figure 6.6 illustrates one result – the finding that higher levels of voice and accountability are associated with greater accessibility of the poor to public services (Kaufmann 2003, 24).

Survey evidence and case studies of participatory programmes suggest that they require a long-term commitment from established governments along with technical and organisational help. For example, case studies of USAID Community Partnership Grant Programmes in South Africa found that successful programmes had broad-based involvement combined with support from the incumbent local government. The one clear failure was when USAID worked with a defeated politician whose efforts were undermined by those in power (Adams, Bell and Brown 2002). Trevor Brown (2001) documented the importance of technical assistance in developing local government capacity in Ukraine and cites other supportive results from around the world. People who are not used to political power need time to learn how to exercise it responsibly. A 1998 study reports that over eighty Brazilian cites have begun to adopt some form of participatory budgeting (de Sousa Santos 1998). This suggests that one could review these efforts to see which ones worked and which failed.

One positive example comes from work by Ritva Reinikka and Jakob Svensson (2002, 2004a, 2004b). They document the severe leakage of central government funds meant for local primary schools in Uganda: $1 of central government funds produced $0.20 in budget for local schools. Their study led to a simple, information-based reform that had positive results. Reform focused on publicity combined with better monitoring. After its introduction, $1 expended by the centre produced $0.80 of local school funds, a 400 per cent increase. Nearly 75 per cent of the improvement in the targeting of funds can be explained by a newspaper campaign to publicise funding levels so that parents would know what funds their children's schools were due to obtain (Reinikka and Svensson 2004a, 2004b). Importantly, parents were already organised and able to exert pressure. Mere publicity will not work in isolation. The study gives no estimate of the cost of newspaper advertisements and notice boards, but they must have been minimal. The most substantial costs were increased official monitoring and the time spent by parents in checking on the school budgets. Because 20 per cent is still lost, the returns on a dollar of actual education spending would need to be at least 12.5 per cent for the returns to the central government on the programme to be 10 per cent. Before the reform, however, the returns would have needed to be 50 per cent! Thus, the programme appears to be cost-effective although it also has an upper bound – losses will never go to zero. A key feature of the Uganda case, however, is the existence of parent–teacher groups at the village level that can perform monitoring. In countries where such groups do not exist or where powerful local or regional actors can steal with impunity, more costly and complex interventions will be necessary. Even in Uganda, education may be a special case because it is a service used by school-aged children on a daily basis, unlike, say, health care where demand is more episodic, and sick and injured users are vulnerable to exploitation.

Uganda provides a 'best'-case scenario. Conditions were very bad *ex ante* and once research revealed the shortfall, a centralised information provision policy combined with better enforcement reversed the percentages. This reform does not answer the question of how much a country ought to spend on education but suggests that, with the reform, education spending will appear to be more productive. This result may lead to an increase in the budget. Suppose, just for the sake of illustration, that the extra costs of the anti-corruption programme are \$0.10 for every dollar of appropriated funds, then every \$100 of budget would produce \$100 − \$10–0.2(\$90) = \$72 of education spending, up 360 per cent from before the reform. Of course, as noted above, these are only pecuniary gains so one would also want to know how many resources were wasted hiding the fraud and the rate of return on education compared to the use of the diverted funds. At the very least, however, the distributive impact of the reform is in favour of children, many with low income. The gains are very large if one takes as given the share of the government budget going to education.

To perform a CBA of this reform, one would need an estimate of the rate of return to primary education spending in Uganda. Unfortunately, such data are not available. However, in wealthy countries returns to an added year of education are in the range of 8–12 per cent in increased earnings for individuals. Because these estimates ignore public benefits from an educated citizenry, social benefits ought to be larger. Recent attempts to measure the impact of education on economic growth have produced disappointing results in the developing world, suggesting that years of education are not a good predictor (Easterly 2001, 71–84). Jere Behrman (2003), in a review article, argues that older studies showing high returns to education in poorer parts of the world overstate the private and public returns to schooling. Perhaps the disjunction between the results for individuals in developed countries and cross-country studies lies in the fact that a year of schooling in a poor country may not mean much in terms of actual learning if corruption and self-dealing lead schools to operate poorly. Easterly refers to absent teachers and school officials who sell school supplies for person gain. Literacy levels would surely be higher if these illegal practices could be curtailed. The study in Uganda suggests that simple theft of resources by regional officials was the reason for underfunded schools. If theft is high, years in school may be a poor proxy for learning.[12]

Other instructive cases concern the devolution of authority in Nepal, India, Bangladesh and Indonesia. In Nepal and Karnataka researchers estimated that the productivity of external aid funds doubled as a result of more local control. The programmes were of direct benefit to local people – roads, irrigation projects. Thus, they had a reason to assure that funds were used effectively. However, research in Rajasthan, Tamil Nadu, Bangladesh, and Indonesia highlights the need to give careful consideration to local conditions to avoid failure.

In Nepal, a pilot programme involved local people in the direct administration of a food-for-work programme through information diffusion and a

[12] Careful work at the country level is sometimes possible. For example, Esther Duflo (2001) estimated the economic returns to a school construction programme in Indonesia in the seventies. She found that each school constructed per 1,000 children led to a average increase of 0.12 to 0.19 years of education and a 1.5 to 2.7 per cent increase in wages. This implies economic returns of 6.8 to 10.6 per cent. Duflo also performed a cost/benefit analysis that found internal rates of return of 8.8 to 12 per cent. The high values partly depend upon Indonesia's solid growth rate. Notice that if the cost estimates include kickbacks, the value of the programme would have been substantially increased if the kickbacks had been eliminated.

workable structure of monitoring. Standard practice involved national government guidelines for paying workers that were far above market wages. As a result, contractors with the national government paid market wages and pocketed the difference. When control was transferred to a sample of villages in an experiment, they paid market wages and built twice as many miles of roads with the same budget. The result was a dramatic increase in the cost-effectiveness of aid programmes and a large increase in client satisfaction. The costs were the time spent by the villagers in administering the programme as well as the cost of technical assistance to establish the system. However, presumably there are corresponding savings at the national level where bureaucratic inputs could be reduced. The main issue in such cases is how to generalise the positive experience in an experiment to the country as a whole. Key questions about the relationship between local authorities and the national administration are not answered by positive experiences in a few villages. In fact, in Nepal efforts to expand the programme failed as national-level officials and private contractors mounted resistance (Meagher, Upadhyaya and Wilkinson 2000).

In Karnataka, decentralisation improved government performance and limited corruption according to fieldwork done between 1978 and 1981 (Crook and Manor 1998, 22–84). Public sector workers, especially teachers, worked harder because they were, in the words of one person interviewed, 'under the supervision of the questioning public mind' (Crook and Manor 1998, 60). Absenteeism continued to be a problem, but those who did come to work performed better. Although the number of people involved in corrupt acts increased, they siphoned off fewer resources (Crook and Manor 1998, 61). Before decentralisation 'a large fraction' of funds was diverted. The Indian decentralisation policy increased the number of officials (elected and otherwise) from over a score to 3,000, this increased the number of potential bribe takers. However, the greater transparency of the political process limited the overall level of pay-offs. A vigilant press, an active two-party system and effective voluntary organisations contributed to transparency. For a given level of funding from the centre, there was a large increase in micro-level infrastructure projects. The authors conclude that this increase resulted both from the preferences of local political actors for such projects and from a decline in corruption. Under the decentralisation policy corruption took 5–25 per cent of local government funds, with most districts falling in the 5–10 per cent range. Only in two–three remote districts was the share 25 per cent. This was a major improvement over the past. However, although overall corruption decreased, most people believed that it had increased because of the greater transparency of government operation (Crook and Manor 1998, 79).

On the downside, increases in local control do not necessarily increase transparency and accountability but might instead promote locally based corruption and even facilitate organised crime influence (Das Gupta, Grandvoinnet and Romani 2000; Gong 2002; Anderson, Kaufmann and Recanatini 2003, 11). In a worst-case scenario, devolution enhances the power of local patrons and entrenched interests. For example, an interview-based study of forest management in the Indian state of Rajasthan demonstrated the way a *de jure* institution transformed into a stable system of extra-legal exchanges (Robbins 2000). Robbins reports the range of *de facto* prices for various uses of the forest and explains how personal connections interacted with pay-offs to favour some individuals and families over others. As a result, many of the national conservation goals were unmet with some species of trees and wildlife becoming particularly endangered. Households lost the ability to complain because of their own complicity. Increased 'oversight' would have been ineffective. According to Robbins, nothing will change without a change in local power relations (Robbins 2000, 434–5, 439–40).

Consider also an experiment in Bangladesh (Crook and Manor 1998, 85–135). Here an effort to decentralise political decision making increased corruption and increased the inefficiency of public works spending. According to the authors, 'corruption assumed major proportions, so that the councils would need to receive huge injections of funds if significant amounts were to be left over for development after profiteering' (Crook and Manor 1998, 112). Based on interviews and their own observation, the authors estimate that perhaps 30–40 per cent was stolen (Crook and Manor 1998, 119). Notice that if the funder wants a rate of return of 10 per cent on its money, then the underlying project would have to earn 14–17 per cent. The authors attribute the high rate of corruption and theft not only to the venality of local leaders but also to the permissive attitude of higher authorities.

In Tamil Nadu in the 1980s and 1990s investments in tank irrigation systems were supported by overseas aid through procedures that encouraged the formation of local Water User Associations (WUAs). The WUAs were to contract for work, organise construction and manage the improved systems using resources from new community rights over local resources. An outside team supported each WUA including a technical assistant, an institutional organiser and a process documenter (Mosse 1997, 268). Mosse details the caste and other conflicts in the WUAs and the way that the WUAs were embedded in local social structures. They became a locus for conflict, not a site for reform. The actions of the WUAs were, according to Mosse, driven by the priorities of outsiders as much or more than the wishes of village residents.

Finally, in Indonesia, another study documents how resources were wasted through corruption and self-dealing in village-level aid projects and suggests some ways of involving the beneficiaries in monitoring the programmes using existing local institutions such as local Muslim prayer groups (Woodhouse 2002). A further study of the way local communities and the state dealt with allegations of corruption in Indonesia stresses the interactions between local processes and the state. Local procedures to recover corruptly obtained funds were successful in many cases, but often only because of the threat of going to the courts. Outside actors involved in the administration of aid programmes or willing to provide legal help for free were often essential to persuade local people to pursue a case against powerful local individuals. Even in such cases, however, court judgements were difficult to enforce and even if an official went to jail, the lost funds were not recovered. Because of the distance of the courts from remote villages, once a case entered the formal legal system it lost salience at the village level (World Bank 2003). Benjamin Olken, an economist who has done fieldwork in Indonesia, echoes some of these concerns. He observed villagers who feared retaliation from elites if they reported corruption. If such pressures are powerful, the only place to turn is to more well-organised national civil society groups. Olken also stresses the importance of combining devolution with centralised monitoring and information gathering, as in the Uganda case, and he stresses the need to include the opportunity cost of people's time before recommending devolution over more centralised control.[13]

In evaluating these cases, one must, of course, recognise that money lost to corruption and self-dealing is not burned up: it is used for something. Individual officials and their families are better off with more money in their pockets. A pure CBA is agnostic about who obtains the benefit and looks only at net total gains. The analyst would compare the marginal productivity of the corrupt transfers with the marginal productivity of the public project before recommending reform. However, this is, in my view, a fundamentally misguided way to approach the issue. If, indeed, funds are more productive in private hands, then the government should simply discontinue the programme, not condone corruption. At the very least corruption and self-dealing require wasteful efforts to keep malfeasance secret, skew the distribution of benefits and costs and encourage the use of resources to compete for rents, rather than to engage in productive activity (Krueger 1974; Rose-Ackerman 1999, 9–15, 213–15). If one cannot locate feasible anti-corruption strategies for very ineffective programmes, simply cancelling the programme is always an option.

The cases suggest that there are two ways for grassroots involvement to limit corruption, both of which appear promising. First, local households can monitor the use of central government or foreign aid funds and report to the government when they observe misuse. This can produce very large gains if the status quo is characterised by large leakages at the centre. Second, local people can actually provide the services themselves under contract with an aid agency or a higher-level government. Both of these options require that the public service be one that is actually desired by the local people; otherwise the benefits will be limited to jobs and supplies

[13] Email from Benjamin A. Olken, 11 March 2004.

and few services may be provided as people accept sinecures and walk off with materials. The options also require local organisational structures that are relatively effective and egalitarian. Even if these two conditions hold, the interaction between the grassroots and higher levels of government needs to be analysed to be sure that empowering the local level is actually a sustainable goal. In short, these encouraging successes are not capable of mindless generalisation, although one can surely find other cases beyond those outlined above where they can work well.

The rich variety of experience is both encouraging and humbling. The cases indicate which factors need to be considered but can hardly produce the 'blueprints' or 'best practices' preferred by the international lending organisations. Existing research suggests that a number of factors must come together before government reform can succeed. Transparency and publicity are powerful tools, but only if combined with grassroots organisations with the incentive and the competence to use the information provided. Outsiders can help both in providing information and in helping construct functioning local organisations. These strategies will not work, however, if state officials use intimidation and threats to keep ordinary people from engaging in oversight and political action. Formal state institutions such as the courts, the Ombudsman, a functioning Freedom of Information Act and an independent Audit Office, need to form a backstop for efforts to make government more transparent and accountable to ordinary citizens. It does not do people much good to know what the government is doing if they are too intimidated to act on this information or if the routes for protest are blocked or ineffective. An outline for reform in this area would include both efforts to improve accountability at the grassroots in small towns and urban neighbourhoods and the strengthening of central government institutions that provide accountability. However, even if effective programmes can be designed, they cannot deal with corruption that is not subject to monitoring by individuals. I turn now to two areas where grassroots efforts are not sufficient: procurement and revenue collection.

Procurement Reform

Business executives world-wide believe that corruption in public procurement contracts is prevalent although there is considerable interregional and cross-country variation. The 2002 Executive Opinion Survey of the World Economic Forum shows the proportion of those surveyed who report that bribery is high/very high in various areas of business life including corruption in procurement (figure 6.7). Some business people report that they avoid government business for that reason (Anderson, Kaufmann and Recanatini 2003, 11–13; Kaufmann 2003, 8–9). Of course, corruption in contracting occurs in every country – even those at the high end of the honesty index such as Scandinavia, Singapore and New Zealand – but it appears more widespread and harmful in some countries than in others.[14] This is partly a function of the share of business in government hands. Two countries might have corruption in 20 per cent of all public construction contracts, but if the public sector accounts for 80 per cent of construction in one state and 10 per cent in another, the private construction sector's perception of the level of bribery will probably be affected by this difference.

'Grand' corruption involving major construction projects can increase costs and distort priorities. If the cost of a project is inflated by 10 per cent as a result of corruption, the rate of return on many projects will fall so low as to make the project not worth pursuing. Furthermore, some projects would not be worthwhile with zero corruption; they are only on the government's agenda because of the kickbacks provided. In other cases, the project provides net benefits if pay-offs are zero, and

[14] TI issues a cross-country index of corruption that is a compilation of others' rankings based mostly on perceptions of the level of corruption in business dealings. New Zealand and Singapore are near the top of the list along, with the Scandinavian countries, Canada Australia and the Netherlands. The 2003 Transparency International Corruption Perception Index is available at http://www.transparency.org/surveys/index.html#cpi. The United States Department of Justice (DOJ) prosecutes cases of corruption at all levels of government. Over the decade 1993–2002, the DOJ obtained 20,497 convictions (9,821 of federal officials, 5,782 of state and local officials and 4,894 of private citizens involved in public corruption offences) (DOJ 2003). Obviously some convictions were associated with the same underlying corrupt practices.

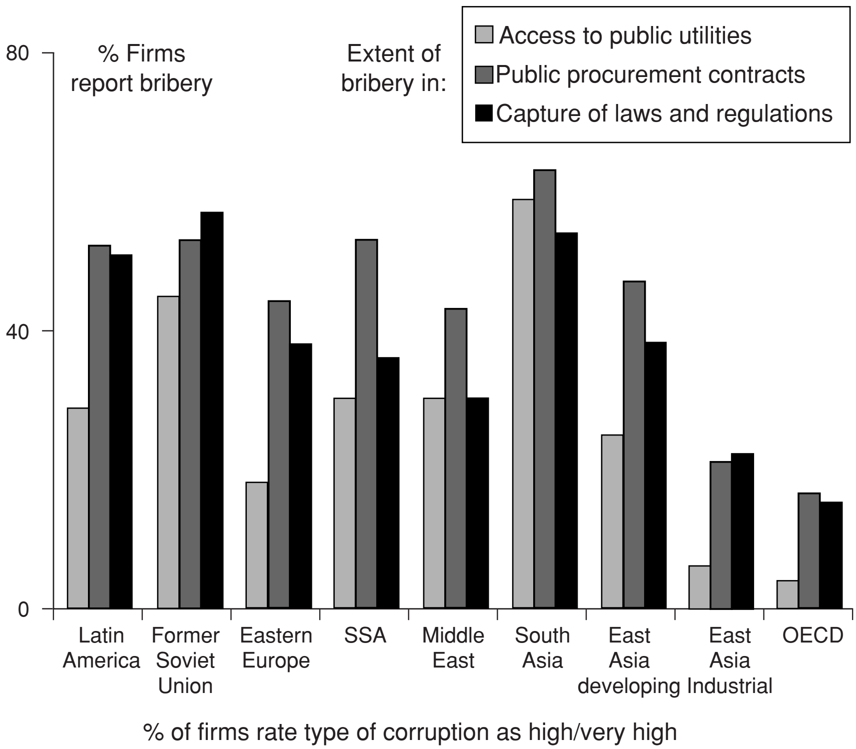

Figure 6.7. *Unbundling corruption (Executive Opinion survey (GCR), regional averages, 2002)*
Source: Kaufmann (2003).

the important issue is the link between bribe payments and the rate of return on the project. Do the bribes just lower the profits earned by contractors in oligopolistic markets, or are they shifted to taxpayers? We have no good estimates of the incidence of bribes, but only under extreme conditions will contractors bear the full burden. Systemic corruption of this kind reduces competitiveness by limiting the number of bidders, favouring those with inside connections over the most efficient candidates, limiting the information available to participants and introducing added transactions costs. If top officials, including the head of state, are concerned primarily with maximizing personal gain, they may favour an inefficient level, composition and time path of investment. Investors' decisions may also be affected by the fact that they are dealing with political leaders.

Consider the officials' decision calculus. The impact of high-level corruption goes beyond the mere scale of public investment and lost revenue for the public budget. Top officials select projects and make purchases with little or no economic rationale. For example, if kickbacks are easier to obtain on capital investments and input purchases than on labour, rulers will favour capital-intensive projects irrespective of their economic justification. One empirical study demonstrates that high levels of corruption are associated with higher levels of public investment as a share of GDP, less productive public investment and lower levels of total investment (Tanzi and Davoodi 2002b). Corrupt rulers favour capital-intensive public projects over other types of public expenditures and will favour public investment over private investment. They will frequently support 'white elephant' projects with little value in promoting economic development.[15] The demand

[15] See Tanzi and Davoodi (2002a) for a review of empirical work on corruption, growth and public finance. A study of structural adjustment lending in seven African countries concluded that much investment spending was of dubious worth. '"White elephant" projects, inflated contracts, flight capital

for cement is one tip-off and might be used as a rough measure of excess public construction. For example, in Italy the annual *per capita* consumption of cement has been double that of the USA and triple that of Germany and Britain. A review of the 'Clean Hands' corruption cases in Italy reveals that many construction projects were poorly conceived, overpriced and had little or no justification beyond their ability to produce kickbacks (della Porta and Vannucci 1999).

Using an Italian case, Miriam Golden and Lucio Picci (2004) demonstrate that more precise measurement is possible. They use a study that finds that, across the Italian regions, corruption has a negative effect on economic growth by reducing private investment and reducing the efficiency of public investment (Del Monte and Papagni 2001). Golden and Picci provide evidence on one important type of inefficiency – excessively costly public investment projects. They combine measures of physical public capital stock in the Italian regions with measures of cost to produce estimates of the relative efficiency and inefficiency of public spending throughout Italy. Building on research that finds that corruption and waste go together, they assume that corrupt officials encourage wasteful projects as a way of generating rents. The physical data cover a range of government capital investments in 1997, including roads, railroads, hospital beds and number of school classrooms, combined into an index that is expressed as a ratio to the national average. They use a perpetual inventory model that adds up past capital formation and deducts assets when they reach the end of their service lives. The financial measures are then corrected for inter regional cost differences and normalised so that the country mean is set at one.[16] Overall, the physical index favours the northern part of the country and the financial index favours the south. The ratio of the two indices is a rough measure of the relative levels of corruption and inefficiency. Figure 6.8 is a map of Italy with the regions shaded from dark to light, with darker regions representing lower values of this measure. The index has a 0.82 correlation with Robert Putnam's (1993) measure of regional governments' institutional performance and a correlation of −0.66 with legal charges of high-level legislative malfeasance.

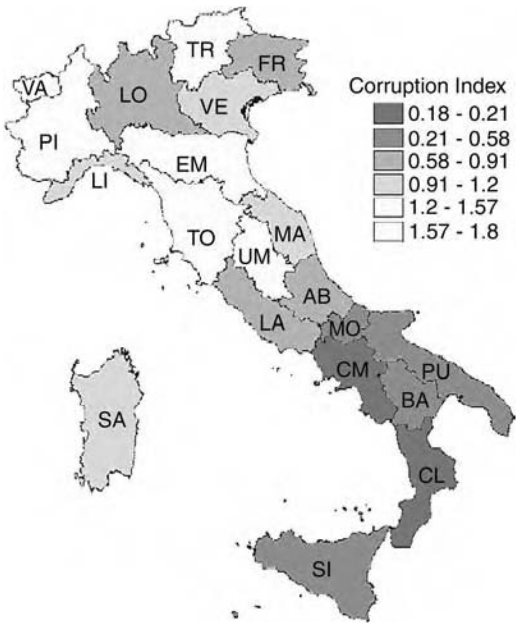

Figure 6.8. *Map of proposed level of corruption, by region, Italy, c. 1997*
Source: Golden and Picci (2004).

Of course, these are just indices that range from 1.7 to 0.2. They do not translate directly into a cost-benefit ratio (CBR). However, if the statistical work has corrected for other reasons for interregional variation, these results indicate that there are large potential gains either from reducing waste and corruption in the poorly performing regions or from transferring funds to the high-performing regions. Unfortunately, the poorly performing regions also tend to be the poorer regions (figure 6.9). Hence, a shift of funds would be regressive. Nevertheless, within the group of low *per capita* income regions the state might announce its willingness to allocate future funds on the basis of past performance. Because the ratios are based on stocks, not flows, the state would also need to be able to calculate flows

and other associated ills became rampant before – and eventually contributed to – the [government fiscal] crisis in each case. A major aim of adjustment programmes has been to weed out these undesirable investments (particularly in the public sector) and to improve overall efficiency' (Faruqee and Husain 1994, 6).

16 For more details see Golden and Picci (2004) who report that the overall index of physical capital is not very sensitive to the method of aggregation.

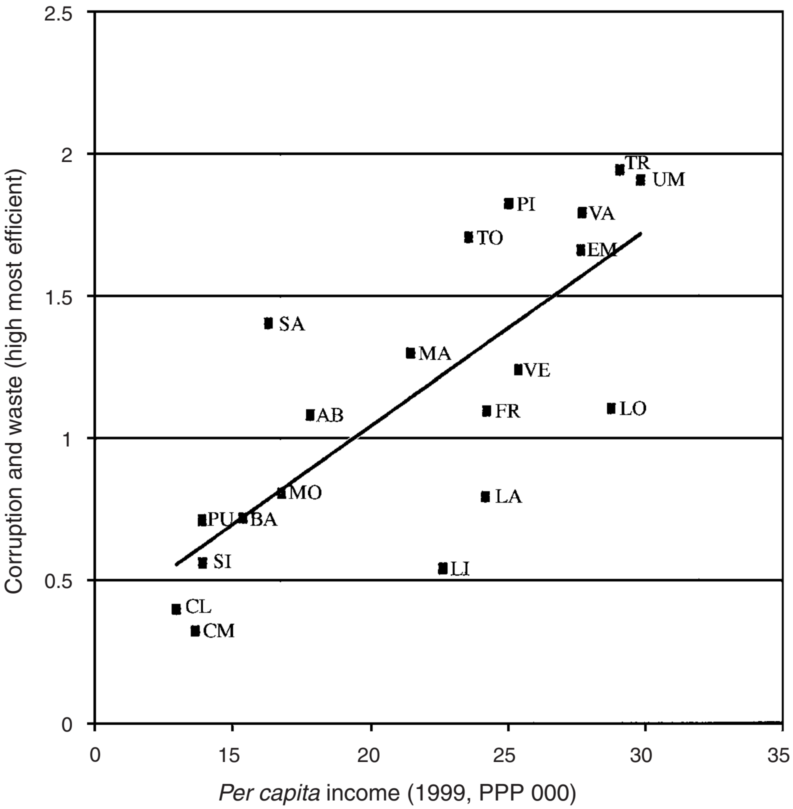

Figure 6.9. *Corruption and* per capita *income, Italy*

over a two- or-three year period. Within individual countries such estimates could help national policy-makers see where the pressure points are. In Italy, regions that are more efficient (less corrupt) than expected given their income are above the regression line in figure 6.9.

As a thought experiment, suppose that we interpret the data as measuring productivity in the sense that $1 spent in the region with the mean score produces $1 worth of output. (Of course, it is possible that the mean represents either a higher or a lower level of absolute output per dollar of input.) Suppose we take the goal of raising the ten lowest regions up to the mean. If productivity in all these regions could be improved to equal the present country mean, this would imply that a $100 invested in these regions would yield $100 of output instead of $53.90, an increase of 86 per cent. Even if omitted variables related to real resource costs explain half the difference, the increase would be over 40 per cent. Of course, the same caveat applies as with the education example above. A full CBA would need an estimate of the social benefits of spending on infrastructure. However, once again, for a given infrastructure budget, output could be increased either by relocating the funds or by reforming the production process in weak regions.

Given the work of Golden and Picci for Italy, one might replicate this work in other parts of the world to permit rough estimates of the variation over regions, states, or metropolitan areas in the productivity of public spending. These results can then be used to allocate public funds in a way that gives sub-national governments an incentive to use funds efficiently. Such a policy, however, leaves the actual reforms to the sub-national governments. Thus, we also need to consider reforms of the *procurement system.*

Procurement reform is a basic component of an anti-corruption strategy. It should be viewed as an opportunity to rethink *what* the government buys as well as *how* it goes about making purchases. Government purchasing specifications should take account of the risk of corruption. When possible, goods sold in international markets where benchmark prices exist should be favoured over custom made or state-of-the-art products. Under decentralised systems, regional and local governments can favour goods and services sold in national market. In such cases, the state can look to private market prices as benchmarks and state its specifications in terms of standard off-the-shelf items (Rose-Ackerman 1978, 132–5; Kelman 1990).

Benchmarking can have an international dimension. Countries and sub-national governments that are small relative to the markets in which they operate can make purchases of standard products in the international market. Market prices are excellent benchmarks here because the small government's own demand is unlikely to affect prices.

One way to obtain rough estimates is through data on US trade. The Trade Research Institute calculates average prices and variances for goods using US trade statistics and estimates the tax revenues lost to the USA from overinvoicing and underinvoicing (Pak and Zdanowicz 1994, 2002; Paul *et al.* 1994). Because of product differentiation even within quite detailed categories, these price estimates are guesses, but they could give developing countries a starting point for negotiating with suppliers.

Benchmarking is in some tension with International Competitive Bidding (ICB) procedures, whose sealed bidding process is often taken to be the presumptive standard of fairness and economic efficiency. The World Bank requires ICB, under which the lowest 'evaluated' bidder must be accepted, for its infrastructure loans and these standards have influenced the development of procurement codes world-wide.[17] The process does permit non-price factors to be weighed in the final decision but requires these factors to be specified and quantified if possible. It is appropriate for a project, such as a dam, that is capital-intensive, self-contained and uses known and tested technology. However, if followed mechanically, it can lead to low-quality work and collusive bid rigging. Instead, for small aid-dependent countries, the reputation of bidders could be drawn from the international arena. An international organisation might keep a roster of contractors with information on their past performance. To avoid controversy, however, such a system should focus on a few key variables that are measurable and comparable across countries. Relevant indicators might include evidence of fraud, corruption, cost overruns and time delays. The World Bank could integrate such a roster into its revised Procurement Guidelines (1999) which state that the Bank will declare firms ineligible for Bank contracts 'either indefinitely or for a stated period of time' if it determines that the firm has engaged in corrupt or fraudulent practices in connection with Bank-financed projects section 1.15(d). Thus one could imagine something similar to Golden and Picci's estimates for Italy, although obviously these estimates would be less precise if applied internationally.

In correspondence with the author, Lucio Picci suggested an intriguing connection between benchmarking in public procurement and citizen oversight. He pointed to the way internet services, such as eBay, provide feedback on the reputation of buyers and sellers. The feedback is entirely voluntary and is a decentralised mechanism with broad reach. Although there are obvious risks – for example, a seller with a low reputation can re-enter the system under a new name – and reputations can be influenced by self-interested buyers and sellers praising themselves (Dellarocas 2003), nevertheless, such a feedback mechanism might have applications to government contracting. Picci suggested that a benchmarking system organised by the central government in a country like Italy or internationally by the World Bank could provide information on the costs of various standardised infrastructure activities under different contracts. Citizens who use the services or observe the work

[17] See World Bank (1999, 25–8) at http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/PROCUREMENT/0,contentMDK:20060840~pagePK:84269~piPK:60001558~theSitePK:84266,00.html. The World Trade Organization (WTO) Agreement on Government Procurement and related documents are available at http://www.wto.org.

being done could post opinions on the internet with respect to particular public works. There are obvious design problems that would have to be overcome to make such a system operational, but it seems worth study for countries with reasonably high levels of both literacy and internet access. It is not a viable option for the people at the bottom of the income ladder in some of the case studies outlined above.

Civil service reform can complement procurement reform by providing incentives to officials to perform effectively and avoid corruption. Bonuses earned by officials who achieve procurement goals could substitute for illegal pay-offs. However, civil service reforms that simply raise wages to competitive levels are unlikely to be sufficient. One study, based on data from thirty-five countries, found that meritocratic recruitment was associated with measures of good bureaucratic performance, but that the role of competitive salaries was unclear (Rauch and Evans 2000). A study that examines the impact of a specific reform effort suggests a reason for the ambiguity. The study deals with a very narrow issue: hospital procurement of standardised supplies – saline solution, ethyl alcohol, iodine povidine and hydrogen peroxide – by hospitals in Buenos Aires (Di Tella and Schargrodsky 2002). The authors studied the impact of a crackdown in which the central authorities checked the prices paid at twenty-eight hospitals and used information of high relative prices as evidence that pay-offs might have occurred. Prices decreased during the crackdown, especially in the early months. Wage levels and enforcement intensity had complementary impacts except at high levels of enforcement where enforcement appeared to be a substitute for high wages. One cannot tell if these results generalise, but they do suggest that a policy of paying high wages to officials needs to be combined with a credible enforcement effort for optimal deterrence.

However, civil service reforms and enforcement against lower-level officials are only necessary, not sufficient, for success in combating corruption in procurement. Scandals frequently have implicated top government leaders who profited from their inside knowledge and connections. The above proposals are not much help in dealing with such ‘grand corruption,’ they focus instead on middle-level procurement decisions under the control of professional civil servants. They are, however, consistent with reforms that shift procurement decisions to career officials and tender boards. If rulers wish to insulate themselves from the demands of political supporters, they should create impartial bodies with independent procurement authority.

The basic reorientation of reforms efforts away from perfecting the bidding process toward making the overall purchasing environment more efficient and effective is a fundamental shift in perspective spearheaded by Kelman’s work (1990, 2002). It seems an especially valuable innovation for developing countries with limited capacity to carry out complex bidding procedures. Although competitive bidding sounds like a good idea, bidding does not play a role in a truly competitive market. Instead, the market price is set through the multiple interactions of many buyers and sellers. The World Bank does permit what it calls ‘shopping’ for off-the-shelf purchases so long multiple suppliers exist (World Bank 1999, section 3.5). My point is simply that countries should try to design their projects to favour ‘shopping’ over sealed bidding as a way of limiting corruption.

Of course, frequently governments do need to make special purpose deals using a well-organised bidding process to minimise costs. Developing countries will be making large investments in special-purpose infrastructure for years to come. These projects are unlikely to require sophisticated new technology, but they are one of a kind. Thus the effectiveness of competitive bidding procedures will remain a central concern. Accepting the validity of the basic principles of ICB procedures for such projects, countries still need to assure robust competition among bidders. The same is true for competitive systems that make use of pre-screening processes. There are two problems – the possibility of collusion and the difficulty of attracting bidders. If contractors are willing to use violence to silence critics, the challenge to democratic state authority is greatest. The first order of business is then protection for whistleblowers and a willingness to follow up on allegations in a way that removes the impunity of officials. These procedures, however, must be designed to avoid encouraging people to use corruption scandals as a way to undermine one's political opponents.[18]

Developing countries could experiment with benchmarking, experience-rating for contractors, the adoption of more transparent processes and civil service reform. In countries with a scarcity of skilled procurement experts and weak public accountability, the case for benchmarking and the purchase of standard items is strong. The cost-benefit calculus here requires a balance between reductions in flexibility and reductions in costs. The reduction in corruption is gained at the cost of a poorer fit between procurement specifications and the government's 'needs'.

Customs and Tax Administration

States cannot function if they are unable to collect taxes. A few countries rely heavily on outside grants and loans from international financial institutions (IFIs), and a few still obtain considerable revenue from publicly owned enterprises. Most countries, however, require a functioning tax system. A legitimate democratic state appears to require that the state be able to collect taxes from its own citizens, not rely on outside sources of revenue. If citizens are not taxed, they have little incentive to hold the state accountable (Moore 1998). Many poor and emerging economies have very low capacities to collect taxes from their own citizens and from businesses and tend to collect taxes in arbitrary and unfair ways. In nearly every developing or transitional country where diagnostic surveys have been conducted, customs and tax administration are cited as loci of frequent and large unofficial payments (Anderson, Kaufmann and Recanatini 2003, 10). One consequence of an arbitrary and corrupt revenue system is to drive firms to operate at least partly off-the-books. The 2002 BEEPS survey in Eastern Europe and the FSU found a negative association between the percentage of sales reported to tax authorities and the proportion bribing tax authorities (Fries, Lysenko and Polanec 2003, 15). Dissatisfaction with the quality of public services becomes a justification for underpayment, and underpayment produces low-quality services. (See Fjeldstad and Sembola's survey in Tanzania: 2001, 2069.) Thus limiting corruption in procurement and service provision can help limit tax avoidance. However, independent corrupt incentives exist in the collection of taxes and duties and reduction in those incentives is the theme of this section.

Businesses and individuals frequently collude with tax collectors and customs agents to lower the sums collected and expedite services. As a result, revenue collection may be both inadequate and distributed unfairly. Taxpayers and corrupt officials divide the savings in taxes and duties. The costs are borne by those taxpayers who are poorer and less well-connected and by the general public in the form of reduced services.

Take just a few examples. A recent scandal in China revealed that state and party officials in a major port in southern China had been entirely corrupted by smugglers with a huge loss in customs revenue (Gong 2002). In Pakistan, one study estimated that if the leakages caused by corruption and mismanagement could be reduced by 50 per cent, the tax–GDP ratio would increase from 13.6 to over 15 per cent (Burki 1997, 16). In Bolivia, a highly politicised tax administration is also viewed as very corrupt and is estimated to lose millions in tax revenues through a mixture of corruption, smuggling and informal, off-the-book businesses (Kaufmann, Mastruzzi and Zaveleta 2003, 355). A study of efforts to reform tax administration in Mexico and Argentina points to the costs of corruption and inefficiency in the revenue system as an underlying cause of the fiscal crises of the early 1980s. The weak and arbitrary aspects of the tax system in both countries contributed to a poorly functioning public sector and inefficiencies in the private sector as well. The resulting crisis persuaded political elites of the need for reform (Berensztein 1998).

The experience of a number of African countries illustrates the magnitude of the problem. In some studies the revenue shortfall was about 50 per cent (Stasavage 1999, 71). In Gambia, in the early

[18] As an example, see 'Treacherous Roads', *The Economist*, 20 December 2003, 56. The article reports on the murder of a young engineer employed by the state of Bihar in India to manage part of a highway project. He sent a letter to the Indian Prime Minister outlining a list of 'dodgy practices'. The letter was leaked to the relevant contractors and the engineer then received threats. The authorities did not respond, and the engineer was eventually shot and killed.

1990s, forgone revenue from customs duties and the income tax amounted to 8–9 per cent of GDP (six–seven times the country's spending on health). Income tax evasion alone was 70 per cent of revenue due. Only 40 per cent of small and medium-sized enterprises (SMEs) paid taxes, and many individuals did not file returns. Underpayment of customs was facilitated by the lack of clear guidelines and of published tariffs. The extensive discretion of officials encouraged corrupt pay-offs designed to evade tariffs. Of course, a well-functioning system would have been able to reduce tax and tariff rates, but the distortions introduced by such a high level of evasion are clear (Dia 1996, 46–7, 94–100). A study of tariff exemptions in Zambia, Tanzania and Mali estimated that exemptions, both justified and unjustified, produced a revenue shortfall of close to 50 per cent (Low 1995). In Mozambique in 1995, the customs service collected 49 per cent of the revenue it would have collected if no exemptions had been given. Officials added extra delays, overestimated the value of goods and applied higher rates in an attempt to extract pay offs (Stasavage 1999). In Zaire, much of the country's output was smuggled out with the complicity of customs officials. Corruption was also pervasive in evading import duties and controls (MacGaffey 1991). Studies of the Gambia, Mozambique and Ghana suggest that corruption permits the rich to avoid taxes (Dia 1996; Stasavage 1999). Tax avoidance in the Philippines reputedly means that the poor contribute twice as much as the rich, and 63 per cent of imports pay no duty.[19]

Corruption in tax and customs is not just a transfer from one pocket to another. In addition, tax burdens are distributed unfairly, and resources are lost keeping the illegal behaviour secret. A corrupt tax and customs system that favours some groups and individuals over others can destroy efforts to put a country on a sound fiscal basis and discredit reform. For example, in Mozambique interviews carried out in 1996 indicated that corruption had grown since the beginning of reform efforts ten years earlier. Overall taxes fell from 20 per cent of GDP in 1993 to 17.6 per cent in 1994 with import taxes falling from 5.1 per cent to 3.9 per cent of GDP (Stasavage 1999). Corruption and other forms of evasion are especially common when nominal tax and tariff rates are very high (Webster and Charap 1993; De Melo, Ofer and Sandler 1995; Fisman and Wei 2004). High nominal tax rates lead to bribes and other types of tax avoidance which lead to even more avoidance and on in a vicious spiral.

One response is to repeal certain taxes that are difficult to collect and to lower overall rates. Tax reform frequently involves simplifying taxes and levying them on bases that are difficult to hide or underestimate. For business taxes, presumptive taxes can be levied that are fixed independently of a firm's actual profitability. The reduction in corruption and tax evasion is traded off against the reduction in fairness. For example, Mexico introduced an alternative minimum tax of 2 per cent on the real value of firm assets. A firm pays the maximum of the value of this tax and the corporate tax otherwise due. Small businesses pay a lump-sum tax per person employed, and medium-sized businesses are taxed on turnover. All these reforms raised additional revenue through reductions in tax evasion and in corruption (Das Gupta and Mookherjee 1998, 311–12). Such reforms are, however, unlikely to be sufficient if officials have no incentive to work effectively and if the state does not punish the underpayment of tax. For example, tax simplification in the Philippines apparently provided few benefits because there were no improvements in the incentives facing tax collectors and taxpayers (Das Gupta and Mookherjee 1998, 410).

Reforms may produce a win–win situation where administrative costs are reduced because of tax simplification and revenue collections rise. Successful reform of a country's system of revenue collection should permit a reduction in nominal rates of tariffs and taxation. This may permit an escape from the trap where high rates lead to evasion and evasion leads to higher nominal rates and even more evasion. A case study of India provides a classic case. Despite an increase in rates, total revenue declined both because of an increase in corruption and a shift into off-the-books activity. In such cases, nothing short of a thoroughgoing reform of the structure and administration of the tax system will allow a breakthrough. Simply raising the wages of tax collectors and increasing surveillance are unlikely to be sufficient (Das Gupta and Mookherjee 1998, 101–2).

[19] *Far Eastern Economic Review*, 20 April 1996.

In contrast, Russia has simplified its income tax system by introducing a flat 13 per cent rate for residents and introducing credible enforcement measures; tax revenues have increased (Rabushka 2002, 2004).

Incentive schemes have sometimes had positive effects. These can provide incentives for both tax collectors and for tax payers. Das Gupta and Mookherjee (1998, 257) report on efforts that combined the creation of a relatively autonomous bureaucracy with a budget linked, in part, to its success at collecting revenue. Reforms of revenue collection services in several African countries had similar features (Dia 1996). For example, in the 1980s Ghana tried an enclave approach to tax and customs reform by creating a new National Revenue Service (NRS). Prior to the reform, tax revenues were 4.5 per cent of GDP. Under the reform, the most corrupt existing officials were dismissed or retired, and pay and working conditions were improved. Increased salaries were accompanied by incentive systems to reward strong performance by individuals and by the agency as a whole. Revenue targets were established, and the NRS was given a bonus of 3.5 per cent of tax revenue and 2.5 per cent of customs revenue. Between 1984 and 1988 tax and customs revenue rose from 6.6 per cent to 12.3 per cent of GDP. Thus as long as the cost of the programme did not exceed 5.7 per cent of GDP, the programme was a net revenue-generator. The reforms illustrate the importance of combining improved base pay with incentives for good performance. Furthermore, rank-and-file officials must believe that corruption is rare at senior levels. The programme was a relative success, but it was not without problems. The rest of the civil service chafed at the special treatment afforded tax collectors. After all, the bonuses received by the NRS increased not only if effort increased but also if taxes rose because of an exogenous increase in GDP. Furthermore, the Ministry of Finance objected to its loss of authority. In 1991 revenue collection was again placed under the authority of the Ministry of Finance, although it retained some of its independence. Corruption reportedly increased (Chand and Moene 1999). The strengths and weaknesses of several African experiments with revenue authorities are summarised by Devas, Delay and Hubbard (2001).

In an instructive study of a failure, Fjeldstad (2002) analysed an unsuccessful effort to reform the Tanzanian Revenue Authority along the same lines as the Ghana case. Before reform, lost revenues were high because of illegal behaviour. Up to 70 per cent of the value of imports did not appear in official statistics, and domestic businesses underreported production volumes and profits and falsified deductions. The reform focused on the control of discretionary tax exemptions, reform of the high and complex rate structures, improved pay and working conditions for tax officials and strengthened enforcement. As in Ghana, a semi-autonomous agency was set up with local leaders of known integrity, and most staff were fired and had to re-apply and take a test. The first year, 1996–97, was a seeming success with a 30 per cent increase in revenue collected. However, between 1997 and 2001 corruption re-emerged and revenue collection fell. The dismissed officials became 'tax experts' who facilitated corrupt tax avoidance deals. Improved salaries did not deter officials. Fjeldstad points to the partial nature of reform: the tax system remained complex, non-transparent and unclear.[20]

One proposal is a contract with a private preshipment inspection (PSI) service that assesses duties before goods leave their port of origin and then earns a fraction of the value of the imports. In general, the PSI firm receives about 1 per cent of the value of the imports inspected with a minimum charge per shipment of about $250 (Yang 2004, 6). The actual duties are collected by customs officials in the importing country on the basis of the information supplied by the PSI service (Low 1995, Yang 2004). Over 50 developing countries have hired PSIs over the last two decades (Yang 2004: 3).

Unfortunately, cross-country evidence suggests that these programmes have little effect.[21] There

[20] The problem of short term gains turning to long term losses seems a more general problem. Introducing a new set of officials may reduce corruption, at first, simply because they have not yet figured out the new system. Over time the gains may erode unless the underlying incentives have been changed. Benjamin Olken stressed this point in an email on 11 March 2004.

[21] Yang (2004: 6–7, appendix A.3) found that the 'import capture ratio' was not affected by PSI programmes. This is the ratio of a country's self-reported imports to the sum of trade partner's reported exports to that country.

are two ways in which importers can undermine such contracts. First, customs inspectors can be bribed, although this type of corruption ought to be fairly easy to detect. Second, and more important, imports are diverted into exempt categories or smuggled outright. Dean Yang (2004) looked at this phenomenon in detail for Colombia and the Philippines. PSI services are so expensive that countries, such as Colombia and the Philippines, do not employ them for all imports. As a result, firms divert imports into exempt categories that are not checked by the PSI service. In the Philippines, where more detailed data were available, Yang concludes that the use of PSI led to significant net losses for the Philippine government. The Philippines only used PSI for imports from nine Asian countries. During the study period, it reduced the minimum threshold for shipments being inspected from $5,000 to $2,500 and eventually to $500. As a result, imports shifted to exempt methods, and Yang estimates that the net loss to the government was over $46 m over the period December 1990 to February 1992 (2004, 20–57). Note that the size of the bribes themselves does not figure into this calculation. The bribe is a transfer from the taxpayer or importer to the official. The social cost is the distortion introduced by the bribe in the form of reduced tax collections from bribe payers and a distorted incidence of taxes.

As another example consider Mozambique that has experimented with such a system for customs revenues. In 1997 revenues jumped by 40 per cent (Hubbard, Delay and Devas 2001). Revenue collection has increased each year. In 2000 the contract was extended and is now set to expire at the end of 2004 (http://www.crownagents.com/). The contract is also meant to be a step toward a reformed and locally operated customs service, but that aspect of the project is behind schedule.[22] The contractor obtains 3.5 per cent of revenues collected but, in addition, Mozambique covers the costs of the expatriate staff. In 2003 there were thirteen expatriate consultants and two short-term specialists. Overall the contract cost over 20 per cent of projected revenues although net costs were presumably lower because the government saved money on its own bureaucracy (Hubbard, Delay and Devas 2001). No study has been done of this case comparable to Yang's research, but this appears to be an expensive programme that is yielding, at least, short-run benefits.

Nevertheless, Yang's research suggests that PSI is not a panacea and may often be a cost-ineffective policy. If it is not comprehensive, many importers will find ways to avoid it. If it is comprehensive, the cost to the importing country may not be worth the benefit. In any case, the long run solution must be a reform of the local customs service combined with simplified and reduced restrictions on trade.

Durable reform should deal with the *underlying incentives for tax evasion*. In some countries, the nominal level of taxes and duties is so high that citizens and businesses justify their evasion on the grounds that they cannot survive if they obey the law. In addition, tax laws are often complicated and unclear, giving tax collectors leeway to make exceptions. These factors can produce a situation where a high proportion of households and businesses are law breakers. This gives the incumbent government a tool for controlling dissent and undermining political opponents. The goal should be a tax system with rates that can realistically be paid and with simple and clear standards. In addition, the rules must be transparent to the public and systems of accountability must exist. If they do not, simple clear rules can simply permit a ruler to extract pay-offs more effectively. Furthermore, governments can give taxpayers incentives to pay on time. The government of Mexico City, for example, is encouraging people to pay their taxes on time by giving them a discount if they file early.

Some reforms in the collection of state revenue are, in principle, costless. The goal is to limit bureaucratic discretion, a policy that ought to both reduce bribes and bureaucratic inputs. The problem is political will, and the political power of those who pay and receive bribes. However, if personnel are deeply corrupt, simply changing the rules may not be sufficient. The state may need to replace officials, and new employees may need to

[22] For example, a 2002 report pointed to problems in achieving this goal. See http://www.u4.no/projects/projects.cfm?id=103.

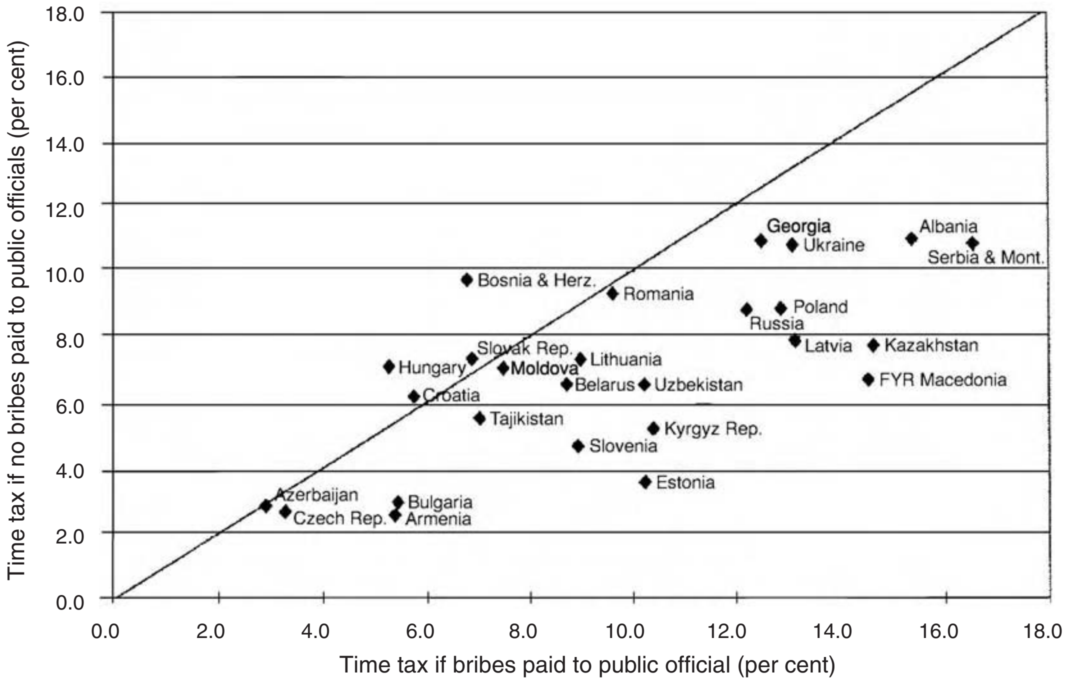

Figure 6.10. *Average time tax for firms paying bribes to public officials and for firms not paying bribes, by country*

Note: The time tax is calculated for each country as an unweighted average of individual firms' responses on the proportion of senior managements' working time spent dealing with public officials. The time tax is calculated separately for those firms that bribe frequently and for those that do not.

Source: Fries, Lysenko and Polanec (2003).

earn higher salaries, have better working conditions and get bonuses for good performance. Costly oversight and auditing may be necessary. One option is to contract with a PSI service based in a developed country. This may increase revenue collection, but it is an expensive option and is unlikely to be a feasible long-term solution.

Business Regulation

A high proportion of firms surveyed in the Executive Opinion Survey in 2002 reported that the illicit purchase of laws, policies, and regulations was high/very high (see figure 6.7). These results appear to include both the outright purchase of general rules and corruption in the administration of existing policies. Bribery to obtain access to public utilities was also a prevalent in some regions. Corruption appears to take time. Data on Eastern Europe and the FSU indicate that the larger the share of firms that bribe public officials, the greater the proportion of senior managers' time spent dealing with public officials (Fries, Lysenko and Polanec 2003, 16–17). The data indicate that corrupt firms usually spend more, not less, time dealing with authorities. Figure 6.10 shows that in most countries in the region, corrupt firms average more time dealing with authorities than firms that report paying few or no bribes. This result suggests that corrupt officials may well create red tape and vague rules as spurs to the payment of bribes.

Corruption occurs both at the time a business is established and later as it seeks to survive. The World Bank has pioneered studies of the hurdles facing those seeking to establish and maintain business firms throughout the world. One part of this research focuses on the costs in time and money of establishing a new business legally. Building on Hernando de Soto's (1989) research in Peru, these studies show how entrepreneurship is discouraged and how those who persevere are pushed into corrupt and off-the-books operations by the tediousness and expense of complying with the law. The second strand of research begins with measures of the shares of managers' and employers' time spent dealing with government officials. This research deals only with registered companies but it, of course, indicates one reason why firms operate in the informal or 'gray' economy seeking to avoid official notice.

A simple conclusion from this research is that firms would be much more productive if the government removed the rules and regulations that make entry and operation costly. This looks like a costless reform. Firm managers and employees redirect their time to productive activities, and more firms enter the market, thus increasing competitive pressures and benefiting consumers with lower prices. Some of the studies of this phenomenon take this viewpoint, and see obstacles to firm entry and operation as pure costs. Unfortunately, this conclusion is too glib. Although reformers should examine the existing rules and regulations in most countries to determine if some can be eliminated, some business–government interactions can be socially beneficial. The proper response is then not to eliminate the programme but to reform it in ways that limit corrupt incentives. However, even with such reforms some costs will remain. I have already discussed two important examples in my discussions of tax collection and procurement and their reform. In addition, rules regulating environmental pollution, waste generation and disposal, worker health and safety, unionisation, the issuance of securities, consumer fraud and product safety and so on have solid public policy justifications even if the details of a state's actual laws are far from ideal. Some countries may have such dysfunctional state institutions that it is better not to take on some regulatory tasks until conditions improve. Others, however, may be able to institute reforms that suit their level of capacity – similar to the simplified tax system discussed above.

This leads to a basic recommendation: expand the diagnostic work already done to more countries but also include a more nuanced policy response that tries to sort out valuable from useless public programmes. However, if reform is selective, the result may simply give the remaining officials more power to extract bribes. It is quite possible that the actual level of pay-offs may increase as the transaction costs of corruption fall. This can still be beneficial, as less time is wasted by the firm and by public officials, but remaining corrupt officials still have an incentive to facilitate market monopolisation to maximise rents. The 'one-stop-shops', much touted by development agencies, may simply be efficient bribe collection agencies. Thus, in streamlining business–government relations, governments need to decide what public functions are really necessary and then construct bureaucratic procedures that limit corrupt opportunities through such devices as impersonal procedures; simple, transparent rules; interbureaucrat competition; effective complaints and appeals procedures; etc. (Rose-Ackerman 1999, 39–68, 146–9).

There appear to be some win–win possibilities here where dysfunctional rules and regulations can simply be repealed. The main cost is an expansion of the diagnostic work already being done by organisations such as the World Bank to include more countries and a modification of existing work to highlight the benefits of government programmes that impose financial and time costs on business.

International Efforts

Multinational firms are involved in many deals with developing countries and emerging economies. If corruption is involved, the result may bring few benefits to the host country and impose costs on the multinational. This has led to international treaties to control corruption – most notably at the Organization for Economic Cooperation and Development (OECD), the Organisation for American States (OAS), the Council of Europe and, most recently, the United Nations. These documents all reflect the salience of the issue of global corruption, but none of them is very powerful as a law enforcement tool. Their impact will depend upon their ability to *change the discourse* inside member countries and in the international business communities in ways that also change behaviour. These treaties have so far not had much concrete impact although they do seem to have changed the dialogue over corruption in ways that have a real impact on firms that care about their reputations. However, to go further, these treaties will have an impact only when combined with strong domestic efforts in both home and host countries. I will not describe these efforts here. Those with a deeper interest in the current status of these treaties can consult the relevant websites maintained by each organisation.[23] I discuss several possibilities that are related to current debates and to some aspects of these international agreements. My main focus is on alternative forms of information disclosure and accountability in extractive industries. I conclude with a discussion of asset recovery initiatives.

Extractive industries (e.g. oil, minerals) are a current focus because considerable empirical evidence suggests that, when the state is weak or venal, there can be a 'resource curse' in which the presence of such resources hurts economic growth by diverting energy into rent-seeking instead of productive activity (Rose-Ackerman 1999, 213–15). Paul Collier and Anke Hoeffler (2004) point to the link between natural resource dependence and civil war (see also chapter 3 in this volume). The management of such resources is of great importance especially in SSA which is on the verge of an oil boom and has many poor resource-dependent countries. According to *The Economist*, 'a handful of states are expected to receive $200 bn in the next decade' as a result of oil and gas exploitation (6 December 2003, 39).

[23] OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, 11 December 1997, http://www.oecd.org/document/21/0,2340,en_2649_34859_2017813_1_1_1_1,00.html. Council of Europe, Criminal Law Convention on Corruption, 27 January 1999, E.T.S. 173 (entered into force 2002), http://conventions.coe.int/Treaty/EN/Treaties/Html/173.htm and http://www.greco.coe.int/docs/ResCM(1999)5E.htm. Inter-American Convention Against Corruption, 29 March 1996, 35 I.L.M. 724 (entered into force 6 March 1997, available at http://www.oas.org/main. United Nations Convention Against Corruption, 9 December 2003, available at http://www.unodc.org/unodc/crime_convention_corruption.html.

One initiative is a campaign backed by a coalition of non-governmental and civil society organisations called 'Publish What You Pay.' The campaign's goal is an international regime that requires disclosure of net taxes, fees, royalties and other payments made by natural resource companies to developing country governments. The aim is to help citizens of these countries hold their governments responsible for the use of revenues from these investments (http://www.publishwhatyoupay.org). Of course, if the country's government is not dependent on the support of its own citizens, this can be an empty gesture that simply informs helpless citizens that their rulers are benefiting at their expense.

The second proposal is an international, multistakeholder effort called the Extractive Industries Transparency Initiative (EITI). The EITI includes host countries in the mix and seeks to have both sides of the transactions make public reports of legal payments. Part of the motivation for this initiative is to permit outsiders to check if there is any discrepancy between the figures reported by firms and by governments. At this point, the EITI is working toward a voluntary pilot programme involving a few resource-dependent countries. The pilot countries are likely to be drawn from the following list: East Timor, Azerbaijan, Ghana, Trinidad and Tobago, Democratic Republic of the Congo, Indonesia and Nigeria. One idea is to use a 'trusted third party', perhaps the World Bank, to develop a standardised process and to receive reports (details and updates at http://www.dfid.gov.uk). As a background report prepared for a February 2003 meeting makes clear, there are a number of problems in making the data comparable and in dealing with contracting issues, including confidentiality. Furthermore, presumably a programme could go forward only if all the multinational and domestic contractors and concessionaires in an industry agree on the procedure. Thus even a 'voluntary' procedure would have to have mandatory aspects as participating countries make disclosure a condition for doing business. Collier and Hoeffler discuss EITI in chapter 3 as a promising option to reduce the risk of civil conflict and to fuel growth. They estimate the total discounted present value of benefits at roughly $29 bn with trivial costs. Even if those benefit numbers are much overstated, the potential net gains look large although they are a very small share of the discounted present value of world income.[24] The main problems are the difficulty of specifying exactly what EITI requires, and of being sure that its terms are followed. This is one example of a programme with small social costs but that will impose massive losses on those in favourable positions to extract rents. Thus it will not be easy to implement.

Third, efforts are underway to monitor host-country use of the funds from oil and mineral extraction. For example, the World Bank, which helped finance the Chad–Cameroon pipeline, has set up an International Advisory Group (IAG) to make periodic reports on the institutional capacity of Chad and Cameroon and on the ways funds are being used (http://www.gic-iag.org). The Bank also required Chad to set up an independent watchdog Revenue Oversight Committee to scrutinise how the oil money is spent. The Committee has rejected over half of the government contracts and insisted on open bidding. However, it has some weaknesses of its own with low staffing levels and tight deadlines that limit oversight (*The Economist*, 6 December 2003, 39). The World Bank has made this project a test case in the effort to be sure that natural resource revenues benefit a nation's citizens. Its successes and failures are worth monitoring as project revenues begin flowing in.[25] However, making natural resource payments from multinationals contingent on a country's own institutional oversight is possible only in very poor, aid-dependent countries such as Chad. Other countries can simply refuse to accept loans from IFIs.

Nevertheless, these efforts seem worth pursuing. The initiatives are related to the OECD Treaty outlawing overseas bribery. Multinationals may hope that by supporting greater transparency, they can avoid having payments that they record as royalties or taxes end up in the personal bank accounts of leaders. They may also hope that transparency will limit the financial demands of host-country officials. However, the leaders of countries that have only weak democratic institutions may not be deterred by transparency which, although necessary for corruption control and good governance, is not sufficient. If civil society is weakly organised in the host country and lacks the expertise to understand company and country reports, transparency may have little impact inside the country. Its main role may be in putting international pressure on both firms and country leaders. This suggests that the NGOs behind the 'Publish What You Pay' initiative have a point in pushing for a mandatory disclosure system managed by an international organisation. The mandatory aspect of such a plan could take the form of making such disclosure by firms and governments a condition for receiving favourable investment guarantees and subsidies from home countries or from the international aid and lending organisations such as the World Bank Group, including the International Finance Corporation (IFC) and MIGA.

The international business community is beginning to recognise the costs of corruption to the global investment environment. Insofar as this is true, it suggests that international businesses themselves could contribute to the effort by providing funds and technical assistance to countries interested in reform. This is already being done through professional associations such as the American Bar Association, but the aid and lending organisations might explore the possibility of collaborative projects. For example, one aspect of the EITI is a plan to provide technical assistance to developing countries to improve their public budgeting procedures and reports. Such assistance could be underwritten by the firms that invest in the countries in question although, of course, they ought not play a direct role in the administration of such programmes.

Although a wide range of options have been proposed to deal with corruption at the international level (Rose-Ackerman 1999, 177–97), I conclude with just one additional possibility, asset recovery – an important part of the new United Nations treaty. One key requirement is to make corruption a predicate offence to the application of money laundering

[24] World income in 2002 was estimated to be \$32.2 trillion. Even supposing no growth in the total, the discounted present value of a 10-year stream at this level, discounted at 5 per cent is \$248.6 trillion. The estimated benefits of EITI are 0.012 per cent of that total.

[25] 'Greasing the Engines of Change in Chad', *New York Times*, 18 February 2004.

requirements. This broadening of the definition was included in the United States Patriot Act in 2001, but it is not a universal provision of such laws. A second issue is the grounds under which assets can be frozen and ultimately turned over to the government of the country of the corrupt official. The process is often cumbersome, if it works at all. Thus the Congo has had little success in retrieving Mobutu's overseas riches, and Nigeria has only recently obtained substantial sums from overseas banks that hold funds deposited in them by Sami Abacha, its former ruler. Kenya's new government has decided not to prosecute its former president, in part because of the difficulty of recovering assets.[26] Enhanced asset recovery appears to depend not so much on a willingness to bear large costs as on changes in entrenched modes of operation. Reform would require a difficult and controversial rethinking of present practices.

Options for Improving Governance and Reducing Corruption

The operation of the state and its interaction with the public are key challenges facing the world. If government performance does not improve in many states, programmes designed to help the poor, improve the natural environment and stimulate economic growth will have little impact and risk inflicting harm.

Estimating the costs and benefits of specific reforms is difficult even if cross-country research indicates that the gains from reducing corruption and improving governance are large. The main problem is tracing specific links from particular, concrete policies to desirable outcomes. Even the World Bank, which has been a leader in quantifying the costs of the corruption, has been unwilling to organise the data in that fashion. However, some options are almost costless. Hence, even if the benefits cannot be precisely measured, the rates of return are large. This is, of course, not to say that there are no losers. Obviously, individuals and firms, many with political power, benefit from the status quo and will oppose change. A major challenge for governance reform is to overcome or coopt entrenched interests.

Unresolved empirical issues limit the estimates of the relative cost-effectiveness of different strategies and the ways in which distinct alternatives interact. Thus an option may be better than the status quo but not necessarily better than another proposed reform. Furthermore, some of the options have never been tried on a large scale and have never been subject to systematic efforts to measure their effectiveness. Thus, reformers need to design experiments and pilot programmes to test the value of options that appear promising. Based on my collection of reform options, there are several promising options (box 6.1).

I conclude with a few thoughts about the relationship between these policy proposals and the international environment. Consider aid and lending: there is presently an ongoing debate about the value of conditionality in the provision of aid. 'Conditionality' in some broad sense is inevitable. International donors must choose where to put scarce funds, and they will consider where the funds will have some positive pay-off. A weak state or one with high levels of corruption will be unlikely to manage aid well and so will get less. A state that does receive aid must comply with financial reporting requirements to assure that the funds are not lost to corruption and waste. Such conditionality, however, is less directly intrusive than aid that comes with explicit requirements for institutional reform. This latter type of conditionality has not been notably successful. An alternative is to organise projects that are directly focused on improved governance. For example, the Chad Revenue Oversight Committee and International Advisory Group for the Chad/Cameroon pipeline are cases in point that deserve to be carefully studied to isolate their strengths and weaknesses.

I have documented some successes and some failures, but projects that improve governance and oversight can benefit from external resources so long as they are designed eventually to be self-sustaining. A condition of such projects should be a *research component* that measures progress (or its opposite) by

[26] 'Kenya joins nations pursuing funds stolen by ex-leaders', *New York Times*, 21 December 2003.

Box 6.1 Options for Reform

Option 1

Grassroots monitoring and service delivery with technical assistance and information provision provided centrally by government or non-governmental organisations.

Benefits
Cost savings on existing programmes that have ranged as high as 400 per cent. Better overall economic performance and access of the poor to public services.

Costs
Opportunity cost of people's time; costs of consultants and central government officials to help design programmes and provide information. Demoralisation costs if government does not respond to citizen complaints

Note
Assuming the underlying programme is beneficial, net benefits for successful programmes are likely to be large with high BCRs, but more needs to be learned about what works and is sustainable.

Positive Model Cases
Brazilian urban democracy, monitoring of Uganda school funding, Nepalese local public works, South Africa Community Participation Programmes.

Option 2

Procurement reform. Develop benchmarks and use them to reward efficient providers of public services. Consider integrating benchmarking with web-based reputation system based on public input. Role for international institutions, regional bodies, or central governments in providing benchmarking cost estimates and setting up interactive public comment systems. Encourage competition in providing goods and services to the state through use of more open procedures. More purchase of standardised products sold in international markets.

Benefits
Cost saving on public contracts that may total 30–40 per cent according to some estimates.

Costs
Costs of gathering benchmarking information and creating a system to use it.

Note
Once again, assuming the underlying project is worthwhile, net benefits and BCRs will be large with benefits many multiples of costs. The main problem is a 'technical' one – no one really knows exactly how to design a viable system.

Model Cases
Golden and Picci's work on Italy, Pak and Zdanowicz's estimates of overinvoicing and underinvoicing in the USA, US procurement reforms in the 1990s spearheaded by Kelman.

Option 3

Reform of revenue collection through tax simplification, incentives to collectors and tax-payer monitoring. Short-term use of private firms from outside the country to assure integrity.

Benefits
Increased revenue collection in the best cases was close to 100 per cent.

Costs
Increased pay and bonuses for collectors or fees paid to outside contractors, but these seldom total more than 50 per cent of the revenue collected. Because the costs apply to all revenue, the existing situation must be quite dire to justify these expenses. But the costs and revenue gains can be checked *ex post* so the policy is self-correcting. A further cost is demoralisation costs imposed on other government employees who see the benefits flowing to the tax office.

Box 6.1 (*continued*)

Note

Net benefits and BCRs will be high in many cases. Either the state can lower taxes or raise the level of service provision, but either way the productivity of public spending rises.

Negative Model Cases: Tanzania

Mostly Positive Model Cases: Ghana, Mozambique

Option 4

Reduction in the state-imposed costs of establishing a new business and in the costs associated with ongoing business–government relations. Regulatory cutbacks tempered with concerns for valid goals of some public regulations.

Benefits

Encourages formation of new businesses and increases economic value of existing businesses. Less managerial time spent dealing with public officials.

Costs

Close to zero for pure ‘red tape’, but reformers also need to evaluate any benefits forgone from programmes with some social value.

Note

If reforms are designed with care, there are very high BCRs and net benefits.

Option 5

International options. Technical assistance to develop monitoring and transparency initiatives as in the Chad–Cameroon pipeline and the EITI. Enhanced asset recovery.

Benefits

More of the benefits of extractive industry projects would flow to developing countries. Given the leakage in some past projects, this could increase host-countries’ benefits substantially. Increased likelihood of asset recovery could reduce the incentives to engage in corruption. These are transfer or pecuniary benefits that shift resources from multinationals and key political insiders to ordinary citizens in poor countries. However, research on the costs of corruption suggest that there are also efficiency gains as well. For example, chapter 3 in this volume estimates that the total discounted present value of a successful EITI initiative could be $29 bn.

Costs

Administrative costs of setting up such systems which should be only a few percentage points of the value of any project.

Note

Although the net benefits of EITI appear large, some technical issues have not been resolved so this is not an ‘off-the-shelf’ option. A range of experiments could be carried out in this area involving pilot programmes in vulnerable countries.

providing information on background conditions, tracking the design and implementation of the reform and measuring outputs. Donors and country partners would try to quantify inputs and outputs in terms such as the speed and effectiveness of government activities, the satisfaction of citizens and the distribution of benefits. Sometimes, as in a tax or procurement reform, the benefits can be quantified in terms of additional dollars collected or cost savings but in other cases, such as more transparent government, the benefits take the form of greater citizen satisfaction and better government accountability. These factors are valuable in their own right and are associated with higher levels of growth and individual well-being, but the precise links from specific policy interventions to outcomes are not well specified.

Recent discussions of how to allocate foreign assistance to developing countries sometimes conclude that some countries have such poorly functioning institutions that no external aid should be provided because so much of it will be lost. This represents not, as some say, an end to conditionality but is instead conditionality writ large – at the level of the country as a whole, rather than at the level of the programme. The best mixture seems to be broad-based decisions about which countries to support with some share of aid taking the form of grants to improve government performance. Outsiders would not micro-manage individual projects, for example, to build roads, support education and provide health care. Instead, they would supply technical assistance that could lead to a quite deep involvement with the details of government operations. In contrast, policies which try to isolate corrupt countries and individuals from the international community encourage their rulers to descend into paranoia and isolation and are ineffective ways to help the citizens of these countries who are the real victims of corruption. Real reform requires *systemic policy initiatives*. Corruption is a problem of *institutional failure*. A 'clean hands' policy in which wealthy countries hold themselves aloof from tainted countries and individuals without doing anything actually to address the underlying problems will simply further divide the world into rich and poor blocs.

References

Abers, R., 1998: From clientalism to cooperation: local government, participatory policy and civic organizing in Porto Alegre, Brazil, *Politics and Society*, **26**, 511–37

Acemoglu, D., 2003: The form of property rights: oligarchic vs. democratic societies, Department of Economics, MIT, Cambridge MA, September, draft

Acemoglu, D., S. Johnson and J. A. Robinson, 2001: The colonial origins of comparative development: an empirical investigation, *American Economic Review*, **91**, 1369–1401

Adams, C. F., M. E. Bell and T. Brown, 2002: Building civic infrastructure: implementation community partnership grant programmes in South Africa, *Public Administration and Development*, **22**, 293–302

Ades, A. and R. Di Tella, 1997: National champions and corruption: some unpleasant interventionist arithmetic, *Economic Journal*, **107**, 1023–42

1999: Rents, competition and corruption, *American Economic Review*, **89**, 982–3

Anderson, C. J. and Y. V. Tverdova, 2003: Corruption, political allegiances and attitudes toward government in contemporary democracies, *American Journal of Political Science*, **47**, 91–109

Anderson, J., D. Kaufmann and F. Recanatini, 2003: service delivery, poverty and corruption – common threads from diagnostic surveys, background paper for the 2004 *World Development Report*, World Bank, Washington DC, 27 June, www.worldbank.org/wbi/governance/capacitybuild/d-surveys.html

Andvig, J. C., 1995: Corruption in the north sea oil industry: issues and assessments, *Crime, Law, and Social Change*, **28**, 289–313

Anechiarico, F. and J. B. Jacobs, 1996: The pursuit of absolute integrity: how corruption control makes government ineffective, University of Chicago Press, Chicago

Bardhan, P., 1997: Corruption and development: a review of issues, *Journal of Economic Literature*, **35**, 1320–46

Batra, G., D. Kaufmann and A. H. W. Stone, 2003: The firms speak: what the world business environment survey tells us about constraints on private sector development, chapter 9 in G. Fields and G. Pfefferman (eds.), *Pathways out of poverty: private firms and economic mobility in developing countries*, Kluwer Academic Publishers, Amsterdam, http://www.worldbank.org/wbi/governance/pubs/firmsspeak.html

Behrman, J., 2003: Labor markets in developing countries, chapter 43 in O. Ashenfelder and D. Card, *Handbook of labor economics*, 3B,

Blake, C. H. and C. G. Martin, 2002: Combating corruption: reexamining the role of democracy, paper presented at the Annual Meeting of the Midwest Political Science Association, Chicago, 25–28 April

Brown, T., 2001: Contracting out by local governments in transitioning nations: the role of technical assistance in Ukraine, *Administration and Society*, **32**, 728–55

Burki, S. J., 1997: Governance, corruption and development: the case of Pakistan, paper presented at the Workshop on Governance Issues in South Asia, Yale University, New Haven, 19 November

Buscaglia, Jr., E. and M. Dakolias, 1996: Judicial reform in Latin American courts: the experience in Argentina and Ecuador, World Bank

Technical Paper, 350, World Bank, Washington, DC
Chand, S. K. and K. O. Moene, 1999: Controlling fiscal corruption, *World Development*, **27**, 1129–40
Ciocchini, F., E. Durbin and D. T. C. Ng, 2003: Does corruption increase emerging market bond spreads?, *Journal of Economics and Business*, **55**, 503–28, available at http://www.sciencedirect.com
Collier, P. and A. Hoeffler, 2004: The challenge of reducing the global incidence of civil war, Oxford University, Oxford, January, draft; see chapter 3 in this volume
Crook, R. C., and J. Manor, 1998: *Democracy and decentralization in South Asia and West Africa: participation, accountability and performance*, Cambridge University Press, Cambridge
Das Gupta, A. and D. Mookerjee, 1998: *Incentives and institutional reform in tax enforcement: an analysis of developing country experience*, Oxford University Press, Delhi
Das Gupta, M., H. Grandvoinnet and M. Romani, 2000: State–community synergies in development: laying the basis for collective action, World Bank, Washington, DC, draft
Dellarocas, C., 2003: The digitalisation of word of mouth: promise and challenges of online feedback mechanisms, *Management Science*, **49**, 1407–24
Del Monte, A. and E. Papagni, 2001: Public expenditure, corruption, and economic growth: the case of Italy, *European Journal of Political Economy*, **17**, 1–16
Della Porta, D. and A. Vannucci, 1999: *Corrupt exchange*, Aldine, New York
De Melo, M., G. Ofer and O. Sandler, 1995: Pioneers for profit: St Petersburg entrepreneurs in services, *World Bank Economic Review*, **9**, 425–50
De Soto, H., 1989: *The other path: the invisible revolution in the third world*, Harper & Row, New York
De Sousa Santos, B., 1998: Participatory budgeting in Porto Alegre: toward a redistributive democracy, *Politics and Society*, **26**, 461–510
Devas, N., S. Delay and M. Hubbard, 2001: Revenue authorities: are they the right vehicle for improving tax administration?, *Public Administration and Development*, **21**, 211–22
Di Tella, R. and E. Schargrodsky, 2002: The role of wages and auditing during a crackdown on corruption in the City of Buenos Aires, in D. Della Porta and S. Rose-Ackerman, (eds.), *Corrupt exchanges: empirical themes in the politics and political economy of corruption*, Nomos Verlag, Frankfurt; a longer version is in *Journal of Law and Economics*, **46**, 2003
Dia, M., 1996: Africa's management in the 1990s and beyond: reconciling indigenous and transplanted institutions, World Bank, Washington, DC
Dollar, D., M. Hallward-Driemeier and T. Mengiste, 2003: Investment climate and international integration, draft paper prepared for Conference on the Future of Globalization, Yale Center for the Study of Globalization, World Bank, Washington, DC, 11 October
Duflo, E., 2001: Schooling and labor market consequences of school construction in Indonesia: evidence from an unusual policy experiment, *American Economic Review* **91**, 795–813
Easterly, W., 2001: *The elusive quest for growth: economists' adventures and misadventures in the tropics*, MIT Press, Cambridge, MA
Esty, D. and M. Porter, 2002: National environmental performance measurement and determinants, in D. Esty and P. K. Cornelius (eds), *Environmental performance measurement: the global report 2001–2002*, Oxford University Press, New York
Fisman, R., 2001: Estimating the value of political connections, *American Economic Review*, **91**, 1095–1102
Fisman, R., and S.-J. Wei, 2001: Tax rates and tax evasion: evidence from 'missing imports' in China, National Bureau of Economic Research Working Paper **8551**, Cambridge MA: NBER, October
Fjeldsted, O.-H., 2002: Fighting fiscal corruption: the case of the Tanzania Revenue Authority, Chr. Michelsen Institute Working Paper, **2002**: 3, Bergen
2003: *Decentralization and corruption: a review of the literature*, U4 Report, Chr. Michelsen Institute, Bergen
Fjeldsted, O.-H. and J. Semboja, 2001: Why people pay taxes: the case of the development levy in Tanzania, *World Development*, **29**, 2059–74
Friedman, E., S. Johnson, D. Kaufmann and P. Zoido-Lobaton, 2000: Dodging the grabbing

hand: the determinant of unofficial activity in 69 countries, *Journal of Public Economics*, **76**, 459–93

Fries, S., T. Lysenko and S. Polanec, 2003: The 2002 Business Environment and Enterprise Performance Survey: results from a survey of 6,100 firms, Working Paper, **84**, European Bank for Reconstructions and Development, London, November, http://www.ebrd.com/pubs/econ/workingp/84.pdf

Golden, M. and L. Picci, 2004: Proposal for a new measure of corruption illustrated using Italian data, draft 4, UCLA and University of Bologna, March; available at http://www.spbo.unibo.it/picci/article.pdf

Gong, T., 2002: Dangerous collusion: corruption as a collective venture in contemporary China, *Communist and Post-Communist Studies*, **35**, 85–103

Graf Lambsdorff, J., 2003a: How corruption affects persistent capital flows, *Economics of Governance*, **4**, 229–43

2003b: How corruption affects productivity, *Kyklos*, **56**, 457–74

Gupta, S., H. R. Davoodi and R. Alonso-Terme, 2002: Does corruption affect income inequality and poverty?, *Economics of Governance*, **3**, 23–45

Gupta, S., H. R. Davoodi and E. R. Tiongson, 2001: Corruption and the provision of health care and education services, in A. K. Jain (ed.), *The political economy of corruption*, Routledge, London

Hellman, J. S., G. Jones and D. Kaufmann, 2003: Seize the state, seize the day: state capture, corruption and influence in transition, *Journal of Comparative Economics*, **31**, 751–73

Hellman, J. S. and D. Kaufmann, 2004: The inequality of influence, in J. Kornai and S. Rose-Ackerman (eds), *Building a trustworthy state in post-socialist transition*, Palgrave, New York, 100–18

Hubbard, M., S. Delay and N. Devas, 1999: Complex management contracts: the case of customs administration in Mozambique, *Public Administration and Development*, **19**, 153–63

2001: Revenue authorities: are they the right vehicle for improving tax administration?, *Public Administration and Development*, **21**, 211–22

Johnson, S., D. Kaufmann, J. McMillan and C. Woodruff, 2000: Why do firms hide? Bribes and unofficial activity after communism, *Journal of Public Economics*, **76**, 495–520

Johnson, S., J. McMillan and C. Woodruff, 2000: Entrepreneurs and the ordering of institutional reform: Poland, Slovakia, Russia and Ukraine compared, *Economics of Transition*, **8**, 1–36

2002: Property rights and finance, *American Economic Review*, **92**, 1335–57

Johnston, M., 2002: Comparing corruption: participation, institutions and development, prepared for a conference on Corruption: Public and Private, John Jay College of Criminal Law, New York, August

Kaufmann, D., 1997: The missing pillar of growth strategy for Ukraine: institutional and policy reforms for private sector development, in P. K. Cornelius and P. Lenain (eds.), *Ukraine: accelerating the transition to market*, IMF, Washington, DC, 234–75

2003: Rethinking governance: empirical lessons challenge orthodoxy, Discussion draft, World Bank, Washington DC, http://www.worldbank.org/wbi/governance/pdf/rethink_gov_standford.pdf

2004: Governance redux: the empirical challenge, discussion draft, World Bank Institute, Washington DC, http://www.worldbank.org/wbi/governance/pdf/govredux.pdf

Kaufmann, D. and A. Kraay, 2002: Growth without governance, *Economia*, **3**, 169–229

Kaufmann, D., A. Kraay and M. Mastruzzi, 2003: Governance matters III: governance indicators 1996–2000, discussion draft, World Bank, Washington DC, http://www.worldbank.org/wbi/governance/pdf/govmatters3.pdf

Kaufmann, D., M. Mastruzzi and D. Zaveleta, 2003: Sustained macroeconomic reforms, tepid growth: a governance puzzle in Bolivia, in D. Rodrik (ed.), *In search of prosperity: analytic narratives on economic growth*, Princeton University Press, Princeton

Kaufmann, D., G. Menvez and T. Gurgur, 2002: Voice or public sector management? An empirical investigation of determinants of public sector performance based on a survey of public officials, discussion draft, World Bank, Washington DC

Kelman, S., 1990: *Procurement and public management: the fear of discretion and the quality of government performance*, AEI Press, Washington DC

2002: Remaking federal procurement, *Public Contract Law Journal*, **31**, 581–622

Krastev, I. and G. Ganev, 2004: The missing incentive: corruption, anticorruption, and reelection, in J. Kornai and S. Rose-Ackerman (eds.), *Building a trustworthy state in post-socialist transition*, Palgrave, New York

Krueger, A., 1974: The political economy of a rent-seeking society, *American Economic Review*, **64**, 291–303

Kunicova, J., 2002: Are presidential systems more susceptible to political corruption? California Institute of Technology, Pasadena, CA, draft

Kunicova, J. and S. Rose-Ackerman, 2005: Electoral rules and constitutional structures as constraints on corruption, *British Journal of Political Science*, forthcoming

La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny, 1999: The quality of government, *Journal of Law, Economics, and Organization*, **15**, 222–79

Li, H., L. C. Xu and H.-F. Zou, 2000: Corruption, income distribution, and growth, *Economics and Politics*, **12**, 155–82

Li, W., 2002: Corruption and resource allocation: evidence from China, in D. Della Porta and S. Rose-Ackerman (eds.), *Corrupt exchanges: empirical themes in the politics and political economy of corruption*, Nomos Verlag, Frankfurt

Low, P., 1995: Preshipment inspection services, World Bank Discussion Paper, 278, Washington, DC

MacGaffey, J., 1991: *The real economy of Zaire: the contribution of smuggling and other unofficial activities to national wealth*, University of Pennsylvania Press, Philadelphia

Manzetti, L., 1999: *Privatization South American style*, Oxford University Press, Oxford

Mauro, P., 1995: Corruption and growth, *Quarterly Journal of Economics*, **110**, 681–712

1997: The effects of corruption on growth, investment, and government expenditure: a cross-country analysis, in K. A. Elliott (ed.), *Corruption and the global economy*, Institute for International Economics, Washington: DC, 83–108

Meagher, P., K. Upadhyaya and B. Wilkinson, 2000: Combating rural public works corruption: food-for-work programmes in Nepal, IRIS Center Working Paper, **239**, University of Maryland, College Park, MD, February; available at http://www.iris.umd.edu/publications.asp

Miller, T., 1997: Kelman's latest proposal and past performance explored, *Federal Computer Market Report*, 21(11), 7 (9 June)

Miller, W. L., Å. Grødeland and T. Y. Koshechkina, 2001: *A culture of corruption: coping with government in post-communist europe*, Central European University Press, Budapest

2002: Values and norms *versus* extortion and temptation, in D. Della Porta and S. Rose-Ackerman (eds.), *Corrupt exchanges: empirical themes in the politics and political economy of corruption*, Nomos Verlag, Frankfurt

Mocan, N., 2004: What determines corruption? international evidence from micro data, NBER Working Paper 10460, Cambridge MA: National Bureau of Economic Research, April

Moore, M., 1998: Death without taxes: aid dependence, democracy, state capacity and aid in the fourth world, in M. Robinson and G. Whites (eds.), *The democratic developmental state: politics and institutional design*, Oxford University Press, Oxford

Mosse, D., 1997: The ideology and politics or community participation, in R. Grillo and R. Stirrat (eds.), *Discourses of development: anthropological perspectives*, Berg, Oxford, 255–91

Nichols, P. M., 2001: The fit between changes in the international corruption regime and indigenous perceptions of corruption in Kazakhstan, *University of Pennsylvania Journal of International Economic Law*, **22**, 863–973

Olken, B. A., 2003: Corruption and the costs of redistribution: micro evidence from Indonesia, draft, Harvard University, July

Olson, M., 1996: Big bills left on the sidewalk: why some nations are rich and others poor, *Journal of Economic Perspectives*, **10**, 3–24

Pak, S. J. and J. S. Zdanowicz, 1994: A statistical analysis of the US merchandise trade data base and its uses in transfer pricing compliance and enforcement, *Tax Management Transfer Pricing Report*, **3**, 50–7, 11 May

2002: US trade with the world: an estimate of 2001 lost US federal income tax revenues due to over-invoiced imports and under-invoiced exports, Trade Research Institute, Miami

Parker, A. N., 1995: Decentralization: the way forward for rural development?, Policy Research Paper, 1475, World Bank, Agriculture and Natural Resources Department, Washington, DC, June

Pasuk P. and P. Sungsidh, 1994: *Corruption and democracy in Thailand*, The Political Economy Centre, Faculty of Economics, Chulalongkorn University, Bangkok

Paul, K., S. Pak, John Z. and P. Curwen, 1994: The ethics of international trade: use of deviation from average world price to indicate possible wrongdoing, *Business Ethics Quarterly*, **4**, 29–41

Putnam, R., 1993: *Making democracy work: civic traditions in modern Italy*, Princeton University Press, Princeton

Rabushka, A., 2002: The flat tax at work in Russia, Hoover Institution Public Policy Inquiry, The Russian Economy, February http://www.russianeconomy/org/comments/022102.html

2004: The flat tax at work in Russia: year three, Hoover Institution Public Policy Inquiry, The Russian Economy, April, http://www.russianeconomy/org/comments/042604.html

Rauch, J. E. and P. B. Evans, 2000: Bureaucratic structure and bureaucratic performance in less developed countries, *Journal of Public Economics*, **75**, 49–71

Reinikka, R. and J. Svensson, 2002: Measuring and understanding corruption at the micro level, in D. Della Porta and S. Rose-Ackerman (eds.), *Corrupt exchanges: empirical themes in the politics and political economy of corruption*, Nomos Verlag, Frankfurt

2004a: Local capture: evidence from a central government transfer program in Uganda, *Quarterly Journal of Economics*, **119**(2)

2004b: The power of information: evidence from a newspaper campaign to reduce corruption, Policy Research Working Paper Series, World Bank, Washington, DC

Robbins, P., 2000: The rotten institution: corruption in natural resource management, *Political Geography*, **19**, 423–43

Rock, M. T. and H. Bonnett, 2004: The comparative politics of corruption: accounting for the East Asian paradox in empirical studies of corruption, growth and investment, *World Development*, **32**, 999–1017

Rodrik, D., 2003: Growth strategies, *Handbook of Economic Growth*, Kennedy School of Government, Harvard University, Cambridge MA, draft; available at http://ksghome.harvard.edu/~.drodrik.academic.ksg/growthstrat10.pdf

Rose-Ackerman, S., 1978: *Corruption: a study in political economy*, Academic Press, New York

1999: *Corruption and government: causes, consequences and reform*, Cambridge University Press, Cambridge

2002: Grand corruption and the ethics of global business, *Journal of Banking and Finance*, **26**, 1889–1918

2004: Establishing the rule of law, in R. Rotberg (ed.), *When states fail: causes and consequences*, Princeton University Press, Princeton, 182–221

Rotberg, R. (ed.), 2003: *State failure and state weakness in a time of terror*, The Brookings Institution, Washington, DC

2004: *When states fail: causes and consequences*, Princeton University Press, Princeton

Sandholtz, W. and W. Keotzle, 2000: Accounting for corruption: economic structure, democracy, and trade, *International Studies Quarterly*, **44**, 31–50

Seligman, M., 2002: The impact of corruption on regime legitimacy: a comparative study of four Latin American countries, *Journal of Politics*, **64**, 408–33

Shleifer, A. and R. Vishny, 1993: Corruption, *Quarterly Journal of Economics*, **108**, 599–617

Slinko, I., E. Yakovlev and E. Zhuravskaya, 2004: Effects of state capture: evidence from Russian regions, in J. Kornai and S. Rose-Ackerman (eds.), *Building a trustworthy state in post-socialist societies*, Palgrave, New York, 119–32

Stasavage, D., 1999: Causes and consequences of corruption: Mozambique in transition, *Commonwealth and Comparative Politics*, **37**, 65–97

Stella, P., 1992: Tax farming – a radical solution for developing country tax problems?, IMF Working Paper, WP/92/70, IMF, Washington, DC

Steves, F. and A. Rousso, 2003: Anti-corruption programmes in post-communist transition countries and changes in the business environment, 1999–2002, Working Paper, **85**, European Bank for Reconstruction and Development, London

Svensson, J., 2003: Who must pay bribes and how much? Evidence from a cross section of firms, *Quarterly Journal of Economics*, **118**, 207–30

Swamy, A., S. Knack, Y. Lee and O. Azfar, 2001: Gender and corruption, *Journal of Development Economics*, **64**, 25–55

Tanzi, V. and H. Davoodi, 2002a: Corruption, growth, and public finance, in G. T. Abed and Sanjeev (eds.), *Governance, corruption and economic performance*, IMF, Washington, DC, 197–222

2002b: Corruption, public investment and growth, in G. T. Abed and Sanjeev (eds.), *Governance, corruption and economic performance*, IMF, Washington, DC, 280–99

Torgler, B., 2003: Tax morale in central and eastern European countries, paper prepared for the Conference on Tax Evasion, Trust, and State Capacity, University of St Gallen, St Gallen, 17–19 October

Treisman, D., 2000: The causes of corruption: a cross-national study, *Journal of Public Economics*, **76**, 399–457

United States, Department of Justice (DOJ), Criminal Division, Public Integrity Section, 2003: *Report to Congress on the activities and operations of the public integrity section for 2002*, Washington, DC

Uslaner, E. M., 2003: Tax evasion, trust and the strong arm of the law, paper prepared for the Conference on Tax Evasion, Trust, and State Capacity, University of St Gallen, St Gallen, 17–19 October

Van Rijckeghem, C. and B. Weder, 2001: Bureaucratic corruption and the rate of temptation: do wages in the civil service affect corruption, and by how much?, *Journal of Development Economics*, **65**, 307–31

Webster, L. M. and J. Charap, 1993: The emergence of private sector manufacturing in St Petersburg, World Bank Technical Paper, 228, World Bank, Washington, DC

Wei, S.-J., 2000: How taxing is corruption on international investors?, *Review of Economics and Statistics*, **82**, 1–11

Woodhouse, A., 2002: Village corruption in Indonesia: fighting corruption in the World Bank's Kecamatan development program, report to the World Bank, Washington DC, June

World Bank, 1997: *Helping countries combat corruption: the role of the World Bank*, Poverty Reduction and Economic Management Network, Washington, DC

1999: Guidelines procurement under IBRD loans and IDA credits, World Bank, Washington, DC, January, http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/PROCUREMENT/0,contentMDK:20060840~pagePK:84269~piPK:60001558~ theSitePK:84266,00.html

2003: Village justice in Indonesia: case studies on access to justice, Jakarta, draft, September

Yang, D., 2004: Can enforcement backfire? crime displacement in the context of a common customs reform, working paper, Gerald R. Ford School of Public Policy and Department of Economics, University of Michigan, Ann Arbor MI, April

You, J.-S. and S. Khagram, 2004: Inequality and corruption, Working Paper, RWP04–001, Kennedy School of Government, Harvard University, Cambridge MA

Alternative Perspectives

Perspective Paper 6.1

JENS CHRISTOPHER ANDVIG

The challenge raised by poor governance and corruption to be emphasised here is a challenge of *tools*: Do we have the ability to meet any global challenge if our basic tools for dealing with them, the formal organisations, are populated with a large number of leaders and ordinary members who shirk, embezzle or engage in corrupt transactions? The very same tools have to be applied when solving the problems of governance and corruption. Hence, if corruption is a key problem, do we have any way of solving it?

Rose-Ackerman (2004, chapter 6 in this volume) underlines a different side of corruption: skewed distribution of purchasing power based on private wealth induces illegal buying of influence. That undermines legitimate political power, particularly when based on voting power. This illegal buying of political and judicial decisions by private business, is nowadays called 'state capture' and recent research has been able to capture some of its possible quantitative dimensions (e.g. Hellman *et al.* 2000). I think this return to old Marxian fields of inquiry has already become fruitful. There are also important spillover mechanisms from the political game to the day-to-day behaviour of formal organisations. Still, I consider the consequences of corruption for that behaviour to be the key challenge.

Rose-Ackerman addresses five options, five roads of attack in chapter 6: Voice and accountability, procurement reforms, tax reforms, changes in systems of business regulation and international efforts to limit high-level corruption in business. For reasons of space I will focus on the last option.

Data: Do We Have Sufficiently Precise Knowledge of the Governance Challenge?

Looked at from outside, chapter 6 may appear somewhat peculiar by classifying both the consequences and causes of corruption according to their sources of statistical information. A rather heterogeneous picture of seemingly unrelated phenomena and measures is presented. This is not, however, a flaw in the chapter as such, but reflects in an interesting way some inherent characteristics of the corruption and poor governance challenge itself and, to some degree, temporary limitations of current state of relevant research. It has not yet quite digested the large amount of recently available data in the field.

In the following I will mainly discuss corruption, not because I believe that corruption and the other aspects of poor governance are synonymous phenomena, or always strongly linked, but because I have not found any option where tradeoffs between the different dimensions of governance are both essential and possible to determine. With the more precise weighing of forces implied by such

I am grateful to Nick Duncan and Arne Melchior for helpful comments and to Eilert Struksnes for comments and minor language editing.

tradeoffs, the problem of 'noisiness' in the different governance indicators becomes acute.[1]

With exceptions, such as Gunnar Myrdal (1968), few economists believed until recently that corruption was a researchable phenomenon. It was not researchable partly because no interesting model had been constructed but, more importantly, no quantitative data were available. Not least due to the early efforts of the author of chapter 6 (Rose-Ackerman 1978), interesting models were soon constructed, but quantitative data were missing until the mid-1990s. The publication of such data, beginning with the Corruption Perception Index (CPI) of Transparency International (TI), was part of the political process that has made corruption and poor governance available as a public challenge where quantitative cost-benefit analyses (CBAs) of measures at least are thinkable.

Nevertheless, I will argue that corrupt transactions remain in many ways as unobservable as before. The quantitative information is not based upon direct observation, with the exception of a few case studies that still are extremely scarce. The information is rather based on questionnaires that differ widely in how they relate to observable action. Since the different sources of quantitative information reflect the various forms of corruption and poor governance at different distances from the actual acts, it is reasonable to build different kinds of empirically based models around them. When closer to the actual corrupt acts, the wide variety of situations, reflected now also in the data, cries out for specific empirically based models to analyse the set of normally small-scale options tailored to that particular challenge.

Most quantitative research has been cross-country studies based on the most aggregate data. TI's CPI index has been most frequently used, but another developed in the World Bank, roughly using the same sources of information, but applying different principles of aggregation, is likely to become as important.[2] These indexes now allocate numbers for the average corruptibility of almost every country in the world of some economic significance, stimulating both political discussion and research. That research is of great potential value in assessing the economic dimensions of the challenge of poor governance and corruption. The quantitative specification of the negative effects of corruption on growth has been paradigmatic (Mauro 1995), but many other effects have been studied, some of which have been dealt with in chapter 6. Since the corruption level is not a policy instrument, however, models where corruption plays the role as dependent or intermediate variable are more immediately relevant. For example, in Ades and Di Tella (1999) the degree of economic openness impacts corruption, and corruption influences growth. Since it is possible to influence the degree of openness by a large number of policy instruments, including tried methods of trade policy, the implications for the search of policy options are obvious.[3]

The informational core of the TI's and World Bank's governance indexes is assessments made by experts and businessmen collected by different organisations. When constructing the indexes both the TI and the World Bank economists have, of course,

[1] With regard to the problem at hand, one may, for example, believe that the long periods of relatively high degree of political stability in Kenya with relatively low-scale political violence are related to the high level of corruption. But are we in this case dealing with processes that are so predictable that we may, for example, settle for an option that reduces corruption by 20 per cent at the cost of increasing the probability of civil war by 10 per cent? With such mixes of data 'noise' and difficult-to-predict situations, I believe it is reasonable to restrict the range of options considered to situations where all the good things go together – less interesting for economists, but less demanding for the quality of the governance indicators. That is, I shall in the following treat 'corruption' and 'poor governance' as synonymous.

[2] The aggregation principles of the World Bank index are explained in Kaufmann, Kraay and Zoido-Lobaton (1999). They allow information from sub-series covering only a few countries when constructing the aggregate index covering most countries in the world. By being able to include data from more countries and through the fact that the World Bank researchers have built up other, easy to access, governance indicators of bureaucratic quality, voice and the rule of law, using the same aggregation methodology, it is safe to predict that it will become the database for much research into corruption and poor governance in the future.

[3] As pointed out in chapter 6, many explanatory variables in the corruption equations are past events, historical or geographical givens, impossible to influence today and useless in option search. It is difficult to take authors seriously here when discussing the counterfactual of how much less corruption one might observe in parts of present-day Russia if it had been colonised by England (Treisman 2002)!

noted many of the problems which arise through the aggregation of these heterogeneous data sources and devised two different econometric solutions.

Both solutions, however, assume that the stochastic errors across sub-indicators are independent. The assumption is crucial and difficult to relax, as noted by Kaufmann, Kraay and Zoido-Lobaton (1999, 10). Without it, the gains in precision by aggregation become indefinite.[4] How reasonable is it that the strong correlation between the sub-indexes is due to correlation of errors, and not to independent observations of the same government characteristics? Several of the sub-indicators with the strongest intercorrelation are based on respondents' answers to very general and vague questions about their perceptions of corruption levels in country *A*, *B* or *C*. The questions are not leading the respondents to focus on their own experience. At least in countries where the citizens have no daily, individual experience of corruption, the assessments have to be based on the process through which information about corruption reaches the public domain. What is that process?

As far as I know, little precise, empirically based knowledge is available. As a first approximation, however, I would expect strong correlation and spillover effects: the experts read the same reports and gauge other experts' statements. Since the assessments are often not based on individual experience, when expert *X* claims that corruption in country *A* is very high, expert *Z* has no clear evidence to the contrary, so when knowing *X*'s statement it may be optimal to make an assessment close to hers. Informational cascades may easily develop in this context.[5] The fact that the TI index in particular is widely published reinforces the argument. The case of expatriate businessmen is somewhat different, but they are not likely to base their assessments only on their own, independent experience either. Most will be based upon other businessmen's communication. The degree to which that will contain private information, will at best depend on how much genuine information other expatriates reveal.[6] The striking way that corruption has moved from being perceived as a sideline issue in the public mind to a major challenge today may in part reflect this emperor-has-no-clothes informational structure (Andvig 2002).

The work under the auspices of the World Bank since 1996 to develop more detailed and focused information about corruption, such as the size and frequency of bribes paid by enterprises and other parts of public administration, is one of the most interesting and important expansions of statistical information since the development of national accounting. The thrust of this research is reflected in Kaufmann's (2003) strong headline: 'The power of data: governance can be measured, monitored, and rigorously analysed.' It is now possible to construct reasonably comparable (across countries) measures of different forms of corruption, whether corrupt deals are honoured and so on, for a large and increasing number of countries, all seen from the enterprises' point of view.

For some countries that information may be compared with the private households' and public officials' experience or perceptions in so-called diagnostic surveys.[7] In another line of research

[4] Another reason Kaufmann, Kraay and Zoido-Lobaton (1999) do not emphasise this problem is that the relaxing of the assumption would result in a greater variance in the country estimates and that would only support their polemics against TI's use of its index to publish a precise ranking of countries in terms of their (perceived) corruptness. An important ingredient in the World Bank aggregation procedure is that it (endogeneously) gives greater weights to those sub-indexes that are more strongly intercorrelated with the others. If that intercorrelation is due to intercorrelation of errors, however, this property of the aggregation procedure may not be of any advantage.

[5] Many of the conditions for of such cascades to develop are fulfilled in this case (see, for example, Bikhchandani, Hirschleifer and Welch 1992).

[6] The main reason why most information about corruption remains private (except the daily demand for bribes in high-corruption areas) is, of course, that corrupt transactions usually are criminal and the agents performing them are interested in keeping them secret. Furthermore, the agents most likely to discover corrupt transactions, the public or private bureaucracies directly involved, are also normally interested in keeping the acts secret from the public. In the case of private enterprises the economic losses when such information is revealed, may prove significant, around 5 per cent of stock values in more serious cases (Karpoff and Lott 1995). At this level, the information game may at best have a prisoner's dilemma structure. It may be better for all enterprises if everyone told about her experience; if only you reveal it, you will lose.

[7] See: http://www.worldbank.org/wbi/governance/ capacity-build/diagnostics.html.

guided by somewhat different theoretical presumptions, the World Bank has focused on the different branches of public government and asked different groups of officials about their perception and experience of governance issues, including corruption.[8] For a few Latin American countries Seligson (2002, 2003) has also collected a set of corruption data where households are asked about their direct experience.

So far, however, most micro-based research has relied on the more widely collected business perception data, mentioned above, such as the World Business Environment Survey (WBES), but the results of these surveys are interpreted as if they report the officials' or enterprises' own experience. In many cases, this may be misleading. Sensibly, in order to gain answers from the enterprises about their experience of sensitive corruption, the questions had to be 'phrased indirectly about the corruption faced by "firms in your line of business"' (Hellman *et al.* 2000, 20). Despite the precautions taken, this is not the same as reporting experience. Given the informational nature of corrupt transactions, these perceptions are also likely to be strongly influenced by the other agents' communication of *their* perceptions, which may or may not be based on their own experience.

An important example of possible ambiguity is the World Bank group's paper on multinational companies' behaviour in transition countries (Hellman, Jones and Kaufmann 2002). Here they find that enterprises from low-corruption countries roughly behave as corruptly as the locals even in the most corrupt countries. It is an interesting hypothesis, to which I return when dealing with the international efforts option, but a more straightforward interpretation is that the multinationals simply perceive the corruption problem roughly in the same way as the locals, they share the same 'folklore of corruption' (Myrdal 1968, 940).

Chapter 6 does not discuss the weak observational basis of most quantitative measures used in this field. The result is that one may believe this challenge to have more precise dimensions than are warranted. Despite all the progress and insights and hypotheses made through the quantitative perception data, the challenge of corruption as a field of empirical research is still its secret nature. In order to gain a more precise idea about the size of the corruption and poor governance challenges, more detailed analysis of data sources is needed. In particular, we should know more about how the perceptions about them are formulated and, eventually, how these perceptions may influence the performed actions. A few suggestive observations have been made,[9] but to my knowledge few concentrated research efforts. Cábelková's (2001) study from Ukraine is an interesting exception. It models the impact of actual experience, the impact of media and friends on perceptions and the impact of perceptions on the reported incidence of corrupt transactions at a number of public institutions.

Options: Do We Have the Tools to Deal with the Corruption Challenge?

As pointed out by World Bank researchers (Huther and Shah 2000) we have two rather different corruption challenges. In one case we have an honest principal, a government willing to deal with corruption and other forms of poor government, and where corruption is not a dominant form of behaviour among politicians and most branches of public administration. In this situation one may often simply create new, working tools that may repair the defective ones: working anti-corruption agencies, reorganisation of public auditing and hiring agencies and so on. Corruption and poor governance certainly may also prove important and difficult to handle issues in this case since corruption implies that people try to collect potential economic rents attached to their positions in difficult-to-monitor situations. As crime, it is difficult to detect. We may also have

[8] In the case of Bolivia, see Manning, Mukherjee and Gokcekus (2000). So far, only a few countries are covered.

[9] For example PriceWaterhouseCoopers (2001, 6) compares the distribution of different forms of *experienced* economic crime with their *perceived* prevalence among about 3,400 European organisations, mostly business enterprises. While embezzlement constituted 63 per cent of the actual economic crime incidence, but 29 per cent of the perceived prevalence, corruption constituted only 11 per cent of the actual incidence, but 23 per cent of the perceived prevalence. The sample space is defined by a list of possible types of economic crime.

strong positive spillover effects in this case: if you make a corrupt transaction it becomes easier for me to do the same.

It is the other challenge, however – the situation where the principal is dishonest or too weak to deal with a public apparatus permeated with corruption – that is really the serious one. Given the present level of cross-country information and concern, the resulting large pockets of mismanagement and deep poverty represent a major global challenge. The option of simply creating new bureaucratic tools is not likely to be available here, they are also likely to be tainted. The tools available to deal with such situations are either too weak or too harsh.

This is also the answer I read from chapter 6. Since the harsh tools of outside military interventions or internal revolutions are both extremely risky and costly with too uncertain benefits, they will remain outside our scope of attention. To transform, let us say, the World Bank into a kind of activist, anti-establishment type of organisation is not an option either. We have to focus on the weaker instruments. Hence, chapter 6's outline of options deal with a combination of fairly weak measures that may have some positive effects on the second situation and some measures that may mainly work as a response to the first.

As noted in the Introduction, in the deep corruption situation the national authorities are unlikely to have regular tools available since they are all likely to become corrupt. Note that this proposition assumes that the spillover mechanisms across different sectors of the public apparatus inside a country are much stronger than cross-country spillovers within the same sector of administration, such as customs. While probably realistic in most cases, the assumption is left unexplained. Nevertheless, closer cross-country interaction at sector level, such as the international anti-corruption movement in customs administrations, may assist in reducing corruption in the customs in high-corruption countries (or, eventually, stimulate corruption in low-corruption administrations). In outlining international measures Rose-Ackerman has not sufficiently underlined the possibilities through cross-country interaction at sector level. More generally, interactions between a thoroughly corrupt public apparatus and some outside agencies or interests have to be established to release internal pressures in corruption-decreasing directions.

This is clearly the central part in the first 'oversight and transparency' option in chapter 6. Here Rose-Ackerman reports several cases where the combination of publication of precise information of local programmes reaching locals with strong interests in them has succeeded in mobilising groups of locals to become effective monitors of them, sometimes drastically reducing the corrupt waste involved. Due to the painstaking research made at the World Bank (Reinikka and Svensson 2004) it has been possible to determine the pre- and post-experiment waste in the school transfer programme in Uganda. While 80 per cent of funds, according to chapter 6, were wasted before the experiment, only 20 per cent were wasted afterwards. In addition to its scientific interest the example indicates the size of the waste involved in countries with high embezzlement and corruption propensities.

If it is true that public expenditures in these countries are deliberately moved away from education to large infrastructure projects due to the even larger corruption possibilities there, an obvious conclusion is that most foreign aid projects based on cost-benefit analysis (CBA) need to be killed before leaving the drawing board. That is a conclusion I, like most others, am unwilling to draw, but here we have a major challenge. If we calculate the value of resources spent on bribing to be zero, as Rose-Ackerman does, the return on the original programme needs to be 50 per cent in order to have a 10 per cent return on the whole programme.[10]

[10] I find Rose-Ackerman's proposal here for how to do a CBA of anti-corruption projects very reasonable. The more valuable the original projects are, the more costly will the corruption waste be, and for given anti-corruption project expense, the higher the rate of return of that project. In general, a person who believes that no foreign aid project is likely to be of value should not be so worried about corruption. The funds should not be transferred in any case. Another person, believing in the value of many of the original projects, may reach the same conclusion if corruption waste is very high, but for her the potential rate of return on corruption projects will be very high, if they work. If no efficient anti-corruption project is possible to formulate, we have a very difficult ethical situation, in many ways analogous to peace-keeping operations.

Since unpaid local mobilisation may be difficult to sustain in the long run, and international support is short-run in nature, one may doubt if anti-corruption programmes of this kind will be sustainable. In particular, in the Uganda case, the anti-corruption project may have been so successful in the first place because the rent collectors here were among the less powerful.

Presumably, most formal organisations located in the rich countries are comparatively low-corrupt and external to the system of formal organisations of the highly corrupt countries. May they, either through designed or uncontrolled interaction, become tools for improving the workings of the governance of high-corruption countries? Since I consider chapter 6 to be somewhat unsystematic here in both its choice of issues and choice of options, I will focus on this matter.

International Efforts

North–South Interactions: Multinational Companies

May the strong governance systems of the large multinational companies somehow induce lower corruption in high-corruption countries? The companies will be involved in three major type of activities: (1) regular exports with modest involvement with public authorities, (2) delivery on public construction and consultancy projects (public procurement) which implies denser interaction and the even tighter involvement implied by (3) foreign direct investment (FDI).

The international pressure towards opening the trade regime may induce less corruption here than before, but in public procurement and FDI activities there are no obvious system-wide changes with clear impact on corruption tendencies. Data collected about multinationals' behaviour give few grounds for optimism. For example, World Bank research into multinational bribing activities in the post-communist countries may indicate that their bribing – connected to regular sales, in public procurement and FDI-related capture activities – are roughly on the same scale as the locals', although differing in detail (Hellman, Jones and Kaufmann 2002). While not so clear-cut in this respect, the TI index of corruption propensity in major exporting countries does not clearly contradict this result.

One result of this research is that the corruption behaviour of US multinationals is not among the best in the transition countries. It may support Rose-Ackerman's neglect of the OECD convention against bribing and the other treaties that intend to apply stronger judicial systems in the home country to reduce their involvement in corrupt transactions in poor, highly corrupt countries. This conclusion appears to follow since the USA has applied its judicial apparatus this way since the introduction of its Foreign Corrupt Practices Act in 1977. The low probability of being caught supplies an explanation of why this may be the case.

Nevertheless, this may be too rash a conclusion. The companies involved deny vehemently that they are engaged actively in corrupt activities abroad but, more importantly, the data may, as argued before, be interpreted as reflecting *perceptions*, not behaviour. Furthermore, in certain bribe situations created under experimental conditions, low-probability but high-value punishment is surprisingly effective in mitigating some forms of corruption (Abbink, Irlenbusch and Renner 2002).[11] It will be misleading to translate the effects of strong punishment in the experiment into real-world conditions by minor jail sentences or similar punishment directed against individuals. Long-lasting international bid denials better simulate these experimental conditions, particularly so for large, multinational companies. To develop the OECD and the UN conventions in this direction may make them a more potent option in fighting cross-country corruption. The fact is that the World Bank's list of companies not allowed to bid because of their violation of no-corruption conditions of the Bank, so far (to

[11] Rose-Ackerman does not use any of recent experimental evidence. Given the difficulty of transferring the results to real-world conditions, that may be reasonable, but since it is so difficult to observe corrupt transactions, the experiments may be more useful than in most other fields of economics but sometimes even more difficult from an ethical point of view. At present experiments may shed light on such issues as whether stricter monitoring may increase corruption, the role of transparency in certain situations, the effectiveness of appointed versus elected monitors, the preventive effects of rotation of officials and so on.

my knowledge) does not contain any major, multinational company and this surely undermines the credibility of the list.[12]

I still believe more may be achieved along this road to make the multinational companies contribute less to corruption in high-corrupt countries than the voluntary 'Publish What You Pay' and EITI initiatives recommended in chapter 6. While increased information and transparency are certainly to be welcomed, I believe the NGO interests are too muddled and transient to become any external force that may make the kind of pressure performed by the parent–teacher groups in Uganda. With regard to the interest groups internal to the harmed country, I expect their pressure to also be weak in this case, since the potential increase in tax income resulting from the initiatives is likely to be widely spread.

North–South Interactions: Foreign Aid

Another important arena for transactions between high- and low-corrupt organisations is foreign aid. May such meetings result in the low-corrupt public and semi-public NGO organisations transferring their standards to the high-corrupt public apparatuses, or may the transfer of standards go in the opposite direction? After all, corrupt transactions are profitable for the individuals involved.

Again, we have few direct observations. To my knowledge there has been no systematic collection of evidence, although in a number of countries with a tradition of investigative journalism, such as Kenya, the number of documented stories are large. So far, we have to rely on more indirect evidence. Alesina and Weder (1999) show that, unlike private FDI, there is no indication that most foreign aid organisations until then had systematically tried to avoid highly corrupt countries, which may not be so surprising since these countries on average are also among the world's poorest. Nevertheless, there is also, according to the World Bank and TI indexes, a wide variation in the corruption propensities and governance quality inside this group of countries.

One of the most hotly debated options is whether one may use the information in the governance indexes to systematically direct foreign aid away from the most corrupt and into the poor countries with better governance. In addition to the direct effects such a scheme may give, it may yield disincentives for behaving corruptly, giving politicians directing highly corrupt bureaucracies less resources for patronage. Following this line of approach, recent evidence has shown that even inside highly corrupt countries there are wide variations in the quality of the public sub-sectors (e.g. as documented for Bolivia in Manning, Mukherjee and Gokcekus 2000). Might not this information also be used in even more fine-grained aid allocation?

Rose-Ackerman (2004) touches upon this option at the end but, believing that the countries with the worst governance would then tend be isolated, probably sinking into even deeper poverty, she does not discuss it systematically. Svensson (2001) suggests a more careful application of the idea: to give programme and fungible forms of aid to countries with good results on governance indicators (and good macroeconomic policies), while limiting aid to poor-governance countries to non-fungible projects or projects implemented by well-working NGOs, but within the framework of a country plan drawn up by the aid giver. To some degree the allocation of foreign aid has recently been influenced by governance considerations, but to my knowledge no study of the effects of the policy shift on corruption has been made.

Rose-Ackerman's objections are reasonable, but since it is an option that goes to the core of the problem of corruption as a global challenge, I miss a more extensive discussion. The option deals, after all, directly with the transmission mechanism from the ideas for solving a major global economic or social challenge, to their possible implementation. It is also evident that if, let us say, 80 per cent of aid funds may reach its destination under a system of good governance but only 20 per cent with bad governance, very few projects will give any positive

[12] This list has already had an important impact on the bidding outcomes of other public organisations. The impending case of Acres International now being considered by the World Bank's sanction committee may become an exception and improve the credibility of the list (*Guardian*, 16 March 2004).

internal rate of returns (IRRs) in the last case, so to scrap projects up front may make good economic sense.

As pointed out in this context by Kaufmann and Kraay (2002), the margin of error of the government indexes is so large, that if aid could be given only to countries that are among the 50 per cent least corrupt (and at least in the best half among half of the other indicators (which is the so-called Millennium Challenge Account conditions)), only two of the seventy-four aid candidacy countries would be certain not to qualify and only eight would certainly do so.

If the errors in the sub-indexes are correlated, the confidence intervals would become even wider (Kaufmann, Kraay and Zoido-Lobaton 1999). I think we have good reason to believe that the indicators are likely to be influenced by country opinion fashions in the aid industry. It is striking that in 2002 countries such as Rwanda, India and Mozambique were among the eight aid-worthy countries.[13] For countries where there are observations from only one sub-index, the 90 per cent confidence interval is so wide that in most cases the outcome – to be aid-worthy or not – would almost be determined by pure chance. The same would naturally apply to the thirteen countries where data are completely missing. Hence, it is not possible to apply the policy in any rigorous manner.

Moreover, if any index were allowed to determine the aid given, all kinds of manipulation of the index, so well-known from the former Soviet system, are likely to be tried, undermining the information value of the index itself. This said, the indexes of country corruption combined with bits of less perception-based indicators represent an improvement on the purely anecdotal-based fashions which may otherwise rule the aid industry. Sometimes that fashion is so strong that it overrules the governance indicators. As pointed out by Cooksey (1999), Uganda has been able to collect an unreasonable share of foreign aid by projecting a good governance image although being at least as corrupt as its neighbours according to several corruption indicators.

Among the reasons why there appear to be few, if any positive spillover effects from the low-corrupt administrations to the high-corrupt ones, is that some are deeply entrenched and difficult to do anything about. For example, a large number of informal feedbacks about the execution of a public project internal to a democratic country are likely to reach citizens and taxpayers. Some are collected by relevant pressure groups and put into effective use. No similar mechanisms exist with regard to foreign aid. While some multilateral organisations such as the World Bank try to compensate by having more professional evaluation procedures than the bilateral aid organisations, their projects are one step further away from the ultimate aid giver. The potential monitors of foreign aid such as NGOs and researchers will not have the capacity for informal monitoring that home-country projects are exposed to. Moreover, they usually receive their main support from the same organisations they may monitor. Here is, of course, some possibility of reform by financing monitoring differently. In particular cases, such as the Uganda school case, it may even be possible to stimulate pressure groups in the receiving country.

Some corruption-stimulating aspects of cross-country aid interactions are in principle easy to reform. As noted by Svensson (2001), the pressure on aid administrations to disburse loans and grants before the end of the year and the incentives for disbursing funds in both the bilateral and multilateral aid organisations are strong disincentives against strict monitoring and stimulate collusion with highly corrupt officials in poor countries.

In research on corruption in high-corruption countries, low administrative wages are often emphasised. That sometimes is a problem, but a neglected problem in the cross-country aid interactions is rather that wages for tasks performed for foreign aid agencies often are way above regular government pay. Two widely different price levels for the same good or service are well known to be a clear stimulant to corruption. Here, collusion

[13] As pointed out in Seligson (2003, 6) the decline in Argentina's status on the TI index from 5.2 in 1995 (the second best in Latin America) to the bottom half (2.8) in 2002, is remarkable. Such drastic change is difficult to explain, except through noting that Argentina in 1995 was considered very 'successful', while after the Financial Crisis of 2001–2 it was considered a 'failure' among experts, and probably also among the experts who judged its corruption rate.

among donor agencies may bring down expert wage levels closer to government levels and thereby reduce the level of rent-seeking and corruption in the aid agency–country official interactions.

So far, we have little information about the spillover from highly corrupt countries into aid agencies. Participating experts claim that the difference between the corruption propensities in the aid-giving and receiving countries persists in the aid interactions while corruption in multilateral organisations is somewhere in between (Cooksey 1999). If not for other reasons, to make the anti-corruption work initiated recently by many different aid agencies credible, more systematic information should be collected and published.

South–North Interactions: The Migration Pressure

Another major challenge – migration, in this case international migration – is also tied to the existence of two prices for the same service, labour performed in rich or poor countries (see chapter 8 in this volume). This situation is driving bribes in the opposite direction in the cross-country agency interactions; bribes are paid by citizens in poor countries to international agencies and formal organisations located in rich countries.

In TI (Kenya)'s first corruption survey (2002) 'Embassies and international organisations' were ranked as 10 among 52 public organisations taxing Kenyan households through bribes. In early 2002, the UN Office of Internal Oversight Services released a report (UNOIOS A/56/733) which showed that part of the UNHCR staff had colluded with large gangs in refugee camps in Kenya, taxing each successfully receiving refugee status for between US$2,000 and US$5,000. Local, international and foreign embassy organisations were involved.

Focusing on what might be done about global challenges, including corruption, the tools of cross-country agency interactions are clearly important. I have discussed and outlined a set of reforms based on Rose-Ackerman's suggestions. Alas, I believe that, so far, research-based analysis has not discovered any sufficiently strong instrument to really meet the challenge of corruption and bad governance.

References

Abbink, K., B. Irlenbusch and E. Renner, 2002: An experimental bribery game, *Journal of Law, Economics and Organization*, **18**(2), 428–54

Ades, A. and R. Di Tella, 1999: Rents, competition and corruption, *American Economic Review*, **89**, 982–93

Alesina, A. and B. Weder, 1999: Do corrupt governments receive less foreign aid?, NBER Working Paper, **7108**, Cambridge, MA

Andvig, J.C., 2002: Globalization, global and international corruption – any links?, *The globalization project, report no. 6*, Norwegian Ministry of Foreign Affairs, February

Bikhchandani, S., D. Hirshleifer and I. Welch, 1992: A theory of fads, custom and cultural change as informational cascades, *Journal of Political Economy*, **100**(5), 992–1026

Cábelková, I., 2001: Perceptions of corruption in Ukraine: are they correct?, CERGE-EI Working Paper, **176**

Cooksey, B., 1999: Do aid organizations have comparative advantage in fighting corruption in Africa?, Paper delivered at the 9th International Anti-Corruption Conference, 10–15 October, Durban

Hellman, J. S., G. Jones and D. Kaufmann, 2002: Far from home: do foreign investors import higher standards of governance in transition economies?, World Bank Institute, August

Hellman, J. S., G. Jones, D. Kaufmann and M. Schankerman, 2000: Measuring Governance, corruption and state capture, World Bank Policy Research Paper, 2312, April

Huther, J. and A. Shah, 2000: Anti-corruption policies and programmes: a framework for evaluation, World Bank Policy Research Working Paper, **2501**, December

Karpoff, J. M. and J. R. Lott, 1995: The reputational penalty firms bear from committing criminal fraud, in G. Fiorentini and S. Peltzman (eds.), *The Economics of Organised Crime*, Cambridge University Press, Cambridge, 199–250

Kaufmann, D., 2003: Rethinking governance: empirical lessons challenge orthodoxy, Discussion Draft, World Bank, Washington, DC, 11 March

Kaufmann, D. and A. Kraay, 2002: Governance indicators, aid allocation and the Millennium Challenge Account, World Bank Institute, December, draft

Kaufmann, D., A. Kraay and P. Zoido-Lobaton, 1999: Aggregating governance indicators, World Bank Policy Research Paper, **2195**, October

Lambsdorff, J. G., 2003: Framework document 2003, Transparency International, September

Manning, N., R. Mukherjee and O. Gokcekus, 2000: The experience of public officials in Bolivia, World Bank (unpublished 2nd draft), May

Mauro, P., 1995: Corruption and growth, *Quarterly Journal of Economics*, **110**(2), 681– 712

Myrdal, G., 1968: *Asian drama*, vol. II, Pantheon, New York

PriceWaterhouseCoopers, 2001: European economic crime survey

Reinikka, R. and J. Svensson, 2004: Local capture: evidence from a central government transfer program in Uganda, *Quarterly Journal of Economics*, **119**(2),

Rose-Ackerman, S., 1978: *Corruption: a study in political economy*, Academic Press, New York

2004: Governance and corruption, chapter 6 in this volume

Seligson, M. A., 2002: The impact of corruption on regime legitimacy: a comparative study of four Latin American countries, *Journal of Politics*, **64**(3), 408–33

2003: Corruption and democratisation in Latin America, University of Pittsburgh Latin American Public Opinion Project, Department of Political Science

Svensson, J., 2001: Bistånd: Fungerar det? Kan det fungera (Foreign aid: does it work? May it ever?), Report, May; available at www.iies.su.se/~svenssoj/

Treisman, D., 2002: Postcommunist corruption, Department of Political Science, UCLA, May

TI (Kenya), 2002: The Kenya urban bribery index

UN-OIOS, 2002: Report(A/56/733) on investigation into UNHCR branch office, Nairobi, January

Perspective Paper 6.2

JEAN CARTIER-BRESSON

Susan Rose-Ackerman's chapter 6 perfectly charts the current state of the literature in economics on corruption and governance in countries undergoing development or transition. It deals less with the issue of corruption in market democracies. The chapter responds to three traditional questions: (1) What are the causes of corruption? (2) What are its consequences? (3) What are the available means for an efficient and credible campaign against this very old and universal phenomenon? A fourth question has emerged out of the framework of the Copenhagen Consensus: (4) What are the stakes of the fight against corruption for the other challenges considered by the conference?

To a large extent, we share Rose-Ackerman's approach, as summarised in the following four points:

- Institutionalised corruption is a symptom of a *dysfunctional state* that must be understood within a larger conceptual framework than that of poor governance. In effect, this concept enables a broadening of the subject by integrating problematics concerning: (a) the nature of the political regime, (b) the processes of the exercise of power and of exchanges between the public and private spheres, (c) the capacity of governments to prepare, formulate and administratively implement social and economic policy (World Bank 1997). This approach is clearly institutional and proposes reforms enabling state-(re)building (Abed and Davoodi 2002).
- It is impossible to propose a *global, empirical cost-benefit analysis* (CBA) for at least two reasons. First, the illegal nature of the transactions (corruption) or acts (misappropriation of funds, extortion), as well as the character of the actors concerned (mainly elites in the case of high-stakes corruption), seriously limits access to the kind of hard data needed to determine the direct costs of specific phenomena (the sums in question) and their subsequent distortions; without such data, it is impossible to ascertain the marginal benefits of a reduction in such phenomena. What was the contribution of poor governance or exchange rate policy to the Asian Financial Crisis? Was a small bribe paid to inspectors the cause of the Chernobyl disaster? Moreover, in regard to the second part of the calculation, the widely shared hypothesis that the battle against corruption involves a multi-pronged approach (World Bank 2000a, 154) precludes any rigorous accounting of the very diverse costs involved in the improvement of governance. What is the cost of implementing deregulation, democratisation, and efficiency wage within an administration? In the case of a state reform agenda, or even one of political regime change, one encounters the problem of imputing costs related to a wide range of objectives. Secondly, it is necessary to take into account the distortions that lead to these forced transfers which, in turn, encourage agents to adapt (flight to the informal sector, brain drain, disappearance of innovative entrepreneurs) and it is impossible to stick to the traditional rent-seeking approach focused on the waste of time and money.
- Methodologically, Rose-Ackerman (1999, 3–4) remains sceptical on the pertinence of using *cross-country research* for overcoming problems of data. She privileges, instead, 'bottom-up' analyses and case studies.
- Theoretical and empirical analyses of the causes and consequences of, as well as the means of fighting against, corruption have reached a certain level of maturity. The functionalist currents,

which viewed corruption as a system that lubricates the cogs of the bureaucratic machine, have disappeared. Economists have reached a consensus on the very negative effects of the phenomenon and on its primary importance for a number of development projects (namely, the challenges elaborated in this conference). Unfortunately, this maturity has still not paved the way for a meaningful advance in the *improvement of governance*, for the political barriers erected by the losers of such reforms are formidable.

Despite these points of concurrence, chapter 6 tends to understate some significant areas of disagreement that continue to persist among economists on the causes of corruption and the means of combating it. These dissensions parallel two classic debates. The first opposes the partisans of state failures to those of market failures, the second opposes proponents of universalist policies to adherents of institutional compromises specific to each environment. While we share Rose-Ackerman's disappointment concerning both the lack of political will for waging the anti-corruption battle and the consequent lack of results, analysis of the obstacles to international coordination and of the national barriers to state reform is progressively becoming the new challenge. Our Perspective paper thus takes shape around two issues that are essential to the political feasibility of the battle at hand: (1) the obstacles to global governance, (2) the fragility of various models of institutional transition, as well as uncertainty as to their relative costs.

Good Governance: A Global Public Good

It seems important to review briefly the international origins of the agenda for good governance (Glynn, Korbrin and Naim 1997), its stakes and the actors that have promoted it. Until the 1990s, corruption was a taboo subject for international organisations and the vast majority of political and economic observers underestimated the ways in which the phenomenon undermined democratisation, competition, microeconomic and macroeconomic policies and international exchanges. Four factors explain international mobilisation since 1995:

- Globalisation has forced the establishment of international norms guaranteeing the *security of transactions* for international firms
- The new role of the USA, which seeks to harmonise the *agreed-upon terms of competition* between American and either European or Japanese firms, the latter of whom are reputed to be the most corrupt
- The willingness of the World Bank and the IMF to *reconstruct political institutions* capable of applying structural adjustment policies (SAPs), and improving the productivity of their loans in order to prevent international aid donors from becoming discouraged
- The *end of the Cold War and the triumph of the Western model* have led to both the reduction of aid resource allocation based on geopolitical considerations and the universal affirmation of the market democracy model.

The fight against corruption is thus a question on the agenda of global governance, insofar as: (1) The central issue is the stability and security of international economic transactions (trade and direct foreign investments) and the risks arising from the spread of problems are systemic; (2) It involves a common structure for negotiation, decision making and policy implementation. The fight against corruption can thus be defined as a public imperfectly global good (see Kaul, Grunberg and Stern 1999) that poses the typical problems of collective action (free-rider and prisoner's dilemma). It is imperfectly global since, while it tends to be universal over the long term, it creates winners and losers in the short term: countries, politico-economic regimes, generations and social groups. If the international process is geared towards the harmonisation of norms for the benefit of all concerned, in reality, the reformers (see below for further explanation of the importance of this concept) of the less powerful countries in the field of international relations have the feeling that international cooperation is inequitable and tends only to reinforce the power of the wealthier countries. These reformers usually complain that the wealthier countries continue to defend their own national self-interest. Therefore, within the sectors symbolizing international corruption structured by multinational firms (arms, oil, aerospace, public works, etc.), two constants prevail. To begin with, multinational firms, always linked to a particular country, have not concretely demonstrated a strong willingness to leave behind a system that still seems to serve them well. They seek primarily to maintain their traditional clientele (even through illegal payments). Moreover, the governments of the 'North' continue to support their 'strategic' firms with all the resources at their disposal (diplomacy, restrictive standards, informally conditional forms of aid). In actuality, these governments continue to tolerate international and national corruption, failing to set an example of sound governance and have been reluctant to undertake diagnostic studies on international and national corruption, as developing countries have done. Even if they have little scientific reliability, the appearance over the past few years of indices ranking the most corrupt countries (TI 2001) has at least managed to open the debate on the culpability of developing countries in major international corruption. In the same sense, the corporate accounting and stock market scandals of the 1990s reoriented perceptions of unethical behaviour and the costs of these fraud cases towards developed countries. These fraudulent acts are always accompanied by corruption – or, at the least, exchanges of favours to advance shadowy lobbying practices. On this point, the agenda intersects with that of corporate governance.

The questions of international political economy are thus: (1) Who profits from international anti-corruption conventions? (2) Given that their application brings about an improvement in local governance, who should finance these programmes? (3) Who negotiates the options and controls their implementation?

A CBA at the international level is thus indispensable. Cross-country analyses, we should also note, also run the risk of giving a distorted image. The wealthy, democratic countries facing lower costs in terms of investment and growth would thus have little motivation to finance this fight. On the other hand, in adopting a broader but less rigorous perspective, it is easy to see how the collapse of states and widespread poor governance pose risks for the functioning of the world economy.

International cooperation requires the effectiveness of strategies of *reciprocity*. The key to success rests in the exchange of reliable information making it possible to foresee the concrete effects of this cooperation. In developing countries, despite a display of enthusiasm for new governance, the reality is completely different for socio-political reasons. Whether they are dictators – kleptocratic or well-intentioned – or reformers, the leaders in these countries achieve their power through clientelist relations that tend to be arbitrary. The fight against corruption and poor governance is thus either in conflict with their mode of domination or very risky. Perhaps most alarming is the fact that the actors comprising this movement are few and that hidden agendas are always present (the fight against corruption as a means for eliminating competitors, for example). It is for this reason that Rose-Ackerman favours prevention (reform) over repression. The withdrawal of international organisations and NGOs supporting this cause, however, would diminish any chance of progress. In effect, the governments of the 'South' have not yet been convinced that they will receive an equal share of the fruits of cooperation. In the absence of any guarantee of the assistance required for state reform, the fight against corruption will remain political suicide (Klitgaard 1988).

As Rose-Ackerman argues (pp. 335–6), the jurisdictional deficit tends to diminish (for example, due to the proliferation of conventions), but deficits in participation and motivation remain very important since moral and economic arguments do not carry much weight in the field of politics. The impact of such arguments is all the more weak since the system of power legitimation is not primarily based on the performance of and respect for the law (as in the case of a non-democratic regime). These arguments are further weakened in regimes undergoing democratic transition, when results are deteriorating in the initial period following reforms, before they have the chance to make a turnaround. For example, it is, unfortunately, possible that the application of the OECD Convention could, by limiting corruption in international contracts, have effects quite contradictory to those intended. The reduction of illegal rents paid by multinational firms to the leaders of developing countries may diminish the clientelist redistribution that these leaders engage in, without the official system necessarily being capable of replacing them. The cunning of reason could, then, bring about a moralisation of international flows, but also a deterioration of living conditions for the most vulnerable populations linked to clientelism and, ultimately, to a situation of political instability that would limit the possibility of future growth.

When dealing with non-democratic regimes, *ex ante* conditionality (aid in exchange for governance reforms) remains a possibility, even though, as Rose-Ackerman reminds us, the poorest countries, and especially the marginalised people within those countries, will bear the burden of it. For countries experiencing a process of democratisation, reformers must be able to draw clear-cut advantages from international cooperation to show their electorates. What is more, they must be able to demonstrate that the results constitute new conditions of fairness and that their point of view, which most often diverges from that of the major powers, was heard and taken into account in the final compromise. Indeed, only national governments themselves are up to the task of finding solutions adapted to a range of environments. From our perspective, the inability of international organisations to consider the feasibility of reform constitutes the first obstacle to this governance agenda. There can be no improvement of national governance without an improvement in global governance, more sensitive to the diversity of internal political processes. One final remark must be made. We must stop the strategic and diplomatic use of governance norms (for instance, the arbitrary designation of rogue states) or else the programme risks losing its ethical dimension.

In conclusion, the collective mobilisation of international NGOs and institutions gave rise to the good governance agenda. The local relays, however, are still fragile. In order to strengthen these local relays, global governance must prove that it serves the interests of developing countries, and the model of local governance must be adapted and made credible. The cost of this evolution (or the benefit, depending on one's point of view) is the development of a new balance in favour of developing countries.

The State, Social Capital and the Costs of Institutional Transition

If international institutions understand that improving governance entails improving world governance (fairer negotiations), they are often unaware that their proposed governance agenda would amount to political suicide for many ruling governments. An underestimation of the stability of clientelism and the potential costs of transition to market democracy (the cost of disillusionment for Rose-Ackerman) detracts from the credibility of the current discourse. Besides, the governance programme gives a restrictive definition and a very specific view, of state-(re)building, which is not necessarily adapted to fragile institutional environments and situations of acute distributive conflicts.

There has been an excessive use of cross-country analysis to demonstrate the negative effects of corruption and the need to undertake reforms which would address its causes. The method was to present the results of dozens of studies (World Bank 2000b, 103–9) in the form of lists. This aggregative method did not reflect divergences in the microeconomic basis of the studies, the discrepancies between their results and, finally, the persistent disagreements over recommended policies.

For instance, some of the studies suggest that protectionist and certain industrial policies favour the creation of rents and therefore rent-seeking and hence corruption, whereas others demonstrate that structural adjustment policies are faulty. The decrease in civil service salaries, the rise of inequalities, the degradation of social services, as well as the opening to international competition, the reduction of industrial policies and privatisation are seen as encouraging the agents' adaptation to the new constraints through corruption. Trade liberalisation, in itself, is not seen as having reduced corruption, but as having fostered growth. In the cases where openness reduced performance, corruption often increased. In this sense, Harris-White and White (1996) have demonstrated how, in many countries, democratisation and liberalisation have led to more disorganised and destructive forms of corruption, according to the Shleifer and Vishny typology (1993). There is, thus, an older corruption (issuing from rents) and a new form of corruption (stemming from liberalisation), which unfortunately often coexist (Cartier-Bresson 1998). It is, therefore, necessary to determine, on a case-by-case basis, the credibility of the recommendations for fighting corruption in light of the institutional context, and to verify whether the necessary conditions are present to enable an improvement in governance, in the short term, through democratisation and liberalisation. In general, the answer depends primarily on the *objectives* of elites and the *norms* that structure their negotiations. Since redistributive conflicts figure prominently in the stakes of governance and since the evolution of these conflicts has potentially dramatic consequences for certain vulnerable segments of the population, political economic analyses are essential. As in the literature on conflicts and civil wars, the contributions of sociology, history and political science must be addressed and confronted (Andvig *et al*. 2000; Cartier-Bresson 1992), as the necessary complements to economic formalisation.

The ruling political regimes in many developing countries articulate, to varying degrees, forms of neo-patrimonialism and clientelism. Order is based on personalised transactions, the overlapping of both public and private spheres and formal and informal positions. Strategies for accumulation of economic and political resources are conjoined and, according to some political scientists, this is unavoidable over the medium term (Hibou 1999). The scope of analysis should not be limited to studies of bribery, but rather should extend to the networks of clientelist redistribution (Wade 1985; Cartier-Bresson 1997) with their multiple resources (bribes, patronage, favours, public service employment, ballots, rents). Poor governance is therefore a form of government that rests on *micro legitimacies*, and the stability of the system could significantly increase economic performance, if the dictator maximises his utility function over over the long rather than the short term (plunder). This explains why so many studies have recorded a negative correlation between democratisation and growth. There are, roughly, two models of market democracy transition that continue to coexist: public choice and neo-institutionalism (Cartier-Bresson 2000).

According to Public Choice theory, political powers trade rents to pressure groups in exchange for political support. The classic typology distinguishes between: (a) autonomous states (guardian or predator) who, because they are deeply rooted, can pursue their objectives without being subjected to pressure from an opposition and (b) factional states (democratic or authoritarian) which must, in order to make decisions, engage in collective processes with pressure groups. The latter's decisions are constrained by the need to satisfy the demands of its supporters according to an Olsonian logic. The democratic faction state limits predation, but often leads to state paralysis. According to this logic, in countries where the private sector is too weak to counterbalance the state, only an autonomous state of technocrats can 'force' the implementation of shock therapy (like that of an anti-corruption fight). This hypothesis holds that shock therapy (the liberalisation of all markets at once) is the only means to avoid triggering the perverse collateral effects linked to the liberalisation of only a single market. Its application entails either rapid growth and more or less immediate adherence (an unlikely scenario), or a situation in which the short-term costs (decreased growth, increased taxes and decreased subsidies) do not compensate for future uncertain benefits (growth and employment). In the latter case, social resistance will block the implementation of further reforms. This hypothesis lends relative support to certain kinds of pro-market dictatorships and sees all democratisation as accentuating the power of factions. The solution is a strong and autonomous political regime and the drastic reduction of state intervention in the economy.

The main limitation of the rent-seeking approach is that the results of exchanges between the political and economic spheres vary considerably, depending on public policies that are: (a) only the outcome of the influence of powerful pressure groups; (b) the outcome of state power alone; or, finally, (c) the outcome of an interaction between these two components combined with their multiple subcomponents (Meier 1991). If rents have not had a negative effect in Korea, as compared with Pakistan, it is because the political-economic networks that managed the transfers in Korea possessed a kind of legitimacy in a minimally polarised society, the rents were offered to capitalist sectors and the state was powerful and autonomous enough to demand efficiency (Khan 1998). The objectives of elites and mediators, then, become a determining factor, and it becomes counterproductive not to take into account the diversity of exchanged resources and their more or less contradictory effects in the joint construction of the state and the economy. As Bardhan (1997) has remarked, the mistake of studies of rent-seeking and the predatory state is that they do not explain the differences in *levels of corruption* between similar countries, and why identical levels of corruption allow for different levels of performance. Some African states have become predatory after being weakened, whereas strong states in East Asia with interventionist policies and networks mixing private and public sectors have not prevented administrations from functioning relatively efficiently. This finding calls for an explanation of how social order and trust (resolution of the Hobbesian conflict) can emerge in countries with no democratic traditions and where Weberian norms are not rooted. In any case, it is necessary to make exchanges between political and economic powers (since it is indeed power we are dealing with) more efficient (virtuous?) and not to stigmatise them in a model that axiomatically reduces the effectiveness of the political sphere. In many countries, the reduction of rents will not result in a spontaneous emergence of innovative entrepreneurs, and state intervention in the productive system will remain necessary.

According to the neo-institutional analysis of governance (Coase and Williamson), the state is both the problem and the solution. The state is too big for small problems and too small for big ones. Thus decentralisation, regional integration and private ordering offer means to circumvent the bureaucratic state through tripartite negotiations (state, NGO and private sector). At the international and regional levels, one must add to this framework international organisations and 'soft' law procedures. This strategy, which requires the adhesion of all parties, can only be incremental. The legal system (to be reformed first and foremost) must provide guarantees for the execution of contracts, including those coming from private negotiations and which involve compensatory transactions. Increasing social capital (for instance, through peer pressure) reduces transaction costs and improves the efficiency of the system. The feasibility of such a scenario requires a civil society mature enough to not highjack the network coordination of negotiations for the purposes of fraud and corruption. The potential dangers are similar to those of decentralisation. This post-Weberian logic requires an institutional architecture few developing countries possess. Furthermore, for the transaction costs of negotiations to be low and, thus, for consensus to be quick, one would need an understanding, which does not exist, of the redistributive effects of political choices. The social polarisation of developing countries does not favour the success of the governance scenario, since it has not yet been demonstrated that Coasian negotiation can be applied to political stakes while respecting the ability of the weakest parties.

Therefore, it seems to me that public choice offers an analysis of political conflict without a sufficiently refined institutional framework, and that the neo-institutionalists offer an institutional framework without politics. The improvement of 'governance' (state-building) nonetheless requires maintaining these two dimensions simultaneously.

Conclusion

The five alternatives proposed by Rose-Ackerman in chapter 6 seem to me to move in the right direction. They are well chosen, necessary and economically – or 'technically' – credible. However, their political feasibility is uncertain, the short-term secondary social effects are very ambiguous in the absence of a significant increase (that is not misappropriated!) of international aid and the right timing is difficult to determine. The pessimistic tone of this chapter on the feasibility and credibility of policies aiming at the improvement of governance should not cause us to overlook the fact that the stakes are as big as the challenge at hand. Indeed, the state often remains both the problem and the solution, and the difficulties involved in its reform are both political and financial. If rigorous, global CBAs are impossible, it is still essential to continue to quantify – sector by sector – the potential costs and benefits of the reforms to be implemented, and to evaluate the initial results of implemented policies. The diagnostic inquiries being undertaken by the World Bank move in this direction (World Bank 2000b), but must now be used as the basis for local discussions on state reform.

The funding of democratisation (of which no evaluation currently exists to my knowledge), will have to pave the way for an improvement in public services sufficient to making clientelist relations less attractive or necessary. It is only under such conditions that the power and legitimation of reformers will no longer come simply from their words (charisma), but will result from concrete transformations in the relationship between society and the state. This relationship will finally offer a certain security to citizens in exchange for their confidence and their loyalty to the new rules. We are currently in a period of experimentation, and only over the medium term will the empirical evidence become available to distinguish the good from the bad economic recipes.

References

Abed, G. T. and H. R. Davoodi, 2002: Corruption, structural reforms, and economic performance in the transition economies, in G. T. Abed and S. Gupta (eds.), *Governance, corruption and economic performance*, IMF, Washington, DC, 489–537

Andvig, J. C., O.-H. Fjeldstad, I. Amundsen, T. Sissener and T. Soreide, 2000: *Research on corruption: a policy oriented survey*, Chr. Michelsen Institute & Norwegian Institute of Internal Affairs, Oslo

Bardhan, P., 1997: Corruption and development: a review of issues, *Journal of Economic Literatur*e, **35**, 1320–46

Cartier-Bresson, J., 1992: Eléments d'analyse pour une économie de la corruption, *Revue Tiers Monde*, **131**, 581–609

1997, Corruption network, transaction security and illegal social exchange, *Political Studies*, **45**(3), 463–76

1998: Présentation and Les analyses économiques des causes et des consequences de la corruption: quelques enseignements pour les PED, *Mondes en Développement*, **102**, 9–11, 25–40

2000: Corruption, libéralisation et democratization and La Banque mondiale, la corruption et la gouvernance, *Revue Tiers Monde*, **161**, 9–22, 165–92

Glynn, P., S. J. Korbrin and M. Naim, 1997: The globalization of corruption in K. A. Elliott (ed.), *Corruption and the global economy*, Institute for International Economics, Washington, DC, 7–27

Harris-White, B. and G. White, 1996: Corruption, liberalization and democracy: editorial introduction, *IDS Bulletin*, **27**(2), 1–5

Hibou, B., 1999: *La privatization des états*, CERI, Karthala

Kaul, I., I. Grunberg and M.A. Stern, 1999: *Global public goods, international cooperation in the 21st century*, UNDP and Oxford University Press, Oxford

Khan, M., 1998: Patron–client networks and economic effects of corruption in Asia, in M. Robinson, Corruption and Development, *European Journal of Development Research*, **10**(1), 15–39

Klitgaard, R., 1988: International cooperation against corruption, *Finance & Development*, **35**(1), IMF, Washington, DC, 3–6

Meier, G. M., 1991: *Politics and policy making in developing countries*, International Centre for Economic Growth, ICS Press,

Rose-Ackerman, S., 1999, *Corruption and government: causes, consequences and reform*, Cambridge University Press, Cambridge

Shleifer, A. and R. Vishny, 1993: Corruption, *Quarterly Journal of Economics*, **108**, 599–617

Transparency International (TI), 2001: 1999 Bribe Payers Index, in *Global Corruption Report*, Berlin, 237–9

Wade, R., 1985: Market for public office. Why the Indian state is not better at development, *World Development*, **13**(4), 467–97

World Bank, 1997: *The state in a changing world*, World Development Report, Washington, DC

2000a: *The quality of growth*, Oxford University Press, Oxford

2000b: *Helping countries combat corruption. Progress at the World Bank since 1997*, PREM Network, Washington, DC