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The Political Economy of Corruption

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Corruption occurs at the interface of the public and private sectors. Whenever a public official has discretionary power over distribution to the private sector of a benefit or cost, incentives for bribery are created. Thus corruption depends upon the magnitude of the benefits and costs under the control of public officials. Private individuals and firms are willing to pay to obtain these benefits and avoid the costs. Every state must decide when to legalize such payments and when to label them illegal corruption. The proper link between money and politics is a deep one and will be resolved differently by different countries. Nevertheless, economic analysis can isolate incentives for payoffs to government agents, evaluate their consequences, and suggest reform.

Countries vary widely in the pervasiveness and level of corruption, and within individual countries some industries, government departments, and lower-level governments are very corrupt while others are not. In large, diverse countries such as the United States, India, and China, there is no way to measure the level of corruption. Reliable data on the magnitude of corruption across countries does not exist and probably cannot exist in principle.

Nevertheless, when businesspeople are queried, they indicate that the problem varies widely across countries.[1] Within individual countries,

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1. A well-publicized recent example of this type of effort are the corruption perception rankings produced by Transparency International and the University of Goettingen in 1995 and 1996. These rankings evaluated 41 countries in 1995 and 54 countries in 1996 based on an aggregation of other survey work (from various years). The 1996 index is reproduced and explained in *TI Newsletter* (September 1996, 5-8; see also chapters 4 and 10 by Mauro and Elliott, respectively).

surveys demonstrate that some public agencies—for example, customs and tax collection and police departments—are more of a problem than others.[2]

The significance of corruption in international business dealings is also difficult to judge. But, to give a sense of scale, if just 5 percent of the $90 billion of foreign direct investment in the developing world in 1995 were paid as bribes, the total would be $4.5 billion annually. If a similar value of merchandise imports were diverted into payoffs, the combined total would be almost $80 billion (World Bank 1996, appendix 6).

Corruption can significantly affect the efficiency, fairness, and legitimacy of state activities. Extreme cases, although atypical, illustrate the risk of tolerating moderate amounts of corruption. An in-depth study of an irrigation district in India indicated that 20 to 50 percent of the funds the government provided were wasted in corruption and malfeasance (Wade 1982, 1984). Similar work in Pakistan by experts on irrigation indicated that illegal water outlets were purchased from the state, imposing severe costs on downstream farmers (Murray-Rust, Hammond, and Vander Velde 1994; Vander Velde 1990; Vander Velde and Svendsen 1994). A study of corruption in Thailand documented numerous examples of bureaucratic corruption in infrastructure projects, construction, and other areas. Leakage was from 20 to 40 percent of project costs from 1960 to 1990 (Phongpaicht and Piriyarangsan 1994, 25-34). In Brazil under President Fernando Collor de Mello the rake-off on public contracts allegedly increased from 10 to 15 percent to 30 to 50 percent (Fleischer 1995; Manzetti and Blake 1996).

Privatization in Eastern Europe, Russia, and the developing world yields many examples of sales to privileged insiders at below-market prices (Celarier 1996). In Korea, bribery of building inspectors allegedly led to substandard construction of a department store that subsequently collapsed, killing several people (Park 1995). In Indonesia, corruption in the customs service became so ingrown that the head of state signed a contract with a private Swiss firm to take over the duties of the state agency (GATT 1991, 1995). In Guinea, continuous demands for bribes are reportedly a feature of any business deal. Construction contractors locked into a particular site are particularly vulnerable. From Italy to Ghana to Venezuela, allegations of corruption have toppled sitting rulers or led to the arrest of past incumbents (Ayittey 1992; Colazingari and Rose-Ackerman 1995; LeVine 1975; Manzetti and Blake 1996).

As these examples illustrate, corruption is common in both the developing and the industrial worlds. But should it be an object of concern? Some countries alleged to be very corrupt have experienced high levels

2. See, for example, the various World Bank surveys reported in de Melo, Ofer, and Sandler (1995); Novitzky, Novitzky, and Stone (1995); Stone (1995); Webster and Charap (1993); and Yabrak and Webster (1995).

of economic growth. In Indonesia, Thailand, and Korea, corruption and growth have gone together. Perhaps poor and transitional countries should not be concerned about widespread corruption in designing economic reform policies. Perhaps corrupt countries with high growth rates should simply accept diversion of funds as normal. There are two fundamental arguments against such tolerance.

First, systemically corrupt countries that have nevertheless experienced satisfactory economic growth risk sinking into a downward spiral. Corruption can feed on itself to produce higher illegal payoffs until growth is undermined. Tolerating corruption that smooths over the rough spots in the system and siphons off 5 or 10 percent of the value of public projects may generate pressures to increase the take to 15 or 20 percent. The very growth that permitted corruption in the past can produce a shift from productive activities to an unproductive struggle for the spoils, harming future growth and investment. Without self-conscious policy reform, corruption is not something a country will just "grow out of."

Second, economic growth is not the only goal worth pursuing. Corruption also tends to distort the allocation of economic benefits, favoring the haves over the have-nots and leading to a less equitable income distribution. In extreme cases, corruption can undermine political stability (see chapter 3). Even when corruption is a way around excessively restrictive government polices, it is a second-best choice. Especially for emerging and transitional economies, a respectable growth record should not be used to justify the continuing existence of inefficient and unfair state and private-sector relations.

Sometimes there is no distinction between public and private purses, and government officials simply "appropriate" state assets. My interest, however, is in the more complex cases in which a private individual or organization bribes a state official to obtain a benefit. Payment may be for the private benefit of the official or his family, or it may be an illegal campaign contribution. Agent-principal relationships are at the heart of such corrupt transactions, with illegal payoffs one way for public agents to allocate the gains and losses of government activity (Rose-Ackerman 1978).

I ignore purely kleptocratic or "vampire" states in which there is no distinction between the public and the private spheres and where the ruler and his associates simply take as much of the country's wealth as they wish (Andreski 1968). Instead, I concentrate on countries that have legal rules outlawing bribery and other forms of self-dealing by bureaucrats, cabinet ministers, legislators, and judges. Most countries today fall into this category.

In seeking realistic reform it is important to realize that, like all illegal activity, the efficient level of bribery is not zero. Bribery is costly to control. Reforms must consider the marginal costs as well as the marginal benefits of anticorruption strategies.

Furthermore, combatting corruption is not an end in itself. The struggle against malfeasance is part of the broader goal of creating a more effective government. Reformers are not just concerned with corruption per se but with its distortionary effect on development and society. Widespread corruption is a sign that something has gone wrong in the relationship between the state and society.

The incidence and level of bribery and other forms of malfeasance depend not just on potential gains from corruption but also on the riskiness of corrupt deals and on the relative bargaining power of potential bribers and bribees. The structural features I stress here can go only part of the way toward explaining the level of corruption. Many officials remain honest in the face of considerable temptations, and many ordinary people and businesses refuse to pay bribes even when illegal payments promise large, short-term gains.

Let us consider several key questions that arise throughout the industrial and the developing world:

- What opportunities for private economic gains exist at the interface between the public and the private sectors?
- What determines the size and incidence of bribe payments?
- What are the political, economic, and distributive consequences of corruption?
- What strategies can be used to reduce corruption?

What Are the Economic Opportunities for Corruption?

The demand for corrupt services—that is, the supply of bribes—depends on the size and structure of the state. Bribes are paid for two reasons: to obtain government benefits and to avoid costs. An effective anticorruption strategy should both reduce the benefits and costs under the control of public agents and limit their discretion to allocate gains and impose harms (Klitgaard 1988; Rose-Ackerman 1978). What are some of the possibilities?

Paying to Get a Government Benefit

The government buys and sells goods and services, distributes subsidies, organizes privatization of state firms, and provides concessions. Officials frequently have a monopoly of valuable information. These activities all create incentives for corruption.

When the government is a buyer or a contractor, there are several reasons to pay off officials. First, a firm may pay to be included in the list of qualified bidders. Second, it may pay to have officials structure bidding specifications so that the corrupt firm is the only qualified supplier. Third, a firm may pay to be selected as the winning contractor. Finally, once a firm has been selected, it may pay to get inflated prices or to skimp on quality.

Governments frequently sell goods or services at below-market prices. Often dual prices exist—a low state price and a higher free market price. Firms will then pay off officials for access to below-market state supplies. In China, for example, many raw materials are sold at both state subsidized prices and on the free market. Payoffs are common (Gong 1993; Hao and Johnston 1995; Johnston and Hao 1995).

When the supply of credit and the rate of interest are controlled by the state, bribes may be paid for access to credit. Interviews with businesspeople in Eastern Europe and Russia indicate that payoffs are frequently needed to obtain credit (de Melo, Ofer, and Sandler 1995; Webster 1993; Webster and Charap 1993). In Lebanon a similar survey revealed that loans were not available without the payment of bribes (Yabrak and Webster 1995).

Similarly, multiple exchange rates often do not reflect underlying economic fundamentals, thus producing incentives to pay bribes to get scarce foreign exchange at good rates. A World Bank economic memorandum on Paraguay, for example, notes that in the 1980s that country's multiple exchange rate system led to corruption (World Bank 1994). Allocation of scarce import and export licenses is also a frequent source of payoffs and patronage, with bribes linked to the value of the monopoly benefits conferred (Herbst and Olukoshi 1994, 465).

Corruption can also occur when the level of subsidies and benefits for the worthy is too low to satisfy all who qualify, or when officials must use judgment in deciding who is qualified for an entitlement. A service may be scarce so that people will pay to be named recipients or the service may be an entitlement to all who qualify so people pay to be included among the worthy group. In the administration of public housing programs in the United States, for example, the number of qualified households always far outstrips the number of places in subsidized units. In India, some states provide a means-tested pension to the poorest people. The number who qualify exceeds the funds available. Nongovernmental organizations that work with the poor report that applicants must pay to qualify and then must pay postal workers to deliver the benefit checks. Payoffs may be made to alter test results required for university admissions or to induce doctors to declare people disabled so they can qualify for subsidy payments.

Privatizing state-owned enterprises can improve the performance of the economy and in the process reduce corruption. Turning over state assets to private owners can, however, itself create incentives for corruption. Sale of a large parastatal or public firm is similar to tendering for a large public infrastructure project. Thus the incentives for malfeasance are similar. A firm may pay to be included in the list of qualified bidders or to restrict their number. It may pay to obtain a low assessment of the public property to be leased or sold off or to be favored in the selection process. Some corrupt transactions may undermine the efficiency rationale that lies behind economic justifications for privatization. Thus if firms pay to preserve the monopoly power of the enterprise after it enters private hands, the result may simply be a transfer of profits from the state to the new owners. Employees of the newly privatized firm may then face demands from suppliers and customers seeking to share in monopoly benefits.

Before the process was reformed, privatizations in Argentina allegedly favored those with inside information and connections (Manzetti and Blake 1996). Privatizations in Thailand have supposedly involved kickbacks and commission fees (Phongpaicht and Piriyarangsan 1994, 10). Some privatizations in the former eastern bloc have apparently involved similar corrupt transfers (Celarier 1996).

Finally, for all types of government programs, officials are likely to have information that is valuable to outsiders. Thus private individuals and firms may pay to obtain such information or to obtain it sooner than their competitors. Such information as bidding specifications for contracts, the actual condition of soon-to-be-privatized firms, or the location of future capital projects is likely to be worth paying for.

Paying to Avoid Costs

Governments impose regulations, levy taxes, and enforce criminal laws. Officials can delay and harass those they deal with. They can impose costs selectively in a way that affects the competitive position of firms in an industry.

Under public regulatory programs, firms may pay to get a favorable interpretation of the rules or to get a discretionary judgment in their favor. They may pay to avoid or lighten the regulatory load or to clarify regulatory requirements when laws are unclear. Incentives for corruption may be especially high for newly privatized state enterprises dealing with fledgling regulatory agencies with no well-developed track record. Thus those who advise developing and transitional economies on setting up regulatory agencies for public utilities emphasize transparent and open processes (Tenenbaum 1996).

In a federal government, inconsistent rules can make payoffs hard to avoid. A World Bank study of private enterprises in Brazil recounted the (perhaps apocryphal) tale of one entrepreneur who reported that he was visited by state and federal inspectors simultaneously. The goal of the joint visit was to be sure that the firm would be observed violating at least one of the two governments' inconsistent rules on the placement of fire extinguishers (Stone, Levy, and Paredes 1992, 29).

Taxes are always burdensome, so businesses and individuals may collude with tax collectors to lower the sums collected. The savings are divided between the taxpayer and the official. In some parts of Eastern Europe and the former Soviet Union, where nominal tax rates are very high, businesspeople report high payoffs (de Melo, Ofer, and Sandler 1995; Novitzky, Novitzky, and Stone 1995; Webster and Charap 1993). In Italy many allegations of corruption involved payoffs to tax inspectors. Customs officials are particularly likely to engage in corruption since they control something that firms value—access to the outside world. Payoffs are used to reduce tariffs and export fees and to obtain import and export licenses. Customs reform in Indonesia and Mexico resulted from widespread evidence of corruption ("Airport Customs Harnesses 3 Billion Mexican Pesos Per Year," *El Economista*, 13 February 1992; GATT 1991). Here is an area in which the prescriptions of the market-oriented economist and the anticorruption reformer go together. Free-trade policies both improve efficiency under most conditions and reduce the economic rents available to corrupt officials. Tolerating corruption as a way around restrictive trade policies leads to widespread inequities and inefficiencies. Studies show that as tariff rates rise, tariffs collected fall as a share of nominal tariffs and the variance of rates actually paid increases (Pritchett and Sethi 1994). These results are consistent with the view that corruption incentives rise with tax and tariff rates.

Illegal businesses are especially vulnerable to extortion. Law enforcement authorities from the police to prosecutors and judges can demand payments to overlook violations or limit penalties. If evidence of criminal behavior is clear, such businesses will be unable to credibly threaten to report corrupt demands.

But, of course, illegal businesses are hardly innocent victims. They may actively try to corrupt the police. They seek not only immunity from prosecution for themselves but also assurance of monopoly power in the illegal market. In the United States, for example, gamblers and drug dealers have paid officials to raid their competitors or to restrict entry (Rose-Ackerman 1978, 163). At the local level in Thailand, some public authorities shelter criminal enterprises both from competition and from the law (Phongpaicht and Piriyarangsan 1994, 51-97). Instead of inducing state officials to harass their competitors, some illegal businesspeople may engage in outright intimidation of potential rivals, often paying off the police not to intervene in their private attempts to dominate the market (Handelman 1995).

Since time is money, firms and individuals everywhere will pay to avoid delay. For example, if the government or a parastatal does not pay its bills on time, contractors or customers may bribe government officials to get speedy payment. In Argentina a scheme in which insurance companies paid to get claims settled by a state-run reinsurance company degenerated into outright fraud against the state organized by corrupt state officials and middlemen (Moreno Ocampo 1995). In many countries, informal payoffs are required to obtain expedited services such as a telephone, a passport, or a driver's license. Sometimes the service is available only to the corrupt and not to the patient but honest citizen. In St. Petersburg in 1992, the going rate for a telephone installation was \$200 (Webster and Charap 1993). An Indian newspaper recently published a list of the "fees" for a range of routine public services ("Bribe Index," *Sunday Times of India*, 17 December 1995).

Paying for Official Positions

When corruption is pervasive, positions in the state bureaucracy become valuable assets, and there will be derived demand for jobs in the state sector. In some developing countries there is a lively market for positions in the bureaucracy that generate large bribes (Wade 1982, 1984). Positions in a corrupt police department are likely to be especially valuable (Phongpaicht and Piriyarangsan 1994, 99-129). Jobs in departments with few such opportunities, such as the foreign service, may attract few qualified applicants. But if government pay scales exceed those in the private sector, people may pay for such jobs even if few bribes are possible. Because public schools in India pay teachers more than private schools, some people purchase these jobs with their wives' dowries or loans from relatives.

What Determines Bribe Size and Incidence?

The level of corruption is a function of the honesty and integrity of both public officials and private individuals. Holding such factors constant, however, the size and incidence of bribes are determined by the overall level of benefits available, the discretionary power of officials, the riskiness of corrupt deals, and the relative bargaining power of briber and bribee.[3]

Benefits and Official Discretion

I have already explained how the nature of government programs creates corruption incentives in all societies. It is important to recognize,

3. For a fuller discussion of these issues, see Klitgaard (1988) and Rose-Ackerman (1978). Klitgaard (75) reduces this list to a simple heuristic in which corruption equals monopoly plus discretion minus accountability.

however, that the level of benefits is not necessarily exogenous. Corrupt public officials can frequently use their discretion to increase the supply of benefits up for negotiation. There are several ways this can be done. Officials may be able to extract some of a contractor's profits by introducing payment delays or inventing *ex post* regulatory hurdles. They can threaten to enforce criminal and regulatory laws more vigorously than is the norm. They can behave in arbitrary and unclear ways to create a demand for clarity. They can propose white-elephant projects, which are an inefficient way to encourage economic development or use scarce budget resources.[4] Officials may also be able to structure privatization projects or natural resource concessions so that they include a high level of monopoly profits for whomever obtains the newly privatized firm or the concession.

In general, we can distinguish between two kinds of corrupt market structures. Some corrupt systems are roughly competitive. Routine government services often fall into this category. The market is imperfect because of the costs of secrecy and the exclusion of the scrupulous, but approximately the same bribe price is charged to all for such services as a telephone line, a gas connection, or a passport. When the bribe market is less competitive, however, corrupt officials may bribe-price discriminate. They extract bribes that are proportional to the monopoly profits of bribers. Those with higher gains from obtaining the corrupt benefit pay more for it. Tax collection and customs officials may be able to price discriminate in this way if the taxes owed are related to the firm's profitability. One-of-a kind procurements or privatizations fall into this category and can generate very large dollar payoffs. The level is a function of the overall gains and of the relative bargaining power of the parties.

Since officials can create economic rents and control their distribution, the study of corruption must include an analysis of the organization of public officials. Freelance rent seeking creates externalities among public officials. The level of rents can be thought of as a common pasture that is overgrazed by the officials. In the extreme, such overgrazing could seriously undermine the economy. A monopolistic autocrat could rationalize rent collection with efficiency gains all around. Thus some authors suggest that centralized corruption is less damaging than low-level corruption (Rodrik 1994; Shleifer and Vishney 1993). Corrupt top officials with a long-term perspective will not push their greed so far as to destroy the economy. This argument is correct within the terms of the model under which it was developed. It is simply a straightforward application of a result in industrial organization theory. It is not a general conclusion, however, since it ignores the fact that higher-ups are

4. For examples from Nigeria, see Diamond (1993) and Faruqee (1994). See also Ayittey (1992), Ouma (1991), and Werlin (1972) for other African examples.

likely to have greater freedom to create extra rents than lower-level functionaries. The ruler can commit the resources of the entire state to his own corrupt ends. Even a large number of venal low-level officials are unlikely to be able collectively to accomplish so much (Rose-Ackerman 1994). The damage caused by high-level corruption can be especially serious if the ruler is insecure and expects to leave office soon, perhaps as a result of his corruption being revealed. Such a ruler can be in an unstable situation in which his own corruption increases the chance of his overthrow, which in turn encourages him to be even more corrupt, and so forth. Concentrating on reducing low-level corruption ignores these possibilities and is also unlikely to succeed if civil servants are aware of the peculation of their superiors.

Risk and the Division of Gains

The higher the probability that corruption will be detected and punished, the lower the effective benefits available. If the likelihood of detection and punishment is high, either the supply of or the demand for bribes may fall to zero. The analysis can proceed much like any discussion of the economics of crime (Becker and Stigler 1974; Rose-Ackerman 1978, chapter 6). The expected cost of bribery is the probability of being caught times the probability of being convicted times the punishment levied. A risk-neutral briber or public official compares this expected cost with the expected benefit and is corrupt only if the balance is positive. A risk-averse actor must also be compensated for the uncertainty involved in corrupt transactions. In the simplest version of this model, the briber and the official are bribe price takers who do not bargain over the level of the bribe or the service provided in return.

Bribery, however, seldom occurs under competitive market conditions. Instead, a bargaining framework is often appropriate. As the cost of corruption rises, it is not obvious how its remaining gains will be split between briber and bribee. The answer will depend in part on their relative tolerance for risk. It may also depend on whether the probabilities of detection and punishment and the penalties imposed are a function of the level of bribes paid. If they are, payoffs may be quite low but also very common. In contrast, one possible result of stepped-up enforcement is a lower incidence of corruption but an increase in the size of bribes paid in any remaining corrupt deals. This would be most likely if the consequences of being caught are worse for government officials and politicians than for outsiders, a common situation. Thus a larger share of the corrupt gains would need to be given to the official compared with the firm. Officials are either entirely honest or demand large bribes.

The briber's willingness to pay also depends on the alternatives available. First, the potential briber may be able to obtain the same benefits by relocating to another jurisdiction or country. Second, the firm may have the option of following legal procedures at some additional cost. Third, the firm may have access to specialized technology or a type of financing not available elsewhere, or it may have monopoly power in its dealings with the state. Fourth, a private individual may be able to get his or her way by using threats and intimidation instead of payoffs. Fifth, the individual may be able to apply to a different official in the same government to obtain a comparable benefit. This possibility will be credible when many officials can provide a benefit such as a license, a passport, or help in smuggling goods across the border (Rose-Ackerman 1978, chapters 7 and 8). Similarly, in a democratic legislature in which a majority must be bribed, no one legislator has much bargaining power (Rasmusen and Ramseyer 1994).

In short, firms can resist corrupt demands if they have other options. A firm trying to decide where to locate its plant will be in a strong position in relation to corrupt officials if it has several feasible jurisdictions available. In contrast, a firm competing for a privatized company or a mineral concession can be subject to corrupt demands if monopoly profits are expected. In such cases, competition between potential buyers or concessionaires can produce a situation in which most of the economic benefits go to some combination of the state itself and its corrupt officials. Corruption reduces gains to the state through deals in which individual officials take bribes in return for assuring high profits for the successful firms.

The illegality of bribery introduces another cost—the cost of keeping the illegal transaction secret. Corrupt businesses and officials may create an elaborate structure of shell companies with off-shore addresses to hide their peculation. They may engage in other costly efforts to cover their tracks. Furthermore, high transaction costs mean that there is less information available than in a legal market. This may help explain why bribes in many countries are reported as stylized percentages of the value of transactions or as fixed fees—10 percent of the value of a contract, $100 for a license—and that they seem to remain unchanged over time.[5] These pricing conventions may arise from the costs and risks of negotiations. Only for very large, one-of-a-kind deals are specialized negotiations worthwhile. Even those who have been implicated in past corruption may report payoffs if officials start to get too greedy (Alam 1991; Cartier-Bresson 1995).

5. In Thailand, for example, both businesspeople and bureaucrats view a 10 percent commission paid by contractors and suppliers to officials as normal. A higher demand would be labeled corrupt. Most ordinary citizens, however, view even a 10 percent payoff as wrong and many understand that such payments increase the cost or lower the quantity and quality of public services (Phongpaicht and Piriyarangsan 1994, 134-35, 155).

What Are Corruption's Consequences?

Corruption can produce inefficiency and unfairness. It can undermine the political legitimacy of the state. Corruption is also evidence that deeper problems exist in the state's dealings with the private sector. The most severe costs are not the bribes themselves but the underlying distortions they reveal—distortions that may have been created by officials to generate payoffs.

Inefficient Government Contracting and Privatizations

When payoffs are commonplace, government contracts, privatized firms, and concessions may not be allocated to the most efficient bidders. One might, however, argue that the most efficient firm can pay the highest bribe. This will not be so, however, if the firm happens to be scrupulous. Corruption favors those with no scruples and those with connections over those who are the most productively efficient. Although there is no necessary relationship between honesty and efficiency, the need to pay bribes is an entry barrier. Only those who already have a close trusting relationship with government officials and politicians may enter the bidding. Officials may refuse to deal with those they do not know for fear of exposure. Furthermore, the high briber may expect to make payoffs, not just to win the contract or the privatization auction but also to obtain inefficient subsidies, monopoly benefits, and regulatory laxness in the future.

Corruption introduces other inefficiencies into government contracting. Projects may be too large and too numerous if bribe revenues increase with the dollar volume of procurement. They may also be more complex than necessary since corrupt payments are easier to hide if projects are one-of-a-kind. An experienced World Bank official mentioned to me that complaints about "inappropriate capital-labor ratios" in evaluation reports were often a way of flagging corrupt deals. Quality may suffer if contractors make payoffs in order to be allowed to skimp on quality.[6]

In privatizations, there is a subtle reason why the most corrupt firm will not necessarily be the most efficient. A corrupt bidder with good access to insiders may persuade officials to bankrupt or badly manage a parastatal so its value is lowered in the subsequent sale. This tactic will make it difficult for outsiders to evaluate the company, and more of the benefits will go to the successful bidder, who is also an insider, than to

6. Although there is no systematic evidence on the role of corruption in contracting, considerable evidence suggests that much investment in the developing world has little or no productive impact (Pritchett 1996).

the government. This kind of behavior will be difficult to detect since, *ex post*, the privatization will appear to be a smashing success.

The efficiency costs of corrupt privatizations will be especially high if the winning bidder must actually operate the company for a time. If the winner can sell out to a more efficient competitor, it can cheat the state from some of the gains of privatization, but the privatized firm eventually will be operated efficiently. An inefficient corrupt firm might not sell out, however, if it can continue to use payoffs and connections to gain illicit advantages in the future.

Delays and Red Tape

Officials may raise a firm's costs by introducing delays and unnecessary requirements as a way of inducing payoffs. This can happen either in contracting and auctioning or in administering regulatory and tax laws. In addition, paying bribes is itself costly. A portion of a long-distance trucker's load may rot as it waits at roadblocks established to extract payoffs (Rogers and Iddal 1996). Construction delays caused by rent-seeking officials push into the future the date at which the project begins to bring in returns. An efficient bribe seeker would only threaten delays, not actually impose them. But such threats are not likely to be credible unless they are sometimes carried out. Furthermore, the bribe-generating technology may itself be rather primitive. Trucks must be physically stopped; inspectors must actually show up at the building site.

Private production may be of low quality if bribes are paid to induce officials to overlook dangerous conditions or to permit firms to supply low-quality services. Contractors who maintained irrigation systems in Pakistan and India, for example, were found to skimp on quality. Close observers of the operation of several irrigation districts were convinced that the low quality resulted from payoffs to officials to overlook shoddy work (Wade 1982, 1984; Murray-Rust, Hammond, and Vander Velde 1994).

Regulatory laws that are justified by the inefficiencies of the private market will not be effectively enforced. The safety of the workplace and compliance with environmental regulations can be reduced by payoffs. Firms that benefit from such situations are likely to be opponents of regulatory reforms that they would otherwise favor if the system were honest and the laws well-enforced.

Inefficient Use of Corrupt Payments

Illicit funds may be used for consumption by top bureaucrats, may be invested in legitimate businesses at home or abroad, or may be diverted into illegal businesses. Payoffs are more likely to be diverted into illegal activities or foreign bank accounts than other funds because they are already illegal and must be kept secret. Of course, if bribes are paid out of a multinational's profits, the diversion of bribes abroad may have marginal effect on society. The bribe is just a transfer from the excess profits of the contractor to public officials. This is not a general result, however. Bribes may be paid out of profits that are themselves inflated because of the corrupt nature of the transaction. Then the export of bribes is a form of capital flight that is likely to be costly for a nation's citizens.

The net cost of such transfers, of course, depends on whether other capital investment comes in to take its place. If capital markets were perfect, funds from international investors would replace any inefficiently exported corrupt payments. But, especially in the developing world, where knowledge of local conditions is likely to be valuable, the assumption of perfect capital markets does not seem warranted.

Inequities

Corruption has distributive consequences. As with discussions of tax incidence, the actual distribution of gains and losses will often be difficult to calculate. However, a few observations are possible.

In a corrupt contracting and privatization process, a larger share of the gains accrue to winning bidders and public officials than under an honest system. A share of the country's wealth is distributed to insiders and corrupt bidders, contributing to inequalities in wealth. The state must make up for high contract prices and for disappointing revenue generated by privatizations by raising taxes or cutting spending.

If scarce subsidies to agriculture and to business are corruptly distributed, the poorest producers are most likely to suffer. In India and Pakistan, corruption in irrigation systems means that those at the bottom of the system may obtain much less water than they need even for subsistence farming. Some ditches run dry before the end of the system is reached (Wade 1982, 1984; Vander Velde 1990; Vander Velde and Svendsen 1994). Programs that directly aid the poor will be less effective if payoffs are needed to qualify for the service. If applicants pay for a favorable place in line for admission to public housing, the most needy will suffer.

Countries with abundant mineral wealth face special challenges. For example, much of the oil wealth of Nigeria has been dissipated through corruption and other forms of rent seeking (Herbst and Olukoshi 1994; Diamond 1993; Olowu 1993). In 1984, after 10 years of oil boom, the per capita income of the average Nigerian was no higher than in 1974. During the 1980s, the economy declined at a rate of 0.4 percent annually, and in 1990 Nigeria was the 17th poorest country in the world with a per capita income lower than that of India or Kenya (World Bank data cited in Herbst and Olukoshi 1994, 453).

Damaged Political Legitimacy

Systemic corruption undermines the legitimacy of governments, especially democracies (see chapter 3). Citizens may come to believe that the government is simply for sale to the highest bidder. Corruption undermines claims that government is substituting democratic values for decisions based on ability to pay. It can lead to coups by undemocratic leaders. Military takeovers are frequently justified as a response to the corruption of democratic rulers (Ayittey 1992; Brett 1992; Diamond 1993; Gillespie and Okruhlik 1991; Gould and Mukendi 1989; Herbst and Olukoshi 1994; Phongpaicht and Piriyarangsan 1994; Widner 1994).

In contrast, governments that do not depend upon the consent of the governed can use corruption to maintain power by spreading the benefits about. If most wealthy and powerful individuals are part of a network of corrupt payoffs and favors, the threat of exposure can help current rulers maintain power. Thus corruption need not be destabilizing. A stable corrupt state may provide a hospitable environment for business investment in the medium run. Lacking a well-established rule of law, however, such societies always risk an escalating cycle of payoffs and insider deals. In Somalia, for example, autocracy degenerated into warlordism (Coolidge and Rose-Ackerman 1996). Some wonder if Indonesia, which has maintained a stable corrupt system for years, may be verging toward a more kleptocratic situation as Suharto nears the end of his reign (Campos and Root 1996, 136-37).

Slowed Growth

These consequences suggest that widespread corruption is likely both to retard development and to distribute the benefits of development unequally. When corrupt countries grow, this implies that corruption has not gone so far as to undermine economic fundamentals. Growth may, however, be a cause of corruption since it creates gains to share. Although individual bribe payments can facilitate business transactions, tolerating pervasive corruption is not a recipe for growth. Rather, economic development increases the rents available for distribution. The task for developing economies is to maintain conditions that reward productive entrepreneurship. Otherwise, those seeking wealth may instead become rent seekers, using resources to shift benefits from others to themselves without generating any value added. Countries with mineral wealth such as oil, copper, or diamonds can maintain a standard of living similar to their neighbors and still siphon off a high level of payoffs. If a downturn occurs, entrenched corruption is likely to become less accepted because there is no longer a growing pie.

Recent cross-country research suggests a negative association between growth and high levels of corruption and other measures of ineffective government (Mauro 1995; Keefer and Knack 1995; see also chapter 4). Other work suggests that the smallest businesses find systemic corruption especially costly and that arbitrary and corrupt governments push firms into the informal sector (Rose-Ackerman and Stone 1996; Kaufman and Kaliberda 1996), that development projects are less likely to be successful in countries with high levels of corruption (Kilby 1995), and that illegal payoffs can significantly increase the cost and lower the quality of public works projects.[7]

Solutions

Widespread corruption is a symptom, not the disease itself. Eliminating corruption makes no sense if the result is a rigid, unresponsive, autocratic government. Instead, anticorruption strategies should seek to improve the efficiency and fairness of government and to enhance the efficiency of the private sector. I argued above that the size and incidence of corruption depended upon four factors: the overall level of public benefits available, the discretionary power of officials, the riskiness of corrupt deals, and the relative bargaining power of briber and bribee. Anticorruption strategies can be similarly categorized under headings: those that lower the benefits under the control of officials, those that reduce their discretion, those that increase the costs of bribery, and those that limit the bargaining power of officials. Strategies must be designed not just to reduce corruption but also to reduce the distortions that corruption either makes possible or reveals. In other words, we need to distinguish between cases in which payoffs themselves produce inefficiency and unfairness and those in which payoffs are a response to underlying pathologies in public programs.

I begin with strategies that increase the risk of corrupt payoffs. I go on to discuss structural and substantive reforms designed to limit the "economic rents" in the public sector and to reduce the discretion and bargaining power of officials. I conclude with some ideas about how the international business community and development institutions such as the World Bank might productively help control corruption.

Increasing the Risks and Costs of Corruption

Strategies that reduce the net benefits of paying and receiving bribes provide a background for substantive legal reform. Government policy

7. On this last issue the evidence is anecdotal. See, for example, Faruqee (1994) and Diamond (1993) for examples from Nigeria.

can increase the benefits of being honest, increase the probability of detection and punishment, and increase the penalties levied on those who are caught.

Reforming the civil service is an obvious first step. If officials are paid much less than people with similar training elsewhere in the economy, only those willing to accept bribes will be attracted to the public sector.[8] The rest will work in private enterprises or emigrate. Furthermore, if the level of benefits under the discretionary control of some officials is very high, they may need to be paid above the going rate for people with similar skills. This must be done to increase their willingness to resist the high bribes they may be offered. Thus a country will face a choice between a high-corruption equilibrium with a low-wage bill and a low-corruption state with a high-wage bill (Besley and McLaren 1993). In a country with few skilled workers, a high-wage strategy for public servants not only inflates the government budget but also lures skilled workers away from the private sector. Such countries should be especially interested in the strategies discussed below that lower the opportunities for corruption.

When civil service reform is a realistic option, adequate civil service pay is a necessary, but not a sufficient, condition. High pay reduces the marginal value of the extra funds available from taking bribes but does not reduce the value to zero. Paradoxically, high pay may simply increase the bribe an official demands to overcome the risks of losing what is now a quite desirable job. Thus the incidence of bribery falls as fewer officials are solicited or accept payoffs, but the size of the bribes that are paid increases.

Therefore, civil service reform must include features that are tied to the marginal benefits of accepting payoffs. This is a reason for setting civil service wages above the going private-sector wage and for giving public employees generous benefits such as pensions that they will receive only if they retire in good order (Becker and Stigler 1974). Whatever penalties the criminal law imposes on someone convicted of corruption, the costs of losing a government job for malfeasance will be added on. This strategy, however, must be combined with a transparent system of selecting civil servants or else a new form of corruption will arise—people will pay the powerful to be allotted a desirable government job.

Even these reforms may not be sufficient. Although they are tied to behavior that leads to loss of a government job, they are not tied to the marginal benefits of individual corrupt deals. Thus once officials have stepped over the line and begun to take bribes, these policies will

8. Some claim that Botswana's status as a relatively clean African country stems from its rulers' commitment to a professional and well-paid civil service (Raphaeli, Roumani, and MacKeller 1984).

encourage them to take ever higher and more frequent payoffs. If they face a high probability of losing their jobs anyway, why not take as much as possible?

Thus a third strategy is needed. Penalties must be tied to the marginal benefits of the payoffs received. To some extent, this is a job for criminal law and for internal monitoring processes. There are two aspects to this—the probabilities of detection and punishment and the level of punishment, given conviction. Both should be designed so that the expected penalty increases as the level of peculation increases. The marginal penalty will increase with the number and level of payoffs if the chance of detection and conviction is a function of these variables. Similarly, it can increase, even with a fixed probability, if the penalty imposed on those found guilty is tied to the overall amount of money they have received (Rose-Ackerman 1978, chapter 6).

In short, behind all proposals for civil service reform is an effective set of internal controls or antibribery laws with vigorous enforcement. The laws must apply both to those who pay and to those who receive bribes. Thus not only should convicted public officials pay a multiple of bribes received but convicted bribers should also sacrifice a multiple of their gains from bribery. Because bribes represent a cost to those who pay them, penalties should be tied to their gains (their excess profits, for example), not to the amount paid. If potentially corrupt firms are repeat players with the government, they can be deterred by debarment procedures that prohibit corrupt firms from contracting with the government for a period of years. To have marginal effect, the debarment penalty should be tied to the seriousness of the corruption uncovered.[9]

Outside institutions can complement systems of internal control. They must themselves be free of corruption in order to exercise effective oversight. Thus an independent and honest judiciary, including lower-level clerks, is obviously a necessary condition for the effective use of legal sanctions (Buscaglia 1995; Malik 1995). Alternatively, or as a supplement, other independent review and investigative systems such as an anticorruption commission, an ombudsman, or other independent administrative tribunals have been proposed by some.[10] External review bodies, such as Hong Kong's Independent Commission against Corruption, can be valuable, but such a body risks arbitrariness if it reports only to the country's ruler, who could bias its work toward political rivals (Klitgaard 1988, chapter 4; Quah 1993).

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

10. See Jeremy Pope (1996, 73-78). This source book, produced by Transparency International, a nongovernmental organization committed to fighting corruption, reviews in more detail many of the reforms proposed here.

Reporting the peculations of others can be dangerous. If corruption is systemic, one risks being disciplined by corrupt superiors and attacked by co-workers. The whistle-blower may even end up being accused of corruption himself. Yet uncovering evidence of corruption is notoriously difficult because both sides to the transaction have an interest in keeping it secret. Thus governments should consider promulgating whistleblower statutes that protect and reward those in the public and private sectors who report malfeasance (Pope 1996, 59-61). The United States, for example, has a statute that rewards those who report irregularities in government contracts (*US Code* 31, sections 3729-31; Kovacic 1994).

Furthermore, when corruption is systemic, solutions that appear reasonable in other contexts can be counterproductive. Thus some recommend rotating officials so that they are unable to develop the close, trusting relations needed to reduce the risks of accepting payoffs. However, if the entire bureaucratic agency is corrupt, superiors can use their ability to reassign officials as a punishment for those who will not play along with the corrupt system. A study of corruption in an irrigation system in India found that such practices were common (Wade 1982, 1984), and they have been observed in corrupt police forces in the United States and Thailand as well (Phongpaicht and Piriyarangsan 1994, 99-120; Sherman 1974).

Other sources of information about malfeasance are in the private sector. Those concerned with fighting corruption should support a free press and few constraints on creating and operating watchdog groups. They should support freedom of information laws and oppose restrictive libel laws, especially those that give special protections to public officials (Pope 1996, 129-41; Tucker 1994). Elected politicians should not be immune from facing charges of corruption.

Sometimes, when corruption is itself impossible to observe, its effects on the quality of government services may be evident. Thus nongovernmental organizations should be encouraged to carry out and publish public opinion surveys to determine public attitudes toward government services. Sam Paul (1995) has done pioneering work in Asia, and the Economic Development Institute of the World Bank has sponsored several pilot projects that can provide useful models in this area.

Law enforcement and administrative penalties focus on locating corruption after it has occurred. If effective, the perceived risks of becoming corrupt will deter civil servants from accepting or extorting payments. The goal is to use a combination of carrots (desirable pay and benefits) and sticks (legal and administrative penalties) to deter payoffs. In contrast, other mechanisms focus on creating structures within the public sector that make government actions more transparent. Corruption is deterred because it is more difficult to hide.

One example of this is strong financial management systems that audit government accounts and make financial information about the government public. Procurement regulations that keep the process open and fair are also important (Pope 1996, 93-116). Both accounting and procurement rules, however, must not be perceived as silly or overly intrusive. Officials with discretion can accept bribes without their peculation being obvious to the outside world, yet discretion is obviously necessary for governments to function. For example, rules that the low bidder always be accepted can lead to low-quality work or facilitate bid rigging.[11]

Along these same lines, corruption among politicians can be deterred through campaign finance reform and reform of conflict of interest rules. Limitations on legal donations, however, must not be so restrictive that they virtually push candidates off the books. Legal controls must be combined with effective legal methods of financing campaigns either with public money or with contributions from private individuals and organizations.

It is impossible to evaluate the relative merits of these options in the abstract because the costs and benefits will depend upon the context. Most cannot stand alone. For example, increases in civil service pay and benefits would be pointless unless credible monitoring systems are in place to detect wrongdoing. Furthermore, policies to increase the risks and costs of corruption are usually part of reform strategies also designed to reduce the level of potential benefits. When Mexico reformed its customs service, for example, it not only simplified the underlying regulations but also improved civil service pay and auditing and control.

Reducing Incentives for Payoffs

Reforms that simply make corruption risky are not sufficient. Given the difficulty of amassing evidence and carrying out a successful prosecution, law enforcement can provide no more than a set of background conditions within which government programs operate. Similarly, watchdog agencies and private nongovernmental groups have limited ability to observe state activities. A modern state requires strong financial management systems, procurement codes, and civil service reward mechanisms, but these systems may be overwhelmed by the sheer level of benefits and costs dispensed by the state. Thus reform must also reduce the level of benefits under the control of public officials. The strategy must do this, however, without eliminating programs that have strong public justifications and without simply shifting the benefits into the private sector, where they will show up as monopoly profits. There are several strategies to consider.

11. See, for example, Klitgaard's (1988, chapter 6) discussion of bid rigging in US Army contracting in Korea.

The most obvious option is simply to eliminate programs that are permeated with corruption. If the state has no authority to restrict exports or license businesses, no one will pay bribes in those areas. If a subsidy program is eliminated, the bribes that accompanied it will disappear as well. If price controls are lifted, market prices will express scarcity values, not bribes. If a parastatal is the locus of corrupt payoffs, the state should move its functions into the private sector.

In general, any reform that increases the economy's competitiveness will help reduce incentives for corruption. Thus policies that lower controls on foreign trade, remove entry barriers for private industry, and privatize state firms in a way that assures competition will all contribute to the fight against corruption (Ades and Di Tella 1995). As Van de Walle (1994, 136) observes, "Economic liberalization is likely to reduce the amount of rent seeking. . . . Devaluation, tariff reduction, and price liberalization all reduce rent seeking."

But any move toward deregulation and privatization must be carried out with care. Deregulating in one area may simply increase corruption elsewhere. For example, a successful effort to reduce corruption in the transport of agricultural products in Niger simply increased corruption in neighboring countries on the same transport route. A project sponsored by the US Agency for International Development was successful in reducing the number of bribe-extraction checkpoints established by police and customs officials along onion transport routes in Niger. Unfortunately, the ultimate outcome was an increase in payoffs and tax levels in Côte d'Ivoire as the onions neared their destination—the food markets of Abidjan (Rogers and Iddal 1996).

The privatization process can itself be corrupted, as can the new regulatory institutions that will be needed in the privatized world. Instead of bribing the parastatal to obtain contracts and favorable treatment, bidders for the company bribe officials in the privatization authority. A firm privatized with its market power intact may not be corrupt, but it will harm the public by charging monopoly prices. This is not to say that privatization and deregulation are not, on balance, desirable in a wide range of cases but only to caution reformers to look carefully at the incentives for rent seeking that remain.

Limiting Official Discretion

Of course, many regulatory and spending programs have strong justifications and ought to be reformed, not eliminated. Corruption in tax collection obviously cannot be solved by failing to collect revenue. In such cases one solution is to clarify and streamline the necessary laws in ways that reduce official discretion. In the reform of the customs service at the Mexico City airport, for example, the number of steps in the customs process was reduced from 16 to 3. The remaining service was streamlined to reduce delays ("Airport Customs Harnesses 3 Billion Mexico Pesos Per Year," *El Economista*, 13 February 1992).

Rules could be made more transparent with publicly provided justifications. Government might favor simple nondiscretionary tax, spending, and regulatory laws as a way of limiting corrupt opportunities. Obviously, the value of such reforms depends on the costs of limiting the flexibility of public officials. Sometimes a certain risk of corruption will need to be tolerated because of the benefits of a case-by-case approach to program administration. Transparency and publicity can help overcome corrupt incentives even in such cases.

Economists have long recommended reforming regulatory laws in such areas as environmental protection by introducing market-based schemes that limit the discretion of regulators. These analysts also recommend user fees for scarce government services. These reforms have the additional advantage of removing corruption incentives by replacing bribes with legal payments. The sale of water and grazing rights, tradable pollution rights, and the sale of import and export licenses can improve the efficiency of government operations while limiting corruption.

The final group of proposals involves administrative reforms that lower incentives for corruption. Corruption is often embedded in the hierarchical structure of the bureaucracy. Low-level officials collect bribes and pass a share on to higher-level officials, perhaps in the form of an up-front payment for the job itself. Conversely, higher-ups may organize and rationalize the corrupt system to avoid wasteful competition between low-level officials. Top officials may then share the gains of their organizational ability with subordinates, perhaps using them to run errands, transfer funds, and do other risky jobs that expose them to arrest. To break such patterns may require a fundamental reorganization.

The first possibility is to introduce competitive pressures within government to lower the bargaining power of individual officials. When bribes are paid for such benefits as licenses and permits, which are not constrained by budgetary limits, overlapping, competitive bureaucratic jurisdictions can reduce corruption. Because clients can apply to any of a number of officials and can go to a second one if the first turns them down, no one official has much monopoly power. Thus no one can extract a very large payoff, and some officials may give up making corrupt demands. For qualified clients, bribes will be no larger than the cost of reapplication. Unqualified clients will still pay bribes, but even they will not pay much as long as they, too, can try another official (Rose-Ackerman 1978, 137-59).

When officials such as police officers can impose costs, another type of overlapping jurisdiction model should be considered. Police officers seeking to control illegal businesses can be given overlapping enforcement areas. That way, gamblers and drug dealers will not pay much to an individual police officer because a second one may come along later and also demand a payoff. The first one is simply unable to supply protection (Rose-Ackerman 1978, 159-63). This system may work better if the law enforcement officers belong to different police forces—local, state, or federal, for example. Then collusion between officers to defeat the system will be less likely. For instance, the FBI is involved in investigating municipal corruption in the United States. Sometimes the overlap has an international dimension. The involvement of US drug enforcement authorities in investigating the drug business in Colombia led a defector to choose the American justice system over the Colombian and to open the door to information on drug cartel payoffs to Colombian politicians ("Informant's Revelations on Cali Cartel Implicate Colombian Officials," *Washington Post*, 28 January 1996).

Second, if it is difficult to observe the corruption itself, one could design programs to observe its effects. For example, the state might use private market prices as benchmarks to judge public contracts (Ruzindana 1995). Clear rules of proper behavior could be established so violations can be noticed even if the bribery itself is not. Where possible, procurement decisions could favor standard off-the-shelf items to provide a benchmark and to lower the cost of submitting a bid.

Third, many corrupt situations have both winners and losers. Thus the state could introduce ways for potential losers to protest or to organize ahead of time. For example, a land reform program in India was apparently relatively honestly carried out, in part because of a credible, speedy appeals process (Oldenburg 1987). Or the state could make it hard for corrupt officials to organize either themselves or bribe payers. Sometimes bribe payers view themselves as extortion victims who would be better off in an honest world. Such bribe payers are potential allies in an anticorruption effort and will cooperate in efforts to eliminate payoffs. Conversely, in other cases bribery makes both payers and receivers better off with respect to a no-bribery world. Thus control incentives must rest with outsiders not in on the corrupt deal (for example, disappointed bidders, taxpayers, or consumers). The existence of losers such as disappointed bidders with a large stake in the outcome can facilitate efforts to limit corruption (Alam 1995).

Involving Multinational Lenders and Firms

Efficient multinational firms face a "prisoner's dilemma" when they deal with corrupt regimes. Each believes it needs to pay bribes in order to do business, but each knows that all of them would be better off if none of them paid. The playing field is tilted toward unscrupulous but less efficient firms that would not fare as well in an honest system. This realization has led to recent international efforts to limit corruption in international business. Such efforts could complement the solutions outlined above, which largely focus on what a country can do when its leaders are committed to reducing the level of malfeasance.

The World Bank and the regional development banks have a good deal of leverage with their borrowers. They have often been reluctant to use it for fear of being accused of lacking cultural sensitivity or of being heavy-handed advocates of democracy and Western values. The end of the Cold War has, however, changed the balance. Widespread corruption and organized crime's influence in countries such as Russia and others in the former east bloc have made the problem difficult to ignore (Handelman 1995; Shelley 1994). The failure of Africa to develop in the face of substantial progress in many parts of Asia and Latin America raises questions about the role of the state in development. The continuing high level of inequality in many Latin American countries raises similar concerns. The coexistence of corruption and growth in several Asian countries highlights the question of the direction of causation when growth and corruption go together.

In short, multilateral lenders are today freed from the need to support corrupt regimes that in the past could threaten to turn to China and the Soviet Union for help. They remain, however, caught in a bind between the goals of poverty reduction and economic growth on the one hand, and the supporting coalition of developed-country exporters and developing-country governments on the other. Corruption of procurement or privatization is sometimes associated with a close relationship between particular international firms and borrower governments. The home countries of these firms will resist multilateral lenders' concerns with corruption. They have developed a comfortable monopoly relationship that they do not want to disrupt. The opening up of Eastern Europe, the former Soviet Union, and China brings this difficulty into relief. Officials in transitional economies are probably no more corrupt than those elsewhere, but they as yet lack supportive counterparts in the international business community. They also lack strong legal, political, and economic institutions. The wealth of these countries is up for grabs, and potential investors worry that the gains will be dissipated in costly corruption and rent seeking.

The World Bank is proving willing to acknowledge the problem in countries in transition in Eastern Europe and Asia and to consider how its projects might provide constructive help in alleviating the worst excesses. Once such projects are contemplated in Russia and Turkmenistan, it is difficult to argue that they are inappropriate for Guinea, Pakistan, or Brazil. In fact, as private capital becomes more important in some traditional areas of Bank lending, the Bank's role in institutional reform should increase.

The World Bank already supports public-sector management and governance projects in a wide range of areas. Some of these projects began as part of the structural adjustment lending carried out by the Bank in the 1980s and, at a somewhat reduced level, up to the present. This is an awkward vehicle for institutional reform efforts, and free-standing projects are now being carried out. Other loans that aim to reform regulatory authorities, taxation agencies, the judiciary, and other public institutions are being considered or carried out. The Bank frequently advises countries on privatization. All these initiatives require a long-term commitment of funds and expertise and a realization that "output" measures will not be easy to formulate precisely. Nevertheless, the World Bank and other development lenders can provide a framework within which development can proceed as a partnership between the public and private sectors.

Furthermore, greater success in improving the institutional environment for development would be likely if both international aid lenders and borrower governments took a more straightforward approach to controlling corruption and other forms of malfeasance. One recent buzz word in lending circles is "ownership." Projects will fail unless the borrower feels that it "owns" or has a stake in the project. Unfortunately, one form of ownership is all too common. Political figures in borrower countries and firms in lender countries express an ownership interest in projects that produce personal benefits for the politicians and profits for the firms. They will oppose projects that spread the benefits more broadly and that assure free competition. Ownership is a questionable value in cases in which a country's rulers do not seem committed to poverty alleviation. The World Bank tries to maneuver between the economic interests of donor and borrower governments and to manage the tensions between the Bank's broad charitable goals and the politics of lending policy. The issue is a complex one, but acknowledging the problems of corruption and self-dealing in both borrower and lender countries and trying to limit their effect on the Bank's efforts to promote growth and reduce poverty are good places to start. The goal should not be to insulate World Bank projects from a borrower country's corrupt climate or from the payoffs that have become routine in some areas of international business. Instead, it should be to seek fundamental changes in attitudes and institutions in situations in which corruption and governmental ineffectiveness go together.

Conclusions

Some argue that bribes help firms and individuals circumvent government requirements—by reducing delays and avoiding burdensome regulations and taxes. Payoffs seem to be nothing more than the grease needed to operate in a difficult environment. Corruption cannot necessarily be limited, however, to situations in which the rules are inefficiently restrictive. If not vigorously attacked, small-scale, facilitating bribes can feed on themselves. The mechanism is as follows: officials might begin by limiting themselves to bribes that facilitate private business without imposing costs on the rest of society. However, if these officials are unscrupulous enough to take payoffs, it seems unlikely that they will limit themselves to such relatively benevolent forms of corruption. Why not take bribes not only to overlook a pointless and burdensome regulation but also to permit violation of environmental and safety standards or to permit underpayment of corporate income taxes? After all, from the private business point of view, both types of payoffs are profitable. Furthermore, if bribes are paid to avoid burdens, it does not take too much cleverness on the part of officials to recognize that their returns may increase if they threaten to impose additional burdens or promise to award specialized benefits to bribe payers.

Incentives to make and ask for payoffs occur whenever government officials have economic power over a private firm or individual. It does not matter whether the power is justified or unjustified. Once a pattern of successful payoffs is institutionalized, corrupt officials have an incentive to raise the size of bribes demanded and to search for alternative ways to extract payments.

Even when illegal payoffs appear to facilitate commerce, governments and private citizens should not respond with tolerance. Instead, they should move vigorously to avoid creating a culture of illegality. Illegal markets are always inefficient and unfair compared with legal ones. Those with strong scruples will not participate, price information will be poor because of the illegality of the trades, and time and energy must be expended to keep the deal secret and to enforce its terms. In some cases, paying bribes may be more efficient than complying with existing rules, but corruption is always a second-best response to government failure.

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 effect on personal freedoms and human rights. Such a focus could produce a government that is rigid and unresponsive. Thus, the aim is not to achieve complete rectitude but rather a fundamental increase in the honesty—and the efficiency, fairness, and political legitimacy—of government.

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