
Corruption as an International Policy Problem: Overview and Recommendations

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In just a few months in early 1997, Mexico fired its top drug-enforcement official for accepting bribes and ultimately closed the agency because it was so ridden with corruption; Ukraine's president once again declared war on corruption; Chinese Prime Minister Li Peng lamented that his country was losing ground in its war on corruption; President Kim Young Sam deplored endemic corruption in South Korea; Russian Interior Minister Anatoly Kulikov pledged to crack down on corruption and the gray economy; Pakistan's voters, disillusioned by perceptions of widespread corruption, stayed away from the polls in droves; and public schools in Washington were alleged to be rife with cronyism and nepotism.

Corruption scandals in recent years have also contributed to the downfall of governments in Ecuador, Brazil, Italy, and India. Long-entrenched ruling parties have been weakened, including Japan's Liberal Democratic Party and Mexico's Institutional Revolutionary Party. In the United States, two decades after the Watergate scandals prompted new rules regarding political contributions and the passage of the Foreign Corrupt Practices Act (FCPA), campaign finance reform has reemerged as a major political issue.

The number, variety, and importance of countries experiencing corruption scandals highlight both the complexity of this phenomenon and its prominence as a global issue. When it is pervasive and uncontrolled, corruption thwarts economic development and undermines political legitimacy. Less pervasive variants result in wasted resources, increased inequity in resource distribution, less political competition, and greater distrust of government. Creating and exploiting opportunities for bribery

at high levels of government also increases the cost of government, distorts the allocation of government spending, and may dangerously lower the quality of infrastructure. Even relatively petty or routine corruption can rob government of revenues, distort economic decision making, and impose negative externalities on society, such as dirtier air and water or unsafe buildings.

The spread of democratization and market reforms should reduce corruption in the long run. In the short run, however, the opening of political systems may expose previously hidden corruption and create a perception of increased corruption, or it may allow newly empowered citizens to voice disgust more openly. Imbalances in the pace and scope of political and economic reforms may also introduce new forms of corruption or allow more virulent forms to take hold. The privatization of state-owned enterprises, for example, is thought to have been distorted by bribes or favoritism in many countries. Real or perceived increases in corruption during times of transition often threaten to undermine support for difficult reforms. Thus, whether the political and economic opening that is occurring around the world is sustained may depend on the ability of governments to do something about corruption.

Of course, corruption is not just a problem for developing countries and countries from the former Soviet bloc. The fund-raising scandals in the United States, the demise of the Christian Democratic Party in Italy, and the dissatisfaction with politics as usual in a number of Western European countries and Japan demonstrate the need for continued vigilance if democracy is to be sustained.

Increasing global integration has also elevated the importance of corruption as an international issue. The impact of corruption on economic development and political stability within countries sometimes spills over to neighboring countries or the international community more broadly. In an essay for the *Financial Times* (31 January 1997, 18), Grigory Yavlinsky warns of an extreme case in which the potential consequences of corruption and a failure of reforms in Russia could spill far beyond its borders, including “loss of control over nuclear weapons [and] nuclear materials . . . development of a breeding ground for terrorism . . . [and a] high probability of large-scale environmental disaster.” The recent dismissal and arrest of General Jesús Gutiérrez Rebollo as head of Mexico’s drug control agency is an all too familiar—if still shocking—example of the deep connections between corruption and international drug trafficking.

More broadly, as economic globalization grows, so does the potential impact of corruption on international flows of goods and capital. International financial institutions and bilateral assistance agencies are concerned that resources intended to assist development in poor countries be used as efficiently as possible. Developing countries are concerned that the perceptions of corruption will cause them to lag as private capital increas-

ingly displaces official finance in many emerging markets. Government procurement, particularly related to large infrastructure projects in developing countries, has been a focus of several recent international anticorruption initiatives. Finally, US policymakers are concerned that US firms will become increasingly handicapped in international markets if their competitors continue to use bribery as a tool to win business.

This discussion underscores the difficulties facing analysts and policymakers alike in addressing corruption problems. The first task in this overview chapter is to summarize the key analytical lessons elsewhere in this volume and in the literature with particular regard to patterns of corruption that are most damaging to the domestic economic and political development of countries. This chapter also examines the potential international consequences of corruption in an increasingly integrated international economy, before turning to policy options. It examines how trends toward democratization and economic liberalization affect corruption and what types of institutional reforms may be needed to supplement these broader systemic reforms. Next comes an assessment of the international initiatives being pursued in a variety of forums, including the Organization for Economic Cooperation and Development (OECD), the international financial institutions, the Organization for American States (OAS), and the World Trade Organization (WTO). Despite the high-level attention recently given to anticorruption movements around the world, there is a danger that the momentum may flag as it did after a brief spurt of interest in the 1970s. The chapter concludes with priorities for international action to keep that from happening again.

The Many Meanings of Corruption

Graft is what he calls it when the fellows do it who don't know which fork to use.

—Jack Burden in *All the King's Men*

The challenges facing corruption analysts begin with how to define it. Most people know corruption when they see it. The problem is that different people see it differently. The most commonly specified definition is something along the lines of *the abuse of public office for private gain* (Klitgaard 1991, 221; Transparency International 1995, 57-58; Shleifer and Vishny 1993, 599). But, as Johnston notes in chapter 3, the meaning of each of the elements of the definition—abuse, public office, private gain—is subject to debate. And “contention over who gets to decide what those terms mean is [often] the most important political dimension of the [corruption] problem.” Ultimately, defining corruption is a social and political process, although certainly some lines may be drawn and some behaviors universally condemned.

What is clearly excluded from this definition is identical behavior that occurs entirely within the private sector. Insider dealing, bribes to secure private contracts, and other practices that might be considered corrupt are ignored in this analysis, not because their economic effects are small, but because the topic is already complex, and it need not be made even more unwieldy.¹ Both the private and public sectors may also at times be plagued by “internal” corruption—*theft or fraud that is perpetrated on a firm or public agency by its employees without the involvement of an outside actor.* Although graft in the public sector clearly represents “*abuse of public office for private gain,*” it is not a major focus of this analysis, which looks more closely at corruption arising from the interaction between the public and private sectors.

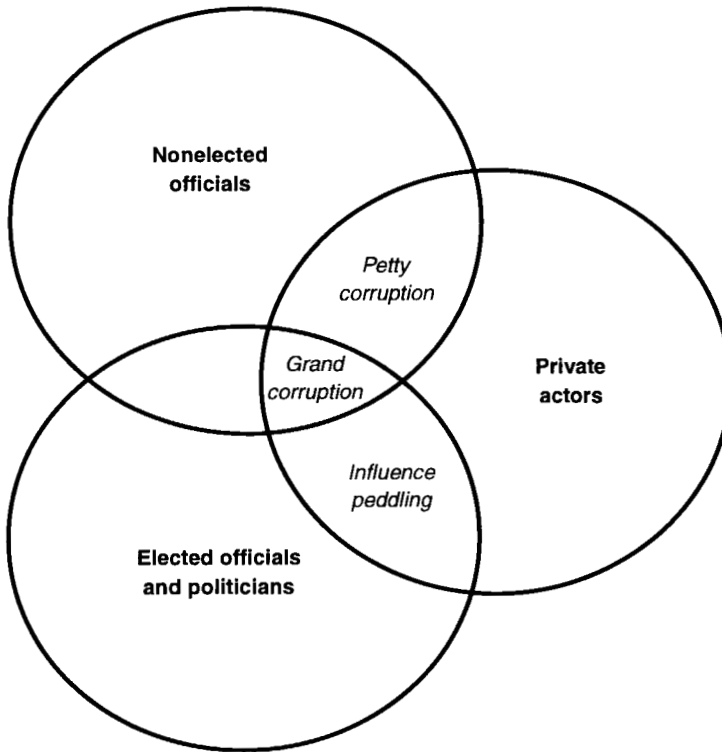
Figure 1 illustrates this nexus, dividing the actors in a country into three groups: private actors, elected politicians, and nonelected public officials identified as bureaucrats and the judiciary.² The figure highlights the fact that sectors often expected to behave autonomously within their separate spheres in fact interact extensively. As emphasized by Johnston (chapter 3), the key difficulty lies in balancing access and autonomy so that public officials have both the information and independence necessary to promote the public interest.

In this stylization, petty corruption occurs when private actors interact with nonelected government officials, particularly lower-level, administrative bureaucrats. These transactions involve taxes, regulations, licensing requirements, and the discretionary allocation of government benefits such as subsidized housing, scholarships, and jobs. It is at the highest levels of government, where political leaders, the bureaucracy, and the private sector all interact, that grand corruption may occur. This consists of government decisions that typically cannot be made without high-level political involvement. Examples include the procurement of big-ticket items such as military equipment, civilian aircraft, or infrastructure or broad policy decisions about the allocation of credit or industrial subsidies. Distortions at both levels can arise from either economic influ-

1. The multibillion dollar bailout of failed savings and loan (S&L) associations in the United States in the late 1980s is a striking example of the potential public costs of private-sector corruption. Although economic forces, regulatory laxness, and the incentives for S&L executives to take excessive risks were the major factors in the crisis, the Congressional Budget Office (CBO) (1992, 12-13) cites estimates by others that fraud accounted for anywhere from 3 percent to 25 percent of the government costs of the bailout. With a total estimated cost of \$180 billion, the lowest estimate of taxpayer losses due to fraud would be nearly \$5.5 billion, although it may actually be much larger (CBO 1993, 6). The role of deregulation in contributing to the crisis should also serve as a cautionary note to those who would emphasize it as a remedy for corruption. The environment in which deregulation occurs is crucial.

2. This stylization ignores the fact that judges in some countries, including in some US states, are elected.

Figure 1 Types of corruption



ences, such as bribes, or from personal allegiances, such as ties of family, tribe, or friendship.

At times the line dividing the licit and illicit interactions of private agents and politicians becomes blurred, as illustrated so vividly by the debate in the United States over campaign finance reform. Noonan (1984, chapter 19) discusses the difficulties in distinguishing between bribes and legal campaign contributions and the degree of reciprocity expected. He offers seven hypothetical situations ranging from a case in which a contributor gives to candidate *X* because he does not like candidate *Y*—meaning he is not rewarding *X* and expects nothing from him—to a case in which the contributor gives to candidate *X* with the expectation that *X* will vote a particular way on a particular piece of legislation—meaning full reciprocity is expected. In the latter case, Noonan notes that the “distinction between bribe and contribution is close to collapsing” (1984, 623). Situations like the latter, especially where contributions to top political leaders or their parties are intended to influence specific decisions, for example on defense procurements, can be labeled grand

corruption. In general, however, because of the complexities involved and because campaign finance reform does not lend itself to international coordination, what is often called electoral corruption is largely ignored in this discussion.

The final area of overlap in figure 1 is between elected and non-elected government officials. The variety of interactions occurring here prevents the use of a handy shorthand for the illicit activity that might arise. One possibility is “bribe sharing,” if politicians pass on proceeds from a bribe in order to influence how legislation is implemented by bureaucrats or vice versa. Similarly, a high-level elected official might share bribe proceeds with lower levels of the bureaucracy in order to fulfill an understanding arising from a bribe. Another possibility is that either bureaucrats or politicians might bribe a judge in order to avoid prosecution or reduce a penalty. Less direct exchanges might also occur, such as appointments of “friendly” judges—even relatives—with the expectation that they will treat the leadership’s friends with leniency.

In each of these spheres, lines must be drawn between legitimate and illegitimate interaction. Kjellberg (1995, 342-43), for example, distinguishes four types of corruption depending on whether the transgression flouts legal, ethical, or social norms, and whether the transaction involves a direct or indirect exchange. Bribes of public officials fall into the category that is easiest to define because they are illegal in most countries and typically involve a direct exchange of money for favors. An illegal transaction involving indirect exchange, perhaps over a period of time, may be more difficult to police and to prosecute in court than a bribe, which is already difficult enough to detect given the secrecy involved. Questionable transactions in which the exchange is indirect and does not run afoul of the law will be the most difficult to discipline. An example of the latter might be the high-level attention given to a trade dispute between the United States and the European Union over bananas, following large campaign contributions by Carl Linder, head of Chiquita Bananas, to both the Democratic and Republican Parties.

In political terms, what is ultimately being sought in all these cases is influence. Each society will, through the process of political give-and-take, draw a line somewhere between licit and illicit public-private interactions. Though the divide may vary across countries and over time, both Klitgaard (1991) and Noonan (1984) note that legitimate gifts can usually be distinguished from illegitimate bribes: gifts can be given openly, bribes cannot. Similarly, Heimann (chapter 8) suggests that corporations unsure about where to draw the line should use the “newspaper test”: if it would cause discomfort on appearing in tomorrow’s newspaper, then don’t do it.

Figure 1 illustrates just one possible set of arrangements; many alternative configurations with different implications for the predominant type or volume of corruption are possible. The relative size of the areas of

overlap will vary with the relative size of government and the balance of power between the executive and legislative branches of government. The size of the overlaps reflects the potential volume of illicit transactions, but it is not necessarily indicative of the magnitude of the impact. Ideally, the figure would be three-dimensional, illustrating depth or density as well. It is possible for some forms of corruption, such as influence peddling, to be widespread but relatively shallow in impact, while others such as grand corruption may occur less often and yet have a deeper impact. Other concrete factors determining the prevalence of corruption are discussed below.

Sources of Corruption

The temptation to engage in corrupt behavior may arise whenever a public official has control over something valued by the private sector and the discretion to determine how it will be allocated (Rose-Ackerman, chapter 2). And since every government in the world spends money and taxes and regulates its citizens to one degree or another, “[w]hatever size and type of state a country chooses, the threat . . . remains” (Klitgaard 1993, 231). But as suggested in figure 1, the incidence of corruption and the predominant forms that it takes across countries might be expected to vary with the size, structure, and type of government as well as the types of activities in which it engages.

Klitgaard (1988, 75) summarizes the “basic ingredients of corruption” in the following formula:

$$\text{Corruption} = \text{Monopoly} + \text{Discretion} - \text{Accountability.}$$

Rose-Ackerman (chapter 2) discusses in detail the factors that determine the incidence and size of bribes. The aim here is to use what empirical evidence is available to look for general patterns across countries.

First, a measure of corruption across countries is needed. Since 1995, Transparency International (TI), a Berlin-based nongovernmental organization (NGO) established in 1993 to combat corruption around the world, has released rankings of countries according to how corrupt they are perceived to be. The ranking, which starts at zero for the most corrupt and goes to ten for the least corrupt, is based on a survey of surveys compiled by Professor Johann Graf Lambsdorff and is available on the Internet. Because it includes only 54 countries, however, I have added corruption ratings from a second source that covers more than 100 countries (see appendix B for more details).

As for evidence on the sources of corruption, it is difficult to measure bureaucratic discretion across countries. But quantitative indicators of potential monopoly—government size and the importance of industrial

policies, trade restrictions, and other state interventions in the economy—are available for many countries. Accountability of public officials, which determines the likelihood that corruption will be punished, is more difficult to measure objectively. But accountability is derived in part from the political structure in which officials operate, and qualitative indicators of relative political openness are also available for a large number of countries.

One simple measure of the role of the state in an economy is its size. LaPalombara (1994, 338) argues that the larger the government, as measured by its share of GDP, the higher the level of expected corruption. A large government share of GDP could indicate a large bureaucracy and a lot of regulation and red tape; it might also be expected that the larger the share of national income that passes through government hands, the greater the opportunities for malfeasance. But, as LaPalombara notes, the experiences of Norway and Sweden show that high levels of government spending do not necessarily lead to higher levels of corruption. In fact, for 83 countries for which data are available, there is a strong positive correlation between low levels of corruption and the level of central government expenditure (table 1). Moreover, in the 16 most corrupt economies for which data are available, the average share of government expenditure is 21 percent of GDP, well below the 32 percent average for the sample as a whole.³

More important than the size of government are the types of activities in which it engages. Most obviously, a government that restricts economic competition—for example, through maintenance of trade restrictions or monopolistic state-owned enterprises—will create economic rents (profits in excess of a normal return in competitive markets) and thus greater incentives and opportunities for rent-seeking corruption.⁴ Table 1 presents evidence on the correlation between corruption and the share of state-owned enterprises in nonagricultural GDP and between corruption and the openness of economies as measured by trade shares. Though simple correlations do not demonstrate causality, both coefficients offer at least some support for the hypothesis that more direct government intervention in the economy will tend to produce more corruption. By far the strongest of the correlations shown in table 1, however, is the qualitative measure of economic freedom developed

3. LaPalombara argues that this problem will be worse in developing countries where “the institutions of civil society that might serve as watchdogs against and brakes on corruption are very weak” (338). But there is also a positive correlation between the size of government and the relative honesty of government when higher-income countries are excluded from the sample.

4. As noted above, however, in sectors that are imperfectly competitive, collusion and rent-seeking can occur whether ownership is private or public. Similarly, fraud and white-collar crime are problems that can involve private as well as public managers.

Table 1 Quantitative and qualitative indicators of potential sources of corruption

Indicator	Number of countries for which data are available	Value of simple correlation coefficient ^a
Central government expenditure as a percentage of GDP	83	0.102
Share of state-owned enterprises in nonagricultural GDP	61	-0.299
Share of exports and imports of goods and services in GDP	98	0.240
Freedom House ranking of economic freedom	66	0.676
Freedom House ranking of political freedom	111	0.534
Per capita GDP	107	0.653

a. The coefficient measures the degree to which the indicator is correlated with the combined corruption ranking for 111 countries described in appendix A. Recall that the corruption ranking runs from 0 for the most corrupt to 10 for the least corrupt. Thus, for example, there is a positive relationship between a country's income level and how "clean" it is and a negative correlation between the role of state-owned enterprises and how clean a country is .

Source: See appendix B.

by Freedom House, which is a subjective index designed to measure in 66 countries the freedom to hold property, earn a living, operate a business, invest one's earnings, and trade internationally.⁵

Ades and Di Tella (1994) provide further evidence that the less competitive the economy the greater the opportunities for corruption. They conclude that in 55 economies in the early 1980s there was a significant negative correlation between corruption and the share of imports in GDP. They also find higher levels of corruption to be associated with qualitative measures of market dominance by a few firms and with lax anti-trust enforcement in a sample of 32 countries. In a subsequent work, Ades and Di Tella (1995) find evidence that various measures of government industrial subsidies are correlated with relatively more corruption,

5. The Freedom House scoring of economic freedom also includes the freedom to participate in the market economy, but that part of the index is excluded because it includes a judgment on how pervasive corruption is and the degree to which it interferes with market forces. The construction of the particular form of the ranking used here is described in more detail in appendix B.

but they suggest caution in interpreting the results, again because of the very small sample size (no more than 32 countries).

Although the level of potential rents created by the government's role in the economy may be an incentive for engaging in corrupt activities, holding public officials accountable for those activities will offset the temptation. Freedom House also gauges governments for the level of political rights and civil liberties permitted and protected. This index captures some elements of transparency (media freedom) and accountability (the degree to which citizens are allowed to express their opinion through protest and the ballot box) that one would expect to find positively correlated with cleaner government. Indeed, table 1 confirms a relatively strong correlation between political openness as measured by Freedom House and lower levels of corruption. This supports Johnston's conclusion that "combating corruption and encouraging open, competitive politics can be closely allied reform goals" (chapter 3).

Other factors that may affect the opportunities for corruption include the stage of economic and political development and how development interacts with cultural tradition. This is not to suggest, as is sometimes argued, that certain cultures are inherently corrupt. Rather, the argument is that broad environmental factors—history and culture—influence the evolution of political and economic institutions, their legitimacy in the eyes of the governed, and the capacity of government to deliver the services demanded of it. Moreover, in times of transition when values, standards, and institutions are undergoing change, countries may become particularly prone to certain forms of corruption.

Table 2 lists countries perceived as more and less corrupt according to the survey of surveys compiled by TI. It is immediately obvious that in the eyes of international business, for whom and by whom these assessments and surveys are compiled, relatively more developed and richer countries are perceived to be less corrupt than poorer ones. It is likely that the differences in relative levels of corruption between developed and developing countries are somewhat overstated because of the way corruption is usually defined and measured in these surveys. Nevertheless, there are a number of reasons that developing countries might be more vulnerable to corruption and that, in turn, corruption might help to keep them poor.

Low wages are frequently cited as a source of corruption (see Ul Haque and Sahay 1996, 761). When public sector wages do not even cover subsistence, the petty bureaucrat may be expected to supplement his salary with "tips." This situation recalls the European feudal era when "public" office typically was regarded as private property, with the proceeds of office serving as remuneration for services rendered (usually loyalty to the sovereign) (Heidenheimer 1970, 10-12). Poverty is also often accompanied by illiteracy, which may make it easier for relatively more literate bureaucrats to exploit their clients. In addition to inadequate pay

Table 2 A partial profile of corruption around the world (1996 rankings)

Least corrupt (in descending order)	Most corrupt (in descending order)
New Zealand	Nigeria
Denmark	Pakistan
Sweden	Kenya
Finland	Bangladesh
Canada	China
Norway	Cameroon
Singapore	Venezuela
Switzerland	Russia/USSR
Netherlands	India
Austria	Indonesia
Ireland	Philippines
United Kingdom	Uganda
Germany	

Note: As Transparency International makes clear, these rankings should not be interpreted as saying that Nigeria is the most corrupt country in the world. The rankings are subjective assessments of business and others; they do not include all forms of corruption and they cover only 54 countries.

Source: See appendix B.

and illiteracy, other factors identified in a cross-country study of seven developing countries in East Asia were: inadequate management controls and lack of adequate technology for monitoring, poor recruitment and selection procedures, including nepotism, poor working conditions and facilities, lack of public information, and generally inadequate capacity to meet the demand for government services (Alfiler 1986, 66; Lee 1986, 101-03).

Social attitudes toward government institutions are also important. Colin Leys (1965) has argued that “new [post-colonial] states” were particularly vulnerable to corruption because “the idea of the national interest is weak . . . [because] the ‘state’ and its organs were identified with alien rule and were proper objects of plunder,” and because corruption is easier to conceal where the rules are unclear, the commitment to them is weak, or the enforcement institutions themselves are weak (the police and judiciary, in particular). It may be that these factors put in motion a vicious cycle whereby initial, supposedly transitional, conditions facilitate corruption that further undermines the state’s legitimacy and capacity, and evokes yet more corruption. This could help explain why many “new” states suffer from pervasive corruption 30 years or more after independence.

Domestic Economic Consequences of Corruption

[S]ure, there's some graft, but there's just enough to make the wheels turn without squeaking.
—Willie Stark, *All the King's Men*

Corruption leads to loss of much needed revenue and human talent for development, distorts priorities for public policy, and shifts scarce resources away from the public interest [P]olitical instability, corruption, and underdevelopment are mutually reinforcing.

—Stephen Ouma, *Corruption in Public Policy and Its Impact on Development*

While positive effects in certain situations have been claimed for corruption, most scholars agree with Ouma that widespread corruption is detrimental to economic and political development. As detailed in the papers in this volume, higher levels of corruption may lower total investment (and thus growth) and skew the allocation of government spending, particularly away from public education (see Mauro and Ruzindana). Even when relatively contained, corruption can cause inefficiency in the allocation of resources, greater inequities in income distribution, and the loss of savings and investment due to the flight abroad of proceeds from bribes (see Rose-Ackerman). In general, the consequences of corruption depend on

- the degree to which economic incentives are already distorted by government policy;
- the degree to which economic incentives are distorted or social objectives undermined by corruption; and
- the prevalence of corruption and the ability of the government to control it.

Corruption as a Second Best

Some analysts and observers argue that corruption need not be inimical to economic development. When facing an inept or understaffed bureaucracy or inefficient regulators, corruption may be a rational second-best response (see Bayley 1970, Leff 1970, and Nye 1970). Also, where the rule of law is weak, as in Russia and China today, corruption may serve as an alternative means of contract enforcement. Samuel Huntington said, “In terms of economic growth, the only thing worse than a society with a rigid, overcentralized dishonest bureaucracy is one with a rigid, overcentralized, honest bureaucracy” (1968, 498-99). In this context, bribes are often called “speed money” or “grease” and are viewed not only as reasonable but as enhancing efficiency in situations where red tape or state control of the economy may be strangling economic activity. As

suggested below, however, the conditions under which corruption has positive economic effects appear to be fragile.

When the demand for government services exceeds the bureaucracy's ability to keep up, speed money, in the form of a "voluntary tax" or "tip," may be offered to a public official in exchange for faster or more efficient service.⁶ This second-best solution has net positive effects for the economy as a whole, however, only if the official is constrained—by limits on discretion or political power or by careful monitoring—from introducing new delays or regulations to increase bribe collections (Rose-Ackerman, chapter 2; Alam 1990). Empirical evidence suggests the net effects are often negative. The Santhanam Committee found in its investigation of corruption in India many years ago that the "custom of speed money has become one of the most serious causes of delay and inefficiency," because bureaucrats will do nothing until paid off (cited in Myrdal 1970, 541). In Ecuador, under allegedly corrupt ex-President Abdala Bucaram, the processing time for import shipments in the port city of Guayaquil reportedly increased from two days to a month (Washington Post, 16 February 1997, A36). More broadly, Mauro (1995, 695) found in a statistical analysis of more than 60 countries that corruption is negatively correlated with investment even in the presence of large amounts of "red tape"—when corruption in the form of grease money would be expected to be most beneficial.

Corruption may also be a second-best response when a bureaucrat is bribed to ignore official duties that entail enforcement of regulations that are inefficient, duplicative, or simply unnecessary. In this case, there may also be a welfare gain. Edward Banfield (1975, 595, 23n) offers the example of the New York City construction industry, which at the time was governed by an 843-page building code that required as many as 130 permits from a variety of city departments for large projects. Banfield cites a city commission study that found that most builders typically applied for only the most important permits, often bribed officials to get those permits quickly, and then paid off the police or inspectors to avoid harassment for not having the others. The commission concluded that none of the bribes they investigated ". . . resulted from a builder's effort to get around the requirements of the building code. What was being bought and sold, an official said, was time."

While corruption in particular situations may be efficiency-enhancing, it is difficult to restrict it to only those situations. Because these transactions are usually secret, it is difficult to monitor them to ensure that the public interest is not subverted. In a competitive market with reasonably honest enforcement agencies, especially the judiciary, Rauch's "perfor-

6. In this case, Tilman (1970, 62) argues that corruption may be seen as "a shift from a mandatory pricing model [for government services] to a free-market model"—what he dubs "black-market bureaucracy."

mance rule” might work to ensure generally efficient outcomes (see his comment in part I). Under this “rule,” if the builder does not abide by essential safety regulations and the building collapses, he will go out of business or go to jail and the corrupt inspector will also be punished. With less competition and accountability, however, both parties will be more likely to escape punishment and more tempted to cross the line, skirting regulations or standards to cut costs in ways that affect quality and are not simply timesaving. And when government benefits are allocated, what ensures that a bribe only cuts through red tape and does not divert benefits intended for “worthy” individuals to those with the ability to pay?

Misallocation and Redistribution of Resources


The supply of bribes is often linked to a desire to influence the creation or distribution of scarce government benefits or of the economic rents that often arise when government intervenes in the economy.⁷ Bribes that are extorted by government officials introduce distortions by raising the cost of doing business. Whether extorted or voluntary, the degree of distortion tends to rise with the rank of the official involved and the value of the bribe (or other exchange) (see figure 2).

The distinction between bribes that are voluntarily offered or extorted is similar to the distinction in Shleifer and Vishny (1993, 601-02) between corruption involving and not involving theft. In the latter case, the official turns over the full cost of the public good or service (for example, a license) to government coffers but is able to extract additional bribes, because he is in a position to withhold the service and in effect create an artificial shortage. In this situation, competition among suppliers of public services might reduce the probability that bribes will be extorted, because the applicant can go to another official. Among those most vulnerable to extorted bribes are firms with high fixed costs and without alternative production locations, producers or brokers of perishable goods, or uneducated taxpayers or other constituents in need of government services. Firms working under contracts with fixed deadlines and penalties for delays will also be vulnerable to bribe demands.

In the case of corruption with theft, the official accepts a bribe in exchange for lowering or waiving the price of the good (for example, by influencing a tax bill), thus depriving the government of its due. As Shleifer and Vishny note, “Corruption with theft is obviously more attractive to the buyers” and competition among buyers in this type of

7. See Krueger (1974) and Bhagwati (1982) for analyses of the inefficiencies and wasted resources arising from “directly unproductive” efforts to capture rents created by government interventions that restrict supply or artificially depress or subsidize prices.

Figure 2 Analyzing the consequences of corruption

Degree of distortion ^a	Voluntary bribes ^b	Extorted bribes
 <p>↑ Petty</p> <p>↓ Grand</p>	Paying to expedite a building permit for which seeker is eligible (speed money).	A licensing officer holds up building permit until a bribe is paid.
	Paying a building inspector to overlook a missing permit although the building is in compliance with all regulations (grease).	The building inspector threatens to levy a fine for not having a permit that builder is unaware is needed, unless a bribe is paid.
	Paying to get offspring who is on waiting list admitted to university.	The tax collector threatens to audit a company unless a bribe is paid.
	Paying the tax collector to lower your assessment and the customs officer to allow you to import steel beams duty-free.	When building is near completion, a high-level construction ministry official threatens to have it condemned as unsafe unless a large bribe is paid.
	Paying a building inspector to overlook deficiencies in building design or construction.	
	Paying a minister in exchange for the award of a contract to build a new hospital despite contractor's lack of experience and higher bid than competitors'.	

a. These examples are intended to be illustrative. Whether a particular situation involves petty or grand corruption depends not just on the type of transaction but also on the size of the bribe and the level of the public official, which are likely to be positively correlated.

b. Voluntary does not necessarily mean enthusiastically, and, in practice, there may be a fine line between bribes offered and extorted.

case will tend to increase the level of corruption (1993, 602; see also Klitgaard 1988, 87).

Petty corruption generally refers to the routine government transactions typically overseen by middle and lower-level bureaucrats, such as tax payments, allocation of permits, and regulatory enforcement. At higher levels of the bureaucracy and among the political leadership, officials and politicians will tend to control more valuable assets or opportunities and have more discretion in their allocation. At this level, decisions are made regarding major procurements (including airplanes, military equipment, power-generating equipment, and telecommunications infrastructure) and major investment projects (including roads, irrigation projects, and dams). The greater the concentration of political power (i.e., the less

Table 3 Opportunities for and consequences of corruption

Opportunities for corruption	
Vying for government benefits Government procurement contracts, ranging from routine purchases of supplies to large infrastructure projects	Access to government services or subsidies, such as scholarships, health care, or subsidized housing
Purchases from or sales to state-owned enterprises	Paying to avoid costs Regulations Taxes
Sales of state-owned enterprises (privatization)	Prosecution (for illegal activities such as prostitution or gambling)
Access to government-controlled or regulated supplies of goods (raw materials, luxury goods, etc.), credit, foreign exchange, import and export licenses, other licenses or permits	Delays, red tape Paying for official positions
Consequences of corruption	
Inefficiencies Misallocation of government resources due to award of contracts to less efficient bidders	Incentives to create additional regulations or delays in order to collect bribes Lost national savings and lowered investment due to flight abroad of bribe "capital"
Distortions in allocation of government expenditure	Inequities Redistribution of assets from public sector to corrupt individuals
Distortions in allocation of privatized enterprises	Redistribution from relatively poorer to relatively wealthier individuals who are more likely to have access to government officials
Inappropriate or poor quality infrastructure	Undermining of political legitimacy
Undersupply of public goods such as clean air or water	

Sources: Rose-Ackerman (chapter 2), Johnston (chapter 3), and Mauro (chapter 4).

accountable that politicians and high-level officials are) the greater the opportunities will be to engage in corrupt behavior.

A cross-country study of administrative corruption in South Korea, Malaysia, Nepal, the Philippines, Singapore, Thailand, and Hong Kong analyzes the prevalent forms and incidence of corruption in three government functions: taxation, expenditure, and regulation (Alfiler 1986) (see also table 3 for a summary of opportunities for and consequences of corruption). The study found that bribery was the most common form of corruption (compared to nepotism and "internal" corruption, basically defined as the theft of government property). As might be expected, it found that reduction of taxes due was the primary corrupt objective in

customs and other revenue collection agencies. With respect to government spending, the study found that overpricing, substandard quality, and the theft of government property for sale on the black market were the most common consequences of corruption. In the regulatory area, most of the cases look at police departments, where the most common outcome of corruption was protection of illegal vice, such as prostitution and gambling.

As Scott (1972, 66) has noted, “the pettiness of corruption refers only to the size of each transaction and not to its total impact on government income or policy.” Indeed, widespread evasion of taxes including customs duties may seriously detract from the ability of the government to provide services. It is also likely to exacerbate the problem of low public-sector wages and further spread the corruption virus. Consistent with Shleifer and Vishny’s analysis of corruption involving theft, the following example from Asia illustrates how competition among public officials in tax collection agencies can increase the volume of corruption:

In Nepal, “chhoties”—customs offices situated in border areas—tried to compete with each other in attracting taxpayers. One way was to reduce their effective tax rates by charging duty only for a certain percentage of goods imported or exported. Businessmen naturally flocked to stations which charged the lowest rates. Some of these chhoties went to the extent of hiring bandits to harass traders using certain routes favorable to their competitors (Alfiler 1986, 48).

If the government is unable or unwilling to reduce expenditures, revenue shortfalls due to widespread corruption could also have severe macroeconomic consequences.

Other potential consequences of petty corruption include

- negative externalities from unenforced regulations (environmental degradation threats to worker or consumer health and safety),
- reduced government efficiency when hiring is based on favoritism rather than merit,
- shortages of subsidized necessities (due to theft and smuggling), and
- misallocation of talent from productive to nonproductive rent-seeking activities.⁸

Of course, similar illicit activities can occur at higher levels of bureaucracy. The more that higher level officials condone or engage in such behavior, the more pervasive corruption and its effects are likely to become.

8. For an analysis of the effects of rent-seeking opportunities on the allocation of talent, and the follow-on effects on growth, see Murphy, Shleifer, and Vishny (1993).

Certain decisions, such as those concerning government procurement and infrastructure, can only be made at higher levels of government. Even where particular projects respond to social needs, corruption may increase their costs, lower the quality, or lead to inappropriate choices of technology. (The more complex the project, the harder it is to prove that bribery rather than technical specifications determined the award of a contract.) Worse are “white elephant” projects that enrich officials and suppliers but serve little public purpose. A National Public Radio broadcast on corruption in Nigeria cited the construction of four incinerators in Lagos, none of which worked properly and which together represented considerable excess capacity (Morning Edition, 27 August 1996; see Rose-Ackerman, Ruzindana, and Tanzi for other examples).

Much of the corruption that comes to light involves white elephant projects or military procurement.⁹ But data limitations and the plethora of factors determining government expenditures make it difficult to move beyond anecdotal evidence and demonstrate that in general more corrupt countries spend relatively more on these types of activities. Mauro, however, finds evidence that more corrupt countries spend relatively less on public education and perhaps less on health, though the evidence is weaker. This has two larger implications. First, some case studies have found an association between illiteracy and corruption (Alfiler 1986). Second and even more important is the contribution human capital makes to growth.

Corruption can also reduce the resources available to poor countries by facilitating capital flight or by driving away international donors. It is estimated that \$60 billion left Russia between 1992 and 1996, with current capital flight continuing at \$12 billion annually, almost all of it illegally (*Financial Times*, 14 February 1997, 3). Corruption may also contribute to capital flight because of the desire to hide illicit wealth from scrutiny or repossession, and the more uncertain the political situation, the more likely that the fruits of corruption will be stashed abroad.

The potential impact on aid flows was demonstrated in the Kenyan energy sector, which was suffering from inadequate capacity and regular power failures in 1995. “Donor allergy” had developed from what one source described as “a slap in the face of the donor community” during construction of the Turkwel Gorge dam several years earlier. The contract was awarded without competitive bidding. In the judgment of a report by the European Community, “the project ended up costing many times its original, already inflated price as a result of kickbacks paid to government officials” (*Financial Times*, 25 October 1995, 9). In late 1995, the *Financial Times* reported that international donors had not funded any power projects in Kenya for the previous five years.

9. Many of the deals that have been exposed as corrupt have involved military procurement.

Finally, decisions on government procurement may lead to less efficient resource allocation when bribery plays a role in the selection of the supplier. If all eligible firms are willing to bribe and have the same information, the most efficient supplier will be able to offer the highest bribe, so that corruption would have no impact on resource allocation. But some firms, including more efficient ones, may choose not to bribe or may be constrained from doing so (as US firms are by the FCPA). The secrecy surrounding corruption also makes information harder to obtain. Firms that may not be the most efficient but that spend the most time “making friends” may obtain inside information that allows them to learn how much to bid and whom and how much to bribe. Since favoritism is another common form of corruption, favored firms may also collude with officials to raise the price of winning bids while setting aside kickbacks for these cooperative officials.

Even though greater amounts of money will typically be required when individual transactions take place at the higher political and administrative levels, it is not clear that the aggregate effects of grand corruption are necessarily greater than those of petty corruption. The harassment element of petty corruption, in the form of extortion, for example, might be expected to have a broader negative effect on private economic behavior than would grand corruption, which is likely to be limited to fewer sectors. Rampant petty corruption may also be more politically corrosive over time because it affects more people on a regular basis.¹⁰ The point is that although a little bit of high-level corruption may be more damaging to an economy than a little bit of low-level malfeasance, pervasive petty corruption may still be quite harmful. Of course, it is unlikely that petty corruption would become widespread in the absence of corruption at top levels of the government, but one should not underestimate the potential effects of low-level corruption simply because individual cases may involve small sums.

Competition, Credibility, and the Systemic Effects of Corruption

When corruption and its consequences cannot be controlled and contained, the credibility of government suffers, the security of property rights erodes, and the level of uncertainty and risk in the economy increases. If public officials cannot be relied upon to deliver on promises when bribed, or if necessary approvals for a project cannot be obtained at reasonable cost because officials at successive layers of bureaucracy demand a piece of the action, then corruption will prejudice economic activity more than if it were controlled and promises were credible.

10. I thank Michael Johnston for emphasizing this point. Also see Klitgaard (1988, 47-49).

Shleifer and Vishny (1993) analyze corruption markets that are monopolistic, competitive, or made up of independent monopolists. When the market structure is monopolistic, a king, dictator, or ruling party (for example the Communist Party in the old Soviet Union) is able to organize the market and ensure both predictability—it is known who must be bribed and by how much—and security of property rights over government goods or services once the bribes are paid. When the market among public officials is competitive, constituents shop around until they find an honest official and avoid paying a bribe. In the real world, however, a business owner or investor often needs several permits from more than one agency. If the public officials in this case act as independent monopolists, each setting a bribe price with no regard for what the others are doing, the total cost of the bribes will not be known in advance and may escalate to a level where the planned project becomes unprofitable. The problem will be particularly acute if there is free entry into the bribe market; that is, if bureaucrats can create new rules or regulations in order to get in on the action. In this case uncertainty is greater and property rights are not secure. Under these circumstances, economic activity that requires interaction with the government will either move into the informal sector, move abroad (or to another city or region), or in extreme cases, such as in Russia today, “mafias” may move in to provide the protection for property rights and contract enforcement that the government cannot.

This analysis provides the backdrop for the empirical evidence presented by Mauro (chapter 4, also 1995) on the impact of corruption on investment and growth. The cross-country data that are available do not clearly distinguish between corruption with and without “theft” or whether it is of the petty or grand variety. However the rankings that Mauro and others have used to study the effects of corruption typically attempt to measure the prevalence of corruption in a country. Thus, these assessments could be considered as indicative of the degree to which corruption is or is not controlled.

As might be expected from Shleifer and Vishny’s model, Mauro finds that higher levels of corruption have a significant and negative correlation with lower levels of gross domestic investment. More recently, Wei (1997) also attributes a large negative impact on foreign direct investment (FDI) to corruption.¹¹ One problem in interpreting these results arises if corruption is endogenous to economic conditions; that is, the observed lower levels of investment are due to the effects of poverty

11. Wei, using the data on corruption from Mauro (1995) and data on FDI flows from 14 source countries into 45 host countries, finds that an increase in the level of corruption from that of Singapore to that of Mexico is equivalent to a 21 percentage point increase in the tax rate on multinationals. In his results, a one percentage point increase in the tax rate is associated with roughly a five percent reduction in FDI.

rather than corruption. In many cases, however, the causality is likely to run in both directions, with corruption and poverty reinforcing one another.¹²

While the negative relationship between corruption and investment may hold in general, some analysts argue that, in countries where the rule of law is weak, corruption may substitute for other forms of contract enforcement and *decrease* uncertainty for investors. Betancourt (1995) argues that China, as it undergoes the transition to a market economy, may benefit in the short run from corruption as a substitute for legal forms of contract enforcement. Wei observes that China in recent years has become the largest recipient of FDI among developing countries, and he argues that China may be a special case, because of the large proportion of its FDI from overseas Chinese. He notes that “overseas Chinese capital apparently is less sensitive to corruption, possibly because [these investors] are better able to use personal connections to substitute for the rule of law . . .” (Wei 1997, 14).

China aside, Wei concludes that “the dampening effect of corruption on FDI is greater for East Asian countries than for the world as a whole” (1997, 12).¹³ Nevertheless, relatively high levels of corruption in many of the economies in that region appear not to have prevented relatively rapid growth. It is possible that these countries would have grown even faster had corruption levels been lower. Borner, Brunetti, and Weder (1995, 58-61), however, argue that it is the government’s ability to keep promises and protect property rights that is the key to growth, not how corrupt it is. They cite the experience of a businessman who responded to a survey and had worked in both Brazil and Indonesia. Both countries received similarly poor ratings for the honesty and efficiency of the bureaucracy and judiciary but very different ratings for political credibility. The businessman commented “that while doing business in Brazil he was always afraid of large policy swings that could destroy his markets, whereas while working in Indonesia he was so convinced that this could not happen that he did not even read the newspapers.”¹⁴

Borner, Brunetti, and Weder also note, however, that corruption typically has negative distributional consequences. In China, for example,

12. Mauro addresses the potential endogeneity problem by substituting an “instrumental variable” for corruption in some tests, as well as by controlling for per capita income.

13. Wei’s results might also be skewed by the relatively small number of host countries in his sample and the absence of government policy indicators. For example, Japan and more recently South Korea have actively discouraged inward FDI in many sectors.

14. The issue of how some East Asian countries have been able to contain corruption and control its effects is obviously related to the larger issue of how the governments of these countries were able to intervene in their economies and use industrial policies relatively effectively when so many other countries have failed to do so.

where rapid economic growth is creating social strains among ethnic groups and economic classes and between rural and urban areas, corruption has become a rallying point for discontent. Recent economic troubles in Japan and South Korea also raise questions about the stability of corruption equilibriums. In particular, the corruption-linked collapse of Hanbo Steel, which may cost the South Korean government billions of dollars in payments to exposed banks and suppliers, underscores the risk of a failure in institutional controls and of corruption spinning out of control.

In sum, corruption that creates broadly felt negative externalities, such as unsafe infrastructure or environmental degradation, will be more damaging socially and politically than corruption that simply reallocates economic rents arising from government policy or imperfect competition. Most damaging of all, however, is corruption that is pervasive at all levels. Given the difficulties in controlling corruption, it is not likely to be compatible with sustainable long-term economic growth, just as it is not compatible with sustainable democracy.

Political Consequences of Corruption

A dog with a bone in his mouth cannot do two things: He cannot bark and he cannot bite.

—Mexican Dictator Porfirio Díaz,
explaining how he ruled so long (1876-1911)

[Corruption is] the gangrene of democracy, the AIDS of democracy.

—Miguel Angel Burelli Rivas, Foreign Minister of Venezuela

Until recently, most of the literature on corruption was in the domain of political science or sociology. Whereas studies on corruption as a problem of economic development have focused on poor countries in the late twentieth century, the literature on the political causes and consequences of corruption covers early industrial England and the United States at least as extensively as it does today's developing countries.¹⁵ There is also a large and rapidly growing literature on the role of money in politics, influence peddling, and campaign finance reform.

Johnston (chapter 3) analyzes the political sources and consequences of corruption in terms of imbalances in domestic political and economic opportunities and in the relative accessibility and autonomy of elites. He identifies four syndromes. Two of them, interest-group bidding, typical of liberal democracies, and patronage machines, such as in Mexico, may involve corruption that is "significant but bounded in scope, serving more to limit the competitiveness of politics and the responsiveness of

15. See, for example, Heidenheimer (1970) and Heidenheimer, Johnston, and LeVine (1989).

government than to threaten their viability.” In the other two syndromes— elite hegemony in China today, and fragmented patronage as in Italy or Russia—corruption may spiral out of control and threaten political stability.

That the political effects of corruption remain a concern for developed, as well as developing, countries is clear from the unseating of the Christian Democratic Party in Italy, the loosening of the Liberal Democratic Party’s hold in Japan, several scandals in France and Belgium, and the growing demands for campaign finance reform in the wake of the most recent and expensive US presidential election in history. In the US case, there are few direct, tangible links between political contributions and policy outcomes, though unequal access certainly influences the policy-making environment. The primary political cost of influence-peddling “corruption” is increased cynicism among voters and the alienation of citizens from their government. Cynical use of corruption scandals by political opponents exacerbates the problem and may contribute to political gridlock. The need to raise large sums of money for political campaigns also dissuades some would-be office-seekers from becoming candidates.

Analyses of political corruption in less developed societies, especially those focusing on the operation of patronage machines, sometimes find beneficial effects. In this framework, corruption helps provide a separate, possibly more accessible communication network, soften the interaction between citizens and a government they may not understand, and may even prevent violence.¹⁶ It is also argued that corruption sometimes provides access for groups otherwise excluded from political influence, for example, ethnic Chinese minorities in Thailand and Indonesia (see Scott 1972 and Schwarz 1995). Similarly, an expert on Asian politics argued recently that corruption in China had had some positive economic effects by providing access to marginalized groups, “which has led to the diversification and strengthening of the economy” (Hillstrom 1996, 4).

Professor Sun Yan concluded, however, that corruption had simultaneously “served to benefit the Mafia and entrenched elites,” and that in general “its undemocratic and detrimental nature causes moral decay, social discontent, and political alienation” (Hillstrom 1996, 4). Johnston (1993, 193) also concludes that

Sometimes corruption appears as an adaptive force, “humanizing” government and enabling citizens to influence policy. More often, corruption allows those with disproportionate money and access to protect and enhance their advantages. . . .

16. See Huntington (1968), Johnston (1993), McMullan (1970), and Scott (1972).

Equally important, as Johnston points out, in some cases “corruption props up institutions and regimes that might otherwise be ready for needed changes.”

On the other hand, corruption may be destabilizing in situations where it is used as a club by the “outs” to attack the “ins” (see also McMullan 1970, 317-18). Opposition parties may exploit scandals, exaggerating or even inventing evidence of corruption in order to undermine support for reforms that affect their constituents or to gain power so they can get a piece of the action. The seemingly endless rotation of military coups and civilian governments in Nigeria is one example (Diamond 1993); Ghana during and after Nkrumah is another (Werlin 1979; LeVine 1989). Thus, in assessing the impact of corruption on political stability, it is important to distinguish between corruption and scandal (Johnston, chapter 3).

Corruption may be particularly dangerous and destabilizing during times of transition. During times of rapid change, the institutions that could control corruption may be weak or underdeveloped. Liberalization and deregulation of the economy, while helpful in the long run, may spur corruption in the short run if development of the institutional structure lags. And, if the gains of liberalization seemed to be skewed because of corruption, and corruption is associated with democratization and market capitalism, reforms become more difficult to implement and could even be short-circuited, as was feared might happen in Russia in its 1996 presidential election.

Distortion of International Trade and Investment

Most public statements about the evils of corruption include a reference to distortion of international competition and trade flows. Former US Trade Representative and Commerce Secretary Michael Kantor called corruption “a virus threatening the health of the international trading system” (Kantor 1996b). The United States has a particular interest in the impact of bribery on international transactions because of the perception that the US FCPA presents a significant competitive disadvantage for US firms competing with multinational firms from countries that do not penalize and may even implicitly encourage the use of bribes to win contracts abroad.

The net impact of corruption on trade is not clear, however. Bribes could lead to either an increase or a decrease in the volume of trade, depending on the circumstances. Although corruption may well affect the composition of trade, with regard to products and countries, it is not clear that focusing on corruption is a more effective policy response than focusing on the conditions that give rise to corruption or on the

observable policy outcomes that may be influenced by corruption. The following sections examine these questions and analyze the potential impact of the FCPA on US trade and investment.

Corruption as an Impediment to International Trade

The general aims of the international trade rules under the WTO are to remove impediments to trade and, to a lesser degree, investment, and to eliminate discrimination among member countries. Depending on the circumstances, however, corruption may either increase or decrease impediments to trade and investment. Impediments will be increased if corruption is out of control, too costly, or primarily in the form of extortion. Impediments might be lower if corruption is a second-best response to existing barriers or other distortions. Also, many procurement markets, such as aircraft, are sectors with economies of scale and imperfect competition, so corruption may redistribute economic rents but have little effect on global welfare.¹⁷ Moreover, while WTO rules are intended to constrain government trade policies, many instances of corruption subvert government policy. When illicit payments influence the outcome of government policy and lead to the creation of a new trade barrier or an illegal export subsidy, the existing rules will normally be sufficient to address the consequences.

Customs agencies are notorious for corruption in many countries. The net impact, however, is not obvious. Extortion of a shipper by customs officials, who, for example, threaten to allow a shipment of bananas to rot on the dock, could reduce the level of imports if the shipper is unable or unwilling to pay the bribe. But imagine an alternative scenario: suppose the exporter of the bananas offers a bribe if the customs official will lower the duty amount. In that case, rather than reducing trade, corruption might actually increase it (while lowering public revenues). And, since the anecdotal evidence suggests that tax evasion is perhaps the most common motive for bribery, it seems plausible that it might increase trade at the margin (Klitgaard 1988; Alfiler 1986). One would also expect that, the more restricted trade is, the more likely that an increase in trade will result from corruption.¹⁸ Either scenario could cause problems for firms prevented from offering bribes—whether from moral sensitivity or by the law. In either case, exporters of homogeneous or highly perishable products would be most vulnerable, those selling specialized and technologically sophisticated products less so.

17. See the discussion of these issues in Rodrik and Rauch (chapter 5).

18. See Wei (1997) for a discussion of the black market and the smuggling of cigarettes and other products into China.

In developing an appropriate international policy response, the impact on the policy of the countries involved also matters. Does corruption influence the formulation of policy and lead to discrimination against imports or foreign investment? Or does it subvert the government's declared policy and international commitments? In the first case, the injured WTO member may be able to use existing rules to challenge the discriminatory policy directly. For example, several US steel companies recently asked the Clinton administration to file a complaint with the WTO claiming that South Korean government subsidies to Hanbo Steel, allegedly influenced by bribes to government officials, had distorted world steel markets (*Journal of Commerce*, 21 February 1997, 3A). In other cases where corruption subverts government policy, and particularly where it deprives the government of customs revenue, the government has an incentive to act, and the problem may reflect inadequate government capacity rather than intent to discriminate.

If corruption affects primarily the allocation of trade flows and not the volume and if any resulting discrimination among suppliers is due primarily to differences in treatment of transnational bribery among exporting countries (rather than the importing government's policy), it might be more appropriate to analyze the problem as a potential export subsidy. As with other export subsidies, which are generally prohibited by the WTO, no exporter gains relative to another if equivalent subsidies are available to all. The prevention of subsidy wars is in fact the major incentive for countries to negotiate agreements to constrain themselves. But in the case of transnational bribery, where a major competitor, the United States, is unilaterally constrained by the FCPA, the incentive for other countries to enact controls is weaker. This has been a major source of concern and frustration for US policymakers and firms.

The FCPA as a US Export Disincentive

Following the corruption scandals of the 1970s involving illicit payments by US multinational corporations to both US and foreign politicians, there was some international discussion of bribery in the context of codes of conduct for multinational investors. However, these discussions did not result in much concrete action (see Pieth and Heimann, chapters 6 and 8). Only in the United States did the Congress pass legislation, the FCPA, which was signed into law by President Jimmy Carter in 1977, making it illegal for US firms to pay bribes to foreign government officials.

From the beginning, some US firms complained that the unilateral nature of the FCPA placed them at a competitive disadvantage relative to international firms based in other countries. In the 1988 Omnibus Trade and Competitiveness Act, Congress amended the FCPA with the

objective of reducing the burden of compliance. In that spirit, Congress also added a provision calling on the president to negotiate an agreement with other OECD members addressing transnational bribery. Little action was taken on the latter provision until President Bill Clinton took office in 1993 (see statement by Larson in appendix A). The attention given to the issue by the Clinton administration raises two questions: Why is international corruption suddenly so high on the US trade policy agenda? How significant a competitive disadvantage is the FCPA and how far should the United States go in addressing it unilaterally?

Why now? Not long after the Clinton administration entered office, Commerce Secretary Ron Brown launched a major export advocacy effort that eventually evolved into the “Big Emerging Markets” (BEM) strategy. As of 1996, the BEMs were considered to be Argentina, Brazil, Mexico, the Association of Southeast Asian Nations (Singapore, Indonesia, Thailand, Malaysia, the Philippines, Brunei, and Vietnam), the “Chinese Economic Area” (China, Hong Kong, and Taiwan), India, South Korea, Poland, Turkey, and South Africa (US Department of Commerce 1995). Comparing this list to table 2, one finds that the three largest BEMs, China, India, and Indonesia, along with the Philippines, are among the most corrupt of the 54 countries in the TI ranking. The TI rankings for Argentina, Brazil, Mexico, Thailand, and Turkey are also below the average score for the sample as a whole. The rankings for Taiwan and South Korea are at about average while Malaysia, Poland, and South Africa receive scores slightly above the average.

The administration also identified “big emerging sectors,” including energy, health care, information, and transportation, which are among those most likely to have a large degree of state ownership or regulation in many countries. Firms in several of these sectors were also reported, during an investigation by the US Securities and Exchange Commission (SEC) of illicit payments in the 1970s, to have made questionable payments to foreign public officials (Jacoby, Nehemkis, and Eells 1977, 141). (Although the FCPA had not yet been passed and these payments were not illegal under US law, the SEC was investigating whether false reporting of the payments could have misled investors or deprived them of pertinent information.) Of the 63 health care, drug, or cosmetics firms responding to SEC investigators, 29 reported making “questionable payments.” In addition, 31 percent of aerospace and 22.5 percent of air transport firms reported making such payments, while between 15 and 20 percent of the firms responding in office equipment, machinery, and electronics and electrical equipment admitted to making such payments. (Industry definitions can be found in Standard & Poor’s “Classification of Industries” published at that time.) A cursory review of press articles over the past two years reveals that the big emerging sectors—and the military equipment sector—are also where corruption has been most often exposed.

But present levels of exports to these countries and in these sectors do not tell the whole story. These markets were selected not just because they were big but also because they were among the most rapidly growing. The size and rapid growth of the BEMs mean that their infrastructure needs are enormous. The US Commerce Department has estimated that new infrastructure projects in Asia alone may be worth over \$1 trillion over the next decade, with perhaps another \$500 billion in such projects being launched in Latin America (US Department of Commerce 1995, 22). With sluggish growth in much of the rest of the world, competition for exports to and investment in the BEMs is expected to be intense. This was why Secretary Brown in a 1995 report on the topic suggested that the US and its major allies and competitors should consider developing

[a] framework for keeping competition in which governments themselves participate within bounds. That would mean taking a look together at all the tools which are being used, and trying to develop some rules of the game in terms of financing (including foreign aid), illicit payments and other kinds of arrangements which are being used to win deals (US Department of Commerce 1995, 45).

How important a competitive factor is the FCPA? For the FCPA to have an important overall effect on US sales abroad, at least the following three things would have to be true: all or most of the large markets in which US firms compete would have to be corrupt; evasion strategies would have to be difficult or nonexistent; and there would be no other offsetting factors.

Because of the nature of bribery, it is obviously difficult to estimate with much confidence the overall magnitude of the cost of corruption. The US Department of Commerce has estimated that bribes may have contributed to US firms losing some \$11 billion in contracts over the period from early 1994 to late 1996 (Trade Promotion Coordinating Committee 1996, 12). The department regards this as a low estimate, because this figure includes only the contracts that have come to light and because it excludes potential follow-on sales (for example, of replacement parts). There has been some confusion over the magnitude of these estimates, however, and it is difficult to evaluate their validity because the analysis on which they are based remains classified (see box 1).

Moreover, in evaluating the effects on US exporters it is also important to keep in mind the *net* effects. As long as there are some situations where it is not necessary to bribe—because government officials are honest or other safeguards are in place—it is possible that bribes shift sources and destinations around without substantially changing global market shares. In a study of the Institute for International Economics on self-imposed export disincentives, Richardson (1993, 131) concluded that “Across-

Box 1 \$45 billion or \$11 billion—more or less?

According to congressional testimony by then-Secretary of Commerce Ron Brown in October 1995:

Since the OECD approved recommendations to limit illicit payments in [April] 1994, the U.S. Government has learned of almost 100 cases of foreign firms using bribery to undercut U.S. firms' efforts to win international contracts worth about \$45 billion (Department of Commerce press release, October 12, 1995).

This testimony and a later speech by then-US Trade Representative Michael Kantor that also cited the \$45 billion figure received extensive press coverage (Kantor 1996a). The *Wall Street Journal*, for example, reported that "Mr. Kantor complained that U.S. companies . . . are losing some \$45 billion annually to foreign companies that use bribes to win business deals" (7 March 1996, A2; on the same date, see also *Journal of Commerce*, 2A, and *Financial Times*, 5). Kantor repeated the figure in a July speech and then added, "Already this year we have learned of about \$20 billion in additional lost contracts" (Kantor 1996b).¹

Examination of the *National Export Strategy* report that contained the \$45 billion estimate, however, shows that this is not the value of foreign contracts lost by US firms. Rather, it is the value of the "nearly ninety cases" in which foreign firms are alleged to have offered bribes while in competition with US firms for contracts (Trade Promotion Coordinating Committee 1995, 35). The report continues:

Of these ninety cases, the U.S. firms have already lost more than twenty contracts—worth almost \$7 billion—at least in part because of the bribes paid by their competitors [emphasis added].

With regard to the sixty or so other contracts, worth \$38 billion, apparently the reason the contract was lost is unknown or contract negotiations have not concluded. The 1996 *National Export Strategy* report alleged there were 139 contracts worth \$64 billion where bribes were offered, with estimated US losses in 36 cases worth \$11 billion. The TPCC regards this estimate as low because "these figures represent only those cases which have come to our attention" (1996, 113).

Unfortunately, the *Foreign Competitive Practices Report* remains classified.² It is extremely difficult to judge the validity of any of these estimates without access to the underlying analysis or at least some idea of the methodology. Further complicating the issue, a preliminary (and apparently unpublished) Commerce Department summary of the review of bribery cases says that about half of them involved defense contracts. Given the political nature of most large sales of military equipment, it is even more difficult to determine the relative impact of bribes vis-à-vis other factors in these sales. It is also unlikely countries would ever agree to subject military sales to open, competitive bidding or that defense contracts will ever be decided on purely, or even primarily, economic grounds.

The raw figures must be put in context. Both the 1995 and 1996 reports conclude that firms offering bribes typically win 80 percent of contracts. But that figure is difficult to assess without knowledge of the percentage of contracts won by US or other firms when no bribes were offered. To provide some sort of baseline, the US share of total world exports in 1994 was about 12 percent; its shares of world exports of power-generating machinery and equipment (SITC 71) and aircraft and parts (SITC 792), two sectors thought to be plagued by corruption, were 21 percent and 40 percent, respectively (Statistics Canada 1996). The TPCC reports also emphasize US government actions to overcome these problems: the 1996 report claims that US government advocacy efforts over the previous two plus years had helped US firms win 230 contracts worth \$40 billion (88).

1. Kantor succeeded Brown as Secretary of Commerce following Brown's death on 3 April 1996.

2. According to the *Wall Street Journal* (12 October 1995, A3) the report was compiled with the help of US intelligence agencies and contained "hundreds of examples of bribery and legitimate—often government-assisted—export promotion."

the-board regulatory burdens, such as procedures mandated for all businesses by the FCPA, seemed generally unimportant.”¹⁹

Another widely cited study of the effects of the FCPA on US foreign direct investment and exports of aircraft did find a statistically significant negative impact on these variables following passage of that law in 1977 (Hines 1996). But the analysis is of the period immediately following passage of the original FCPA so it would not capture possible offsetting effects following the 1988 amendments or other possible adaptations by American firms (see below). Using a more recent and possibly more reliable data set, Wei (1997) finds that corruption on average has a depressing effect on foreign direct investment. But he finds no differential impact on US investors. Multinational firms in other countries apparently are just as cautious as are US investors when it comes to risking their capital in nations where corruption is widespread.

Even if past competitive effects have been limited, however, some of the fastest-growing markets and most lucrative project opportunities are in emerging markets, many of which have also been judged relatively corrupt. Thus, there will now be more demand for corruption-prone types of exports and contracts in more corrupt countries. A second source of growing concern for US exporters might be in the nature of the financing available for these projects. The World Bank and other official financial institutions, international and domestic, usually require international competitive bidding and the right to review contract awards before disbursing funds. A decade ago, the official development finance was 1.7 times greater than foreign private capital flows for developing countries (\$36.7 billion versus \$21.4 billion). In 1995, that relationship had roughly reversed, with private capital flows exceeding official flows by 60 percent (\$78.7 billion private versus \$48.6 billion official). With a greater number of large projects being financed by the private sector, it is possible that the bidding process could become less transparent and more vulnerable to corruption (World Bank 1996d, 35).²⁰

19. This conclusion was based on an analysis of the impact of the regulatory costs of compliance with the FCPA, i.e., of the additional accounting and auditing costs of the disclosure requirements, and not the potential effects on competitiveness of being restrained from bribing in markets where competitors in fact do. Richardson's broader finding of little impact was based on the source-shifting behavior described above and on the fact that no firm interviewed by him mentioned the inability to bribe as a competitive disadvantage.

20. A second potential source of protection for US exporters when official finance is involved is the concern of the World Bank and other international financial institutions that the shares of officially funded procurements that supplier countries receive are not too out of line with their financial contributions to the organization. For example, the US share of World Bank payments to supplier countries for foreign procurements is roughly 19 percent (both for the 1996 fiscal year and cumulatively), slightly above its current quota of 17.4 percent (World Bank 1996a, 225, 239).

Just the same, the prohibition against bribing foreign officials may not be as great a handicap for US firms as has been claimed. Some firms have used the FCPA as a shield to protect themselves from extortion by corrupt foreign officials. George David, president and CEO of United Technologies Corporation, indicated at a meeting on ethics in 1993 that following a crackdown on illicit payments by a subsidiary in Mexico, not only were market share and profitability maintained, but the firm was “able to shorten [its] long, long overdue collection period on government receivables in one of the more notorious problem countries” (David 1994, 8). Just as a reputation for honesty may serve as a shield, a reputation for being willing to pay bribes may open one’s firms to ceaseless demands for more. Some China observers note that whereas honest operations may be more challenging and time-consuming, they may avoid trouble in the long run (Ettore 1994, 21; see also Givant 1994). In another example, Colgate-Palmolive was reported to have used the FCPA as a shield to avoid paying bribes or being forced to engage in “nepotistic employment” practices while building a \$20 million operation in Guangdong Province in 1992 (Pines 1994, 210-11).

Also, where bribes are an additional operating cost (as opposed to being offered to win a contract or other business), firms that can avoid internal corruption among employees and external corruption among suppliers, distributors, customers, and regulators should be relatively more cost-efficient and competitive. Furthermore, if corruption is as common as alleged, the losers must be paying bribes for nothing, further raising costs. Pines (1994, 211-12) notes that, because they lack access to reliable information, some firms may overpay or pay someone who fraudulently claims to have the “right connections.” The perception that contracts can only be won through bribery could also result in reduced innovation and laziness on the part of some firms. Pitman and Sanford (1994, 18-19) argue that the FCPA could have offsetting benefits because it “mandates that [firms] find other, more effective methods to ‘get the job done’ when they previously may have thought bribery was their only option.”

At the other end of the spectrum, some companies may decide to ignore the FCPA and risk getting caught. Lockheed Corporation (now Lockheed Martin Corp.), whose bribery of Japanese politicians in the 1970s brought down a government and contributed to the passage of the FCPA, pleaded guilty in 1995 to bribing an Egyptian official to win an aircraft supply contract (*Wall Street Journal*, 29 September 1995, 1). In early 1996, two other large US multinationals were under investigation for possible violations of the FCPA, but nearly a year later, charges had not been brought (*National Journal*, 20 April 1996, 871).²¹

21. As of early April 1997, the US Justice Department declined to confirm or deny whether the investigations were taking place. In March, however, following settlement of an FCPA

But there are also other, less risky methods of evasion. Among other changes, the amendments to the FCPA in the Omnibus Trade and Competitiveness Act of 1988 explicitly defined allowable facilitating payments for “routine governmental” services (licenses, permits, paper processing, provision of police protection, other government services) and created two affirmative defenses: that the payment is legal in the country where it occurs; or that the payment was for “reasonable and bona fide expenditure” such as travel or lodging for training or other trips abroad for government officials. According to a source at the US-China Business Council, “You’d think Disney World was a training site” (*Wall Street Journal*, 29 September 1995, 1; see also *New York Times*, 12 April 1996, A10). Wei (1997, 5n) also reports that conversations with Chinese businessmen and officials suggest more subtle, possibly legal forms of influence, such as study trips for officials to tour a foreign country, are more commonplace than outright bribes.

Finally, the aggressive advocacy and export promotion efforts of the Clinton administration can provide at least partial and, perhaps, temporary offsets for any hypothetical disadvantage posed by the FCPA.²² For example, although the Middle East is widely thought to be one of the most corrupt regions in the world and aircraft one of the sectors most vulnerable to distortion by bribery, President Clinton’s personal intervention in 1995 helped to clinch the sale to Saudi Arabia of \$6 billion in commercial aircraft for Boeing and McDonnell Douglas. At the time, presidential spokesman Michael McCurry was quoted as saying that the President was not at all hesitant in using his influence to “go to bat for American companies” (*International Trade Reporter*, 1 November 1995, 1824; *Wall Street Journal*, 18 December 1995, 1). The 1996 national export strategy report claimed that US government advocacy efforts had helped US businesses to make deals worth over \$40 billion, nearly four times more than the value of contracts allegedly lost to bribery (Trade Promotion Coordinating Committee 1996, 89).

Whatever the current or anticipated impact, the Clinton administration has stepped up efforts to get other countries, particularly OECD member states, to take action against transnational bribery. In 1996, the Department of Commerce revised its “advocacy guidelines” to buttress the FCPA and to ensure that US-based firms and especially subsidiaries

case with Triton Energy over questionable payments by its Indonesian subsidiary, the head of enforcement for the Securities and Exchange Commission, William McLucas, expressed concern that bribery of foreign officials might be becoming a significant problem for the first time since the FCPA was passed (*Bloomberg News*, 5 March 1997).

22. Some American businessmen and government officials argue that the United States lags behind other countries in these other forms of export promotion, so there is little or no counterweight to the disadvantage posed by the FCPA. See the Trade Promotion Coordinating Committee’s report on *National Export Strategy* (1996).

of foreign-owned multinationals would not benefit from US export promotion programs if they or any part of their worldwide corporate family engaged in bribery. The new requirements state that for US-based subsidiaries or affiliates of foreign multinationals to qualify for US government support when bidding on an international contract, the parent corporation must actively enforce a policy prohibiting the bribery of foreign officials (Trade Policy Coordinating Committee [TPCC] 1996, 119-122).²³ The Export-Import Bank (Eximbank) and the Overseas Private Insurance Corporation (OPIC) also increased their reporting requirements for beneficiaries of their programs. US subsidiaries of foreign-owned companies are already covered by the FCPA. The major aim of the changes in the advocacy guidelines is to put pressure on their overseas parent corporations to adopt stronger policies against bribery.

Some American policymakers have advocated even stronger unilateral action. One proposal, going beyond the augmentation of reporting requirements, would have explicitly *conditioned* eligibility for assistance from the Eximbank or OPIC on the adoption and enforcement of an antibribery policy by the corporate parent. That position was rejected as overly intrusive in the affairs of recipient countries who would also be party to the contract. Potentially more controversial were the oft-voiced hints dropped by Michael Kantor when he was Secretary of Commerce, and earlier as US Trade Representative, that transnational bribery would be defined as an unfair foreign trade practice constituting grounds for retaliatory sanctions under section 301 of US trade law (see for example, Kantor 1996a).

In sum, there is little evidence that the FCPA has a major negative impact on overall US exports. The impact on particular sectors is more significant, and given the potential for more than \$1.5 trillion in infrastructure projects in Asia and Latin America over the next decade, US firms in these sectors have reason to be concerned about possible distortions from bribery. With globalization and democratization making corruption less and less acceptable around the world, however, US firms that have been forced by the FCPA to become more innovative and aggressive should be well placed to reap the benefits. The FCPA could also be a competitive advantage in some newly democratizing countries where politicians or public officials concerned about negative publicity might prefer a US firm because they can more credibly claim that no corruption was involved. For these reasons, and also because meaningful international action against corruption will require cooperation from other governments, the United States should avoid aggressive unilateral actions in this area (see also Heimann, chapter 8, and Pieth, chapter 6).

23. According to the TPCC report, government support in this context “can take the form of letters, representations, or other interventions by US officials” (1996, 119).

Domestic and Institutional Reforms to Control Corruption

Just as the most important sources and consequences of corruption are internal to countries, the fundamental reforms that will most effectively reduce it over time must take place at the national level in the countries where it occurs. And since the specific sources, types, and consequences of corruption vary widely among countries, no simple prescription will fit all cases. Each country must individually identify the most important sources of corruption and the consequences that most cry out for attention. Nevertheless, any analysis of remedies to corruption must begin with its broad underlying sources: restricted economic and political competition, excessive bureaucratic or political discretion, and a lack of transparency and accountability. This section examines how broad-based economic and political reforms can reduce the opportunities for corruption, as well as how these reforms must be supplemented by institutional reforms to improve governance and state capacity to sustain reductions in rampant corruption.

Macro Reforms and Their Limits

Reforms that open up and liberalize the economy and increase competition, by, for example, lowering trade barriers, reduce the opportunities and the pool of rents available for bribery. Economic reforms that eliminate unnecessary regulations and simplify essential ones reduce the power and discretion of public officials, thereby removing opportunities for extortion. Political reforms that give more power to citizens as voters and as users of public services and endow the media with greater freedoms make corruption riskier and increase both the chances of detection and the potential penalty for politicians who get caught. In the long run, all of these reforms should limit the opportunities and incentives to engage in corrupt behavior.

In the short run, however, the balance between political and economic reforms, the sequencing of particular reforms, and the priority given to implementing corollary institutional reforms will determine whether corruption can in fact be reduced. The transfer of state-owned enterprises and other assets to the private sector illustrates many of the pitfalls awaiting would-be reformers. Privatization (or deregulation) in a situation where there is an underlying market failure or the market is not competitive may not result in net gains for social welfare. For example, corruption may be eliminated only to be replaced by private-sector collusion (Rose-Ackerman, chapter 2). When the privatization process itself is corrupt, state enterprises or other public resources may go not to the most competitive bidder but to favored insiders.

Whether ownership is public or private, the incentives persist to maintain rents in the form of direct subsidies, import protection, or other restrictions on competition. The technocratic policymakers in Indonesia were reported to have slowed down the pace of privatization of state-owned enterprises there because of concerns they would be bought up by cronies of Prime Minister Suharto who would then seek special favors such as continued import protection or subsidized access to credit (Schwarz 1995, 148). As Klitgaard (1988, 67) points out, whether a certain activity takes place in the public or private sector is not the issue; rather, whether it takes place in an environment of “*competition and accountability*” is what really counts (emphasis in original).

Perceptions that privatization and other reforms favor certain parties may feed public suspicions about market-oriented reforms and undermine their public support. Opposition parties and political dissidents may use corruption as an excuse to try to reverse reforms. In Russia and other parts of the former Soviet Union, the virulent and chaotic forms of corruption spawned by systemic collapse threaten to undermine the transition of those countries to more open political and economic systems. Rampant tax evasion has left the government unable to pay pensions or workers in the remaining state-owned enterprises, and the conspicuous consumption of those with new wealth also contributes to the nostalgia of some segments of the population for the days of stable Communist Party rule.

Thus, political and economic opening may expose old ways of doing business and open up possibilities for reform, but they may also introduce new opportunities for corruption and bring new players into the game. The *Wall Street Journal*, for example, reported that the movement toward freer markets and democracy in Latin America had also “democratized” corruption and that the inflows of capital following economic liberalization raised the incentives for corruption (1 July 1996, 1). Moreover, even successful economic reforms do not obviate the need for government entirely; the need to raise taxes, provide benefits, and regulate in many areas of public interest will persist. Micro reforms to strengthen government and social institutions must therefore accompany the macro reforms.

Reforming Institutions and Building State Capacity

Even under the best of circumstances, democratization and economic liberalization take time to consolidate. Naím (1995b, 8-11) in looking at the process of economic liberalization and Charlick (1992, 178) in focusing on democratization emphasize the importance of strengthening state capacity and improving governance to reduce corruption and consolidate reforms. Crucial areas for improved governance include civil service

reform; greater tax collection capacity; and reforms to increase the capacity, independence, and honesty of the judiciary. Naim calls these “Stage II” reforms. Analysts who have focused closely on the need for institutional reforms emphasize the need to reduce inequities in access to information asymmetries and the need for changes in incentive structures. Improved information gathering allows agency leadership to acknowledge honest bureaucrats and investigate and punish dishonest ones.

Klitgaard (1988) analyzes several cases of efforts to reduce corruption and derives lessons for reformers. His most detailed case study concerns the efforts of Justice Efren Plana to reduce rampant corruption in the Philippines Bureau of Internal Revenue. In addition to improving information collection and creating an incentive structure to reward performance, Klitgaard recommends punishing “big fish” (i.e., prominent, high-level corrupt officials) to obtain a maximum demonstration effect. The big-fish tactic sends a signal of seriousness and lends credibility to anti-corruption reforms. Box 2 summarizes other recommendations for improving information flows and changing incentives. Rose-Ackerman (chapter 2) offers similar recommendations for institutional reform, and as elsewhere (1978), she emphasizes the deterrent benefit of escalating penalties in proportion to the size of the bribe in the case of public employees and in proportion to the value of illicit gains in the case of the briber.

The benefits of incorporating transparency and accountability in the reform process are highlighted in Oldenburg (1987), who studied the example of a land consolidation program in India. The program, which sought to increase agricultural efficiency by consolidating scattered plots claimed by a single owner, seemed vulnerable to bribery that would influence outcomes. Yet it seems to have been largely free of corruption. Oldenburg attributes this in large part to the openness integrated into the program design. The proceedings were conducted largely in the villages with the participation of affected farmers. According to Oldenburg, “All proceedings [were] open and well publicized, and the records [were] open” (1987, 516). Moreover the farmers were given the right to appeal decisions, enhancing accountability by forcing officials to justify their decisions.

The importance of the right of appeal in making anticorruption reforms work underscores the need to create and maintain an honest and independent judiciary. If not addressed, judicial corruption could facilitate corruption elsewhere in the system by protecting restricted economic or political competition. It would almost certainly impede cleanup efforts if not dealt with because whistle-blowers would otherwise have no protection, reform-minded officials could be harassed, businesses suffering from discrimination would have no recourse, and corrupt officials and business people would not have to fear punishment. An honest judiciary could also provide recourse for third parties suffering the

Box 2 Using information and incentives to control corruption

Improving information gathering and analysis to detect and deter corruption

- Assess the organization's vulnerability to corruption and identify particular areas of concern.
- Look for evidence of corruption (red flags, including lifestyles more lavish than honesty would allow, random inspections, and statistical analysis).
- Increase access to information by opening channels to third parties (media and banks), clients, and the public.
- Strengthen internal "information agents" (auditors and investigators) and protect whistle blowers.
- Create specialized units or agencies (ombudsmen and anticorruption commissions).

Changing incentives to discourage corruption

Increase the rewards for honesty:

- Raise low-end salaries to reduce the need for illicit supplements.
- Introduce merit pay and incentive schemes that reward honest and efficient service, including nonmonetary rewards (for example, desirable transfers, training, travel, publicity, and praise).
- Use contingent contracts (for example, nonvested pensions for public employees and performance contracts for private contractors).

Increase the penalties for corrupt behavior:

- Raise the level of formal penalties. Where that is not possible (for political or other reasons), use nonformal penalties (for example, undesirable transfers, negative publicity, loss of professional standing, and blackballing).
- Increase authority to impose punishment.
- Link the penalty to the expected gain from corruption (the size of the bribe for the public employee; the size of the expected illicit profit for the briber).

Source: Adapted from Klitgaard (1988, 94-95) and Rose-Ackerman (1978).

consequences of corruption; for example, individuals injured when an unsafe building collapses. Thus, judicial reform should receive priority attention from anticorruption campaigners in countries where the judiciary is itself corrupt.

Changes in regulation, tax collection methods, and provision of benefits can reduce opportunities for corruption by reducing bureaucratic discretion (Rose-Ackerman, chapter 2). The adoption of more market-oriented methods of regulating private economic activity, for example auctioning pollution rights rather than setting limits by administrative fiat, often enhance efficiency and may also have antibribery benefits.²⁴

24. This is an additional argument in favor of auctioning import and export quota licenses, though the authors of an Institute study on that topic did not recognize it at the time. See Bergsten, Elliott, Schott, and Takacs (1987).

Increased user fees for scarce government services could also address the excess demand problem that sometimes results in covert payments to affect the distribution of government benefits.

Just as corruption has costs, however, so does fighting it. As noted by Rose-Ackerman (chapter 2),

Corruption can never be entirely eliminated. Under many realistic conditions, it will simply be too expensive to reduce corruption to zero. Furthermore, a single-minded focus on corruption prevention can have a negative impact on personal freedoms and human rights. Such a focus could produce a government that is rigid and unresponsive.

Reducing corruption takes real resources, for example to make civil service salaries and benefits competitive with the private sector or for monitoring and enforcement activities. Living beyond one's (apparent legal) means is frequently cited as potential evidence of illicit enrichment that should be grounds for investigation and prosecution of corrupt officials, but Moisés Naím has warned that witch hunts against public officials can precipitate the loss of some of the best talent in countries that can ill afford it. Overzealous anticorruption efforts may have other indirect costs, such as decreased morale among public employees or impaired government functioning because of too little discretion and overcentralization (see also Klitgaard 1988, 24-25). Thus, costs must also be considered in the development of anticorruption strategies and the selection of particular tactics.

Supporting Internal Reforms: The Role of the International Financial Institutions

The World Bank, International Monetary Fund (IMF), regional development banks, and bilateral aid agencies can lend valuable support for anticorruption efforts in a variety of ways. In the past, the World Bank and the IMF felt constrained in addressing corruption and other sensitive issues because of the requirement that they not interfere in members' internal political affairs. But both institutions, as well as other multilateral development banks (MDBs), have increasingly recognized the importance of governance issues in attaining development objectives. For the first time in public, Bank President James Wolfensohn and IMF Managing Director Michel Camdessus explicitly broached the issue of corruption in speeches at the joint annual meetings of their agencies in Washington in October 1996.

At the request of a member government, these agencies provide advice, technical assistance, and financial support for institutional and policy reforms that often help to reduce corruption either directly or indirectly. The contribution of the IMF comes primarily from the conditions it generally attaches to its loans, which encourage economic liberalization and,

implicitly, reductions in the opportunities for corruption. The World Bank provides financial and technical assistance that can contribute more directly to both institutional reform and development in countries that need and desire such assistance. The argument has been put forth that lending be explicitly conditioned on efforts in borrower countries to reduce corruption, but this suggestion is more controversial.

The primary objective of IMF-sponsored programs is usually macroeconomic stabilization. In this context, the IMF urges national governments to reduce their interventions in the economy by reducing trade barriers, liberalizing financial markets, freeing up other prices, ending subsidies for food and other necessities, and privatizing state-owned enterprises (or at least cutting subsidies to them), among other measures. Whatever their other effects, these reforms also tend to reduce the opportunities for corruption.

But the central plank of most stabilization agreements is some measure of fiscal austerity, which may have unanticipated consequences if not handled carefully. One result of the combined inflation and policy-inspired squeeze on the public sector that occurred in many countries during the debt crisis of the 1980s was a large reduction in the real wages of public sector employees. These reductions, in turn, led to increased pressure to engage in bribery (Ul Haque and Sahay 1996; Klitgaard 1988, 1997). When corruption is widespread in revenue collection agencies, as often occurs, a vicious cycle emerges in which austerity increases the incentives for corruption, which reduces government revenue, thereby leading to further austerity measures. Of course, governments can lower their total payroll costs by reducing the number of employees while maintaining the real wage level, but it is often more expedient not to act and simply allow inflation to erode wages. The IMF cannot and should not dictate exactly how a country achieves its fiscal targets, but it should work with borrowers to ensure that its recommendations do not make a bad situation worse.

The World Bank can more directly support anticorruption efforts because it provides lending for specific projects, in addition to providing resources for structural adjustment.²⁵ In a background paper circulated at the 1996 annual meetings, the World Bank identified key areas where it is contributing to anticorruption reforms:

- support for and technical assistance in implementing *economic reforms* to reduce rent-seeking in the tax and regulatory areas, and to privatize state-owned enterprises or strengthen their regulation in uncompetitive markets and

25. The World Bank's rules intended to prevent corruption in government procurement in relation to the projects that it funds are discussed in more detail in the next section.

- support for *institutional reforms* in the areas of government financial management (budgeting, accounting, and auditing systems); civil service reform; government procurement; and governance more broadly.

As one aspect of improved governance, the Bank is also supporting innovative programs, such as training workshops for journalists conducted in some countries by the Economic Development Institute (EDI) (World Bank 1996c). EDI has also worked with Transparency International (TI) to support establishment of “national integrity systems” in Tanzania and Uganda and to disseminate TI’s “Source Book” for building such systems (United Republic of Tanzania 1995; Transparency International 1996). The Source Book discusses the role in combating corruption played by civil society, the press and the importance of judicial, legislative, and administrative reforms that would heighten monitoring, protect whistleblowers, and promote open and transparent procurement systems and self-policing by the private sector.

The World Bank is also supporting the “Partnership for Capacity Building in Africa,” which was instigated by the Bank’s African Governors at the 1995 Annual Meetings with the goal of “strengthening or improvement of people, institutions and practices that enable countries to achieve their development goals” (World Bank Press Release, 28 September 1996). Even if not explicitly aimed at it, such capacity building should have anticorruption benefits. The World Bank also has increased its focus on human capital development and social spending (education and health), especially as private capital markets assume a larger role in financing large infrastructure projects. If Mauro’s conclusion (chapter 4) that corruption is negatively correlated with government spending on education is borne out by further research, then increased international funding for education could help to offset the effects of corruption. Case studies indicate that illiteracy among government constituents facilitates petty corruption, so increased spending for education can help reduce such abuses.

Finally, some observers suggest that the World Bank and the regional development banks make reduction of corruption an explicit part of their conditionality. Certainly, the World Bank, the other MDBs, and the IMF should be less tolerant than they have been in the past toward corrupt governments. According to a detailed report in the *Financial Times*, the IMF, under pressure from the United States and other Western governments, lent Zaire more than \$1 billion in the 1980s *after* receiving a report from a senior IMF official warning that Mobutu Sese Seko’s government was completely corrupt (12 May 1996, 1-2). Total multilateral lending to Zaire between 1982 and 1994 totaled nearly \$2 billion. With the obvious exception of procurement rules, however, it is not clear that it is either necessary or helpful to bring corruption explicitly into the general conditions attached to development assistance. How

would corruption be defined and how would reductions be observed and measured? Where procurement rules and auditing procedures effectively insulate Bank projects from corruption, should lending be cut off because of corruption elsewhere in the government? If corruption does not obviously interfere with economic performance or the adoption of reforms is it a legitimate concern of these institutions? Given that pervasive corruption usually has an adverse impact on economic performance, is it necessary to introduce explicit conditionality in this area?

Even without explicit conditionality, the Bank has increasingly been emphasizing governance issues, including corruption, in its lending policies and in its policy dialogues with borrower countries. "Country Portfolio Performance Reviews" are conducted annually in most countries and focus on obstacles to the implementation of Bank projects (World Bank 1994, 38). "Country Assistance Strategy" (CAS) statements engage the Executive Board as part of the process of reviewing overall lending strategies in each country. The intent of these statements is to ensure that implementation problems "are taken into account in decisions on the volume and composition of lending." An analysis of a representative sample of 40 such statements in 1994, however, revealed that treatment of governance issues was generally restricted to the fairly narrow area of public sector management. Transparency, accountability, and issues concerning the rule of law were rarely raised in the statements reviewed (World Bank 1994, 38). For these reviews and assessments to be effective tools, however, the Bank must follow through by reducing or suspending assistance when corruption interferes with project implementation or broader development objectives. In these cases, however, the reason for interrupting lending programs is the impact on development goals, not the corruption per se.

The Role of Leadership

Finally, Ruzindana addresses the role of leadership (chapter 7). In his words, "corruption cannot exist without the connivance of the political leadership, even if passive." It is possible to have limited anticorruption reforms even when serious corruption involves top leadership, but political support is still required. Klitgaard's case study of the Philippines Bureau of Internal Revenue illustrates the potential for successfully tackling corruption despite otherwise rampant corruption at the top of the Marcos government (1988, chapters 2 and 3). Yet Marcos still appointed the anticorruption judge who cleaned up the agency and supported him when he punished high-level corrupt officials. Thus, even incremental steps require at least minimal political support.

With the political and economic reforms that are occurring around the world, however, such leadership should be more forthcoming. Moreover,

leadership need not always be imposed from above; it can also come from below. In addition to top-level leadership, Ruzindana (chapter 7) emphasizes the role of civil society and the need to educate the public, to strengthen grassroots groups, and to protect and strengthen a free and independent media. These activities may be supported by the international community, but they must be homegrown to be effective.

International Initiatives to Combat Corruption

Corruption's effects on economic development and political legitimacy spill over a given country's borders, affecting global peace and prosperity. Thus, it is natural that corruption concerns the international community as a whole, just as distortions in international trade and investment flows are also concerns. The most important role of the international community is the one described above of providing financial and technical support to countries undertaking difficult anticorruption reforms.

Other international anticorruption initiatives focus on the role of multinational corporations in offering bribes and the impact on international transactions, particularly government procurement, where the public and private sectors do business directly. Potentially, the most important are the efforts in the OECD to deter and punish transnational bribery. Pieth (chapter 6) discusses the evolution of these efforts in detail, while recent breakthroughs are summarized below. Also discussed here are the Inter-American Convention against Corruption approved by the members of the Organization of American States (OAS), which includes measures to promote cooperation among member states in enforcing anticorruption laws and recent efforts by the World Bank and World Trade Organization to restrict the opportunities for corruption in government procurement contracts. Highlighting the need to address both supply and demand, the UN General Assembly approved a resolution in December 1996 calling on members to take "concrete action" against all forms of corruption. The nonbinding UN declaration incorporates elements of both the OAS Convention and the OECD recommendations discussed below. Some countries have proposed resuming negotiations on a universal anticorruption treaty under UN auspices, but little progress has been made to date and UN action on this issue remains primarily rhetorical.²⁶

Corruption also raises global concerns because of how it facilitates

26. Some European countries that have been resisting strong action against transnational bribery in the OECD proposed universalizing the negotiations in the UN, reportedly in the hope that they would become bogged down as they did in the 1970s. For a brief history of the earlier UN negotiations, see Pieth (chapter 6).

international criminal activity, particularly drug trafficking and money laundering. Money laundering can have significant collateral economic effects and the liberalization of financial markets around the world has contributed to its spiraling growth. Nevertheless, the primary locus of concern is the criminal activity that spawns these activities and, while a reduction in corruption would clearly help, the primary policy responses must still focus on law enforcement, financial market regulation, and drug-addiction treatment.²⁷ Those issues are not addressed in this volume.

The Inter-American Convention Against Corruption

One of the striking things about the OAS anticorruption initiative is the leading role played by several South American countries in advancing the process. The first steps were taken in March 1994 when President Clinton invited heads of state in the Western Hemisphere to a summit to discuss strengthening and consolidating democracy and promoting economic growth in the region. Anticorruption action was an important American objective for the summit, but President Clinton initially spoke of the need for improved governance in the hemisphere without making explicit mention of corruption (Clinton 1994). Inclusion of an explicit anticorruption initiative on the summit agenda was then promoted by Ecuadorian Vice President Alberto Dahik, who was the chairman of the Advisory Council of Transparency International (TI) at the time, and Venezuelan President Rafael Caldera, who attributed the bank failures and financial crisis that struck his country shortly after he took office in 1993 to the corruption of his predecessors.²⁸

At the Summit of the Americas held in Miami in December 1994, the leaders of 34 Western Hemisphere countries (all but Cuba) agreed on a "Declaration of Principles" and a "Plan of Action" for strengthening and expanding cooperation and economic integration in the region (Feinberg 1997). The portion of the plan of action that addresses measures to

27. The *Financial Times* recently reported that global earnings from organized crime, mostly from drug trafficking, reached an estimated \$1 trillion in 1996 (14 February 1997, 1). See Pieth (chapter 6) for a brief discussion of the Financial Action Task Force, which was established in 1990 to address money laundering of criminal proceeds. For analysis of the sources, scope, and potential threat to macroeconomic and financial market stability from money laundering, see Quirk (1996) and Tanzi (1996). For discussions of international organized crime and US policies on international drug trafficking, see Raine and Cilluffo (1994) and the Council on Foreign Relations (1997), respectively.

28. See Transparency International (1995) and Andres Oppenheimer in the *Miami Herald*, 4 December 1994. Ironically, Vice President Dahik is now in exile in Costa Rica, having fled Ecuador to avoid prosecution on charges of corruption. Dahik claims that the corruption charges are simply part of a political vendetta against him.

strengthen democracy included an initiative against corruption.²⁹ Although this initiative listed several steps that countries should consider taking to combat corruption and improve governance, including potentially far-reaching institutional reforms, the initial focus was on the provision calling for development within the OAS of “a hemispheric approach to acts of corruption in both the public and private sectors that would include extradition and prosecution of individuals so charged.” The leaders also called on “the governments of the world to adopt and enforce measures against bribery in all financial or commercial transactions with the Hemisphere.” At the urging of the United States, the leaders also included a suggestion that the OAS establish a liaison with the OECD Working Group on Bribery in International Transactions.

The resulting Inter-American Convention against Corruption was adopted 29 March 1996 in Caracas, a little more than a year after it had been proposed. It was signed there by representatives of 21 countries in a special session. The United States signed before the OAS General Assembly in Panama the following June, after the treaty had been thoroughly examined by the US Justice Department. The principal provisions of the convention require adherents to criminally sanction bribery, transnational bribery, and “illicit enrichment,” and to cooperate with one another in the investigation and prosecution of acts defined as corrupt in the convention, through extradition and assistance in recovering illicitly acquired property or wealth. The convention also discourages the use of bank secrecy laws as the basis for withholding cooperation from investigations of corruption.

The key provision from the US perspective is Article VIII, which effectively internationalizes the FCPA by requiring parties to the convention to make it a crime to bribe foreign public officials. Article IX requires each member state to “establish under its laws as an offense a significant increase in the assets of a government official that he cannot reasonably explain in relation to his lawful earnings during the performance of his functions.” This provision has been depicted as an essential tool in combating a phenomenon cloaked in secrecy and deception. But it was also the most troublesome for US negotiators and prevented the United States from immediately signing the convention in Caracas. Although implementation is subject to the Constitution and fundamental legal principles of each member state, the US Justice Department wanted to ensure that the language did not conflict with the US Constitution and legal tradition that the accused is innocent until proven guilty.

Thus, the focus in the convention is on criminal sanctions and enforcement. Though the scope for an international role is limited, corollary domestic and institutional reforms are still rather weakly dealt with

29. For more detail on the convention and its negotiation, see Elliott (1996).

in the convention. Article III refers to “preventive measures” that members “agree to consider . . . within their own institutional systems.” These measures include standards of conduct for public officials, “mechanisms to enforce these standards,” and strengthening government procedures in the areas of hiring, government procurement, and tax collection. Signatories also agree to consider “whistle-blower” protection and “oversight bodies with a view to implementing modern mechanisms for preventing, detecting, punishing, and eradicating corrupt acts.” Article III notes the need for “mechanisms to encourage participation by civil society” and NGOs and the “study of further preventive measures that take into account the relationship between equitable compensation and probity in public service.” These domestic reforms are crucial if the convention is to be an effective anticorruption instrument. Unfortunately, there are no follow-up measures specified in the convention to support or monitor the implementation of these reforms.

As of the end of 1996, only a handful of countries had ratified the OAS convention, and the Clinton administration had not yet submitted it to the US Senate. OAS Secretary General César Gaviria has suggested that the OAS could assist in the drafting of “model laws” aimed at detecting and punishing corruption and at modernizing the state in ways that reduce the opportunities for corruption. To this end, Gaviria has also suggested that the OAS encourage “horizontal cooperation and exchange of experience in the area of combating corruption and set up a data base of success stories in this field” (Gaviria 1995). The Inter-American Development Bank has also identified ways in which it can support anticorruption efforts, in particular its support of judicial and civil service reforms in the region.

The Inter-American Convention against Corruption is the first document of its kind, codifying anticorruption measures in a treaty reached by both developed and developing countries. If the potential is to be realized, however, a number of steps must be taken. First, the United States should set an example by quickly ratifying the convention. In a recent speech, US Ambassador to the OAS Harriet Babbit said that she hoped to see ratification before the end of the year, that is, about 18 months after it was signed. At the time of her remarks, only Paraguay and Bolivia had submitted instruments of ratification to the OAS. The United States should move as rapidly as possible toward ratification and, along with Secretary General Gaviria, should encourage all OAS members to ratify the convention prior to next year’s summit in Santiago, Chile.

Second, greater attention to other implementation issues is needed. Secretary General Gaviria’s commitment to having the OAS monitor and review implementation, which was not explicitly mandated in the convention, is a useful demonstration of his overall support. His first report on the implementation of the convention is due to be presented to the

General Assembly in 1997. It will be the first indication of how effective the OAS can be in this area. The technical assistance and financial support of the Inter-American Development Bank will also be helpful in meeting the challenge of far-reaching domestic reforms that will be necessary in some countries.

Controlling the Supply of Bribes: The Organization of Economic Cooperation and Development and the International Chamber of Commerce

The initiatives of the ICC and OECD focus on deterring the use of bribery by multinational enterprises in the course of business operations in foreign countries, allegedly a major source of illicit payments. Like the United Nations, the ICC and OECD initially considered the problem of transnational bribery in the 1970s, following a series of scandals and the passage in the United States of the FCPA. These initial efforts failed to make an impact, but interest has been renewed in the 1990s.

The OECD revived its interest in the corruption issue in 1993 under the prompting of the Clinton administration. In early 1994, the Committee on International Investment and Multinational Enterprises approved a recommendation for submission to the Council that urged members to “take concrete and meaningful steps” against the bribery of foreign officials. The recommendation, which also created a Working Group on Bribery in International Business Transactions, was formally adopted by the OECD Council of Ministers later that spring (see Pieth, chapter 6). This was followed two years later by a second recommendation approved by the Council that called on members to end the tax deductibility of transnational bribes and to consider means of imposing criminal sanctions on such behavior.³⁰ Neither recommendation is legally binding on members, but both contain provisions for the monitoring and review of actions taken to implement the recommendations. The working group has also been developing “best practice” principles for accounting and auditing procedures to facilitate effective enforcement. Secrecy is an essential component in the bribery transaction, so transparency and thorough record keeping are important tools to control corruption.

The results with respect to national implementation of the recommendations are thus far mixed, however. Recently, the United Kingdom concluded that a 1906 antibribery law could be interpreted as covering bribery of foreign officials, though it had not previously been used for that purpose. Japan also not long ago announced that it would take

30. At the time the recommendation was approved, Austria, Belgium, Luxembourg, Netherlands, Germany, and Greece allowed “commissions” to be deducted as a business expense with few restrictions. Australia, Canada, Denmark, France, Ireland, Norway, New Zealand, Spain, and Switzerland allowed tax deductibility if the recipient was identified.

steps to criminally sanction transnational bribery, probably by amending its Law for the Prevention of Unfair Competition, which carries criminal sanctions. The Japanese government expects the measure to be passed and to take effect in April 1998, but concerns have been raised as to whether Japan's Fair Trade Commission will be more effective on this issue than it has been on other fair competition issues in the past.

Regarding the tax deductibility of bribes, only Norway has completely implemented the recommendation; a handful of countries have legislation pending, but most OECD members have not moved to implement the recommendation on tax deductibility. France and Germany have said they cannot eliminate tax deductibility until the criminalization issue is resolved (*Transparency International USA Newsletter*, March/April 1997, 2). One OECD member state has taken steps to end tax deductibility for bribes, but only following a criminal conviction for bribery, presumably in the country where it occurs.

The breakthrough in the OECD came in May 1997 when the members agreed to quickly negotiate and promptly implement an international convention to criminalize transnational bribery. Although the United States, supported by most other OECD members, had opposed the convention approach because of the legal complexity and delay involved, France and Germany, supported by Japan and Spain, insisted that criminal sanctions be codified in a formal convention (*Washington Post*, 9 May 1997, A22). The compromise involved setting tight deadlines for final implementation of treaty provisions. The final convention would be based on the draft principles for criminalization developed by the OECD working group. That text defines the perpetrators and collaborators in acts of bribery, acts that would constitute a criminal violation, how to establish jurisdiction, and how to ensure effective enforcement in light of the different legal and judicial systems among OECD countries (OECD 1996). Continued progress depends primarily on peer pressure among governments, as well as the pressure of public opinion in countries suffering domestic corruption of their own (see also Glynn, Kobrin, and Naïm in chapter 1).

As the OECD has progressed in its efforts to prevent international corruption, interest in codes of conduct and compliance programs for multinational cooperation has increased. The ICC appointed a committee in 1994 to review its earlier report on transnational bribery, issued in 1977, and to update the recommendations as appropriate (see Heimann, chapter 8 for further detail). Major contributions of the new report include the strengthened "rules of conduct" for preventing illicit payments and a recommendation to establish a standing committee "to promote widespread use of the rules and to stimulate cooperation between governments and world business." The report, approved by the ICC executive board in March 1996, also calls on governments to make procurement procedures more transparent, to condition government contracts

with corporations on their abstaining from bribery, and to implement promptly the steps recommended by the OECD on this issue. The proposed standing committee has been appointed with one group focusing on developing a detailed compliance program to flesh out the general principles in the code. A second group is working with ICC national committees to get member companies to adopt the proposed code.

Targeting Grand Corruption in Government Procurement: the World Bank and the World Trade Organization

The World Bank and most other international and national aid agencies require international competitive bidding when official funds are used in whole or in part to fund government procurement of goods, services, or projects. The World Trade Organization (WTO) also oversees rules on government procurement, but they are incorporated in a multilateral agreement currently subscribed to by only 22 countries (the United States, the 15 countries of the European Community, Canada, Israel, Japan, Norway, South Korea, and Switzerland). The issue currently before the WTO is how to expand the country coverage of rules on transparency and due process in government procurement.

For those procurements where international competitive bidding is appropriate, World Bank guidelines emphasize transparency at all stages of the bidding process, from the public call for bids through the award of contracts. They also provide for the World Bank to review and evaluate bids and award contracts. The Bank may declare a “misprocurement” if procedures are not followed or if it later finds it had received “incomplete, inaccurate, or misleading information” or if corruption influenced the award. In July 1996, the World Bank further tightened its guidelines by removing the constraint that misprocurement due to corrupt practices can only be declared following a decision by a court of law, by revising the standard bidding documents that must be used in Bank-funded procurements to require disclosure of commissions paid to agents or other third-party intermediaries in the bidding process, and by introducing sanctions against borrowing countries and international firms that engage in corrupt practices. The potential sanctions include rejection of contract awards or cancellation of the portion of a loan linked to fraudulent or corrupt practices, and the blacklisting of firms that engage in such practices, either indefinitely or for a specified period of time (World Bank 1996b).

TI has further suggested that the World Bank should encourage the use of corporate codes of conduct by making them a condition for bidding on Bank-funded projects (see Heimann, chapter 8). Some in the World Bank have resisted this proposal, however, because it could reduce competition (because so few firms outside the United States currently have codes), and it would increase the paperwork and red tape,

which are already substantial. Those in the bank opposed to the proposal also argue that the offsetting benefits may be few because of the difficulties in ensuring that newly created codes are no more than fig leaves.

Finally, recent changes in how the Bank evaluates its own performance, though adopted for other reasons, could have anticorruption benefits. Both personal and institutional success previously were measured by the volume of loan approvals. Complaints from NGOs and other groups about the consequences of this approach in relation to the environment, human rights, and other areas contributed to a reassessment of project review and loan approval. More careful analysis of the development impact of proposed projects should reduce the likelihood that “white elephant” projects receive funding approval. The most important way in which the Bank (and other international financial institutions) can contribute to the fight against corruption, however, is through capacity building and promotion of institutional reforms, as discussed above.

Although bribery and nepotism are recognized as anathema for efficient government procurement, most governments *openly* intervene in favor of domestic suppliers for a variety of procurement projects, arguing national security or industrialization goals. The current WTO Government Procurement Agreement (GPA) is primarily intended to reduce the level of explicit discrimination in favor of domestic suppliers and to introduce greater competition into these markets. In addition to listing the government entities and activities subject to its rules, the GPA specifies extensive and detailed bidding procedures regarded by representatives of some countries as excessively complex and burdensome. Although Taiwan and Singapore are currently involved in negotiations on access to the agreement, few additional countries are expected to join any time soon.

Because the membership of the GPA is limited, the United States is seeking an agreement on transparency, openness, and due process in government procurement that would be mandatory for all WTO members.³¹ Under such an agreement, which US negotiators hope would be an interim step to full acceptance of GPA disciplines, WTO members would not have to reduce home-country preferences or otherwise liberalize their government procurement regimes, but they would have to abide by agreed on procedural rules. A major objective of the proposed rules would be to ensure that when international bids are entertained, the process is not distorted by bribery. At the WTO ministerial meeting in Singapore in December 1996, however, few other countries embraced the US proposal to conclude within a year an agreement on transpar-

31. It should be noted that 75 percent of US exports in 1995 went to countries that are already members of the GPA or are in the process of joining it, or to Mexico, which is covered by the government procurement rules of NAFTA.

ency in government procurement. US negotiators were only able to obtain a rather weak call to “establish a working group to conduct a study on transparency in government procurement practices . . . and, based on this study, to develop elements for inclusion in an appropriate agreement . . .” (World Trade Organization 1996).

Another recent proposal for reducing corruption in government procurement comes from David Finch, a former IMF official (Finch 1996). He recommends that the Berne Union, an international association of export credit agencies primarily from OECD-member countries, require supervised international competitive bidding for appropriate sales guaranteed by them (he excludes military contracts, for example).³² Finch suggests having the World Bank supervise the bidding procedures in these sales, because it already has experience in monitoring its own procurement guidelines. But the World Bank may reject additional responsibilities, and it is not clear that such an agreement would have more than symbolic impact, because OECD figures show that only 3.2 percent of OECD manufactured exports were covered by official export credits in 1992 (cited in Ray 1995, 7).

Finally, World Bank President Robert McNamara has proposed the use of “antibribery” pacts to increase transparency and stem the opportunities for corruption in government procurement. As described in Heilmann (chapter 8), antibribery pacts could be developed to fit the needs of countries or even particular agencies adopting them. The key elements would include commitments by the procuring agency or government to use transparent bidding procedures, guard against extortion by their officials, and establish procedures for monitoring compliance and sanctioning violations; only firms willing to sign the antibribery pact would be allowed to bid and they would also have to commit publicly to refrain from paying bribes and to establish a corporate code of conduct and a program to enforce compliance.

The motivation behind the antibribery pact is, first, to allow reformers to prominently signal that the rules for doing business in their country have changed and, second, to help firms avoid the collective action problem in refraining from offering bribes. Many firms claim that they prefer not to bribe but fear being edged out by a competitor if they unilaterally refrain. The pact is aimed at leveling the playing field.

Priorities for an International Anticorruption Strategy

There are no quick fixes or simple solutions for corruption. The sources and consequences of corruption differ from place to place, and each

32. The OECD, which has rules governing tied aid and subsidized export financing, is also studying this issue.

country must set its priorities and fashion its own responses based on its particular needs. In general, however, reforms that increase political accountability and economic competition are the keys to reducing opportunities for corruption. Contested elections, greater transparency in the policymaking process, and a free media increase the potential costs of corruption, while a more open economy reduces the potential gains.

While many countries today are pursuing democratization and opening up their economies to competition, the institutional reforms needed to consolidate and build upon these efforts often lag. Without “institutional adjustment” or “therapy” (see Klitgaard 1995 and Naím 1995b, respectively) these initial macro reforms may not be sustainable. Among the micro reforms that will support broader systemic reforms and address corruption are

- judicial reforms to ensure honesty and independence and build capacity;
- civil service and other institutional reforms to improve information flows and increase the incentives for honesty and performance while discouraging dishonesty;
- simplification of tax and regulatory systems;
- use of auctions, competitive bidding schemes, and market-based regulatory mechanisms whenever possible to reduce bureaucratic discretion;
- strengthening campaign finance laws and rules on conflict of interest; and
- strengthening the institutions of civil society, including the media, NGOs, and other grassroots groups.

Difficult and far-reaching internal reforms such as these are the building blocks for an anticorruption strategy, but the international community also has a role to play. First, it can encourage and support the internal reforms and, second, it must tackle the international sources and consequences of corruption. The recent OECD commitment to implement an international convention criminalizing bribery of foreign public officials is potentially a major step in this direction.

International Support for Internal Reforms

The international financial institutions already support internal anti-corruption strategies in developing countries in a variety of ways, but they could do more. The World Bank and IMF support anticorruption reforms most importantly through loan conditionality focusing on pro-competitive, market-oriented economic reforms. The Bank also directly

addresses corruption in its guidelines governing procurement that uses Bank funds. It beefed up those regulations in the summer of 1996 and stated more clearly than ever before that it will cancel procurements and punish responsible parties if it finds corruption. To maximize the impact, the World Bank and other MDBs should act quickly on the recent recommendation of the G-7 finance ministers to cooperate in standardizing their procurement guidelines based on the World Bank model.

The international financial institutions also provide technical and financial assistance for institutional reform and capacity building, but they need to focus more attention on governance issues. World Bank staff have begun to use their “country portfolio performance reviews” and “country assistance strategy” statements to explicitly link governance issues and economic development. Early assessments, however, suggest they focus too narrowly on “public sector management issues” and need to include governance issues more systematically in their discussions with borrower countries.

Where corruption is widespread but safeguards against malfeasance in particular projects are possible, the Bank should redirect loans to activities neglected or undermined as a result of corruption, such as education and health. If it is not possible to ensure that official funds will be effectively used or that they are not being stolen or diverted, lending should obviously be suspended and funds withheld in these cases. In such situations, standard conditionality regarding project implementation and economic performance is likely to provide ample ammunition for reduced lending. In some situations, however, it may send a useful signal if the World Bank highlights the role of corruption in blocking a country’s development.

Corruption in International Business

Most countries have laws against bribing their own public officials, but many lack the legal and institutional capacity to effectively deter and punish such behavior. By criminalizing bribery of foreign officials by their nationals and corporations, OECD countries will help to fill this gap. In addition, the World Bank, WTO, and others are studying how to expand the use of open, competitive bidding so that government procurement contracts will not be distorted by corruption. Though bribery in international transactions is only part of the problem, such agreements are an important component of an overall anticorruption strategy.

At the May 1997 ministerial meeting, OECD members committed to implementing by the end of 1998 a multilateral convention to deter and punish transnational bribery. A potential obstacle, however, is the difficulty in observing and documenting illicit payments, which raises concerns about free riders—countries who may commit themselves to sanction such behavior but then fail to enforce with vigor. Thus, the key to

finalizing the agreement and making it effective will be establishing a monitoring process to ensure expeditious and vigorous enforcement.

The model for rigorous monitoring and peer review adopted by the OECD is that of the Financial Action Task Force (FATF) for monitoring implementation of its recommendations to combat money laundering. The first step involves self-reporting by OECD governments on the steps they take to implement anticorruption recommendations. The second step involves review by the Working Group on Transnational Bribery to independently evaluate the speed and scope of actions taken by member countries and to assess whether these actions are likely in practice to be effective.³³ The OECD recommendation calls vaguely for the “provision of regular information to the public.” Both the national reports and the Working Group assessments should be publicly available for outside review by citizen groups and NGOs such as Transparency International, which could then add their own assessments as well as additional public pressure if necessary.

The major weakness of the OECD agreement is that the Agreed Commons Elements for criminalization define only bribery related to obtaining or retaining business as an offense. This addresses only bribery in contracting and would still permit firms to pay bribes in order to evade customs duties or other taxes or to avoid regulations protecting the environment or health and safety. Corruption in these areas are potentially more socially damaging than allocative inefficiencies related to government procurement, and this lacuna should be addressed in the treaty negotiations.

Other mechanisms intended to increase transparency and guard against corruption in international business include the proposal by former World Bank President Robert McNamara for “antibribery pacts,” similar to the TI proposal for “islands of integrity” and the proposal that the World Bank require corporate codes of conduct and effective compliance programs as a condition for bidding on its projects. Under the pact, both government officials and bidding firms would publicly pledge not to offer or accept bribes and would take additional steps to guard against corruption in particular countries, agencies, or single projects.

Because the World Bank already requires international competitive bidding for major procurements, antibribery pacts would be most helpful in procurements not already subject to external supervision. The pacts should be used by countries wanting to lend credibility to their anticorruption efforts, to send a signal to their own officials that the rules have changed and as a signal to multinational corporations that they can no longer do business as usual. Widespread adoption of the antibribery

33. For example, Japan has proposed to sanction transnational bribery under its unfair competition law but some observers fear this will have little impact in practice, because Japan’s competition watchdog, the Japan Fair Trade Commission, has been widely criticized as ineffective.

pacts would also put pressure on international corporations to adopt and enforce corporate codes of conduct and would reinforce OECD efforts to control transnational bribery.

The World Bank can reinforce these efforts and those of the OECD by requiring multinational corporations bidding on Bank-funded projects to have a code of conduct in place. The Bank's concerns about reducing competition by limiting the pool of eligible bidders could be mitigated by announcing with sufficient notice (a few months to a year) that the codes would be required. That would give firms time to develop codes and compliance programs. To minimize the additional paperwork required, the Bank could enforce the requirement by adding a one- or two-sentence addendum to existing bidding documents. To raise the profile of the issue and further deter violations, the addendum should be signed by a high-level officer affirming that the parent corporation and all applicable subsidiaries have and enforce codes of conduct and that they will abide by the borrowing country's laws and regulations relating to corruption in government procurement. It is likely, as the Bank fears, that many firms will nominally adopt a code but not enforce it. Nevertheless, when corruption is alleged in a particular case, evidence as to the steps a firm has taken to enforce compliance, for example, getting a signed statement from local representatives and agents that they have received and read a copy of the code, could be helpful in identifying possible violations.

If, as recommended, other multilateral development banks standardized their regulations on the World Bank model, procurement rules emphasizing transparency and competitive bidding would cover as much as 15 to 18 percent of total nondefense government expenditure on goods and services in 88 low- and middle-income countries (Hoekman 1996, 39). In May 1996, Development Assistance Committee (DAC) members adopted a statement of principle that anticorruption provisions should be included in bilaterally funded procurement contracts. Since October 1996, the US Agency for International Development has included a statement explicitly prohibiting bribery in all contracts and providing for cancellation and legal action in the case of violations (TPCC 1996, 121). If other countries enforce similar rules, the ratio of covered government purchases would rise to somewhere between one-third and one-half of nondefense expenditures in recipient countries (Hoekman, 1996, 39). This could significantly boost anticorruption efforts in many countries, though tied aid, by reducing the level of competition, will reduce the potential benefits.

To expand the coverage of anticorruption safeguards even further, the World Trade Organization should act on the proposal made by the United States in Singapore last December to negotiate an agreement on transparency and due process in government procurement. The procedural safeguards in the Government Procurement Agreement (GPA) could serve as the basis for a separate agreement that would be binding on all

WTO members. Countries that are not signatories to the GPA, however, would not be required to take on its broader nondiscrimination commitments and would be under no obligation to open their government procurement to international competition. They would simply have to be open in the process of awarding contracts, which would tend to reduce the opportunities for corruption. Indeed, an analysis of the costs and benefits of the GPA for less developed countries concluded that “transparency arising from the procedural requirements of the GPA may well be the primary benefit of membership for developing countries—even if strict nondiscrimination is not pursued” (Hoekman 1996, 10).

A phenomenon that has been with us since before biblical times will not be eradicated overnight. But the day when bribes were considered mere gifts, and corruption was a way of doing business, are in the past. While tolerance of corruption may continue to prevail in some quarters, it is no longer publicly expressed. This change in attitude is a big step, but, to reiterate, the international community must take additional steps if the current momentum is to be maintained:

- The World Bank, International Monetary Fund, and other multilateral and bilateral development agencies should emphasize the role of effective governance in economic development and should devote more resources and technical assistance to institutional reforms and capacity building in countries where corruption is rampant. Where corruption blocks reform, the IFIs should cut off countries far more quickly than they did in Mobutu’s Zaire.
- Other MDBs should conform their procurement guidelines to the World Bank’s high standards.
- All DAC members should adopt anticorruption guidelines for their aid programs, and both MDBs and bilateral aid agencies should be even more vigilant in supervising bidding procedures and auditing project implementation to ensure that scarce public resources are not siphoned off for personal use.
- OECD countries should meet or even beat the deadlines they have set for themselves to criminalize transnational bribery and end tax deductibility of bribes. They should also expand the definition of the crime to encompass bribes paid in the course of doing business.
- The members of the World Trade Organization should conclude an agreement providing for transparency and due process in government procurement markets.

Of course, the ultimate responsibility for ending corruption still lies with the leaders of each nation and the citizens who must hold them accountable.

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