

Corruption and transition economies

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*On corruption, the sad truth is that nobody knows how to build an honest, effective state machine in a country where a dishonest, corrupt state already exists. Evidence suggests that democracy, economic openness, and above all, growth tend to help, although the effect can be slow.*¹

Introduction

Corruption has always existed across the world and it will never disappear. This is so because the "optimal" level of corruption cannot be zero as the marginal costs of anti-corruption efforts are likely, at some point, to exceed the marginal benefits. Corruption has also become more sophisticated and thus more difficult and costly to detect. Unfortunately, this pessimistic premise about the secular existence of corruption – along with the realization that the cost of doing nothing about corruption is unacceptably high – appears to be one of the very few issues over which there is general agreement. The definition of corruption varies not only from country to country but from discipline to discipline. Economists have generally accepted corruption to be defined as "the abuse of public power for personal gain", but alternative definitions exist.² Sociologists have also offered a variety of definitions with one, notably, classifying corruption into white, black and grey depending on the extent of consensus as to what corruption is.³ But even if the definition of corruption is agreed on, many conceptual ambiguities remain – causes, consequences and costs of corruption are debatable; and so are the methods how to fight or prevent it.

As a result, corruption remains extremely difficult to study both theoretically and empirically. Its many likely determinants are interrelated and endogenously

determined. For example, corruption may induce policy distortions that negatively affect economic growth while lower growth, in turn, may give rise to increased corruption. Consequently, it is often hard to be definite about the direction of causality and, predictably, empirical studies on the causes and consequences of corruption produce often inconsistent or ambiguous results. Nevertheless, despite the disagreements corruption has recently attracted an extraordinary amount of interest. While the reasons for the increased attention are many, the fall of the Berlin Wall – and thus the beginning of transition for formerly communist countries – is often credited with giving increased prominence to corruption issues.⁴

In principle, corruption could be a central feature in transition because of wide-ranging impacts on legitimacy and credibility of governments during the decisive times of building new political and economic institutions. Corruption is also closely associated with the transition-defining process of transferring the state property into private hands. In addition to being a transition-specific threat, corruption represents danger to the overall development of these countries. Corruption however is not strictly a transition phenomenon: it occurs in all countries and takes many forms.

The aim of this paper is not to offer detailed prescriptions of how to fight corruption in transition economies. Instead, this paper describes the likely sources and consequences of corruption with a view to providing a structured framework for discussing corruption issues in transition economies. The paper presents the concepts of administrative and political corruption and it briefly touches upon privatization of state assets as a potential contributor to corruption.

* The views and opinions expressed here are the author's and not necessarily those of the United Nations Economic Commission for Europe.

¹ D. Treisman, Blaming Russia First, *Foreign Policy*, November/December 2000, p.155.

² "For example, "the intentional non-compliance with arm's length relationship aimed at deriving some advantage from this behaviour for oneself or for related individuals". V. Tanzi, Corruption Around the World: Causes, Consequences, Scope, and Cures, *IMF Working Paper*, WP/98/63, May 1998, Washington DC, p.8.

³ For more on definitions see M. Johnston, The Search for Definitions: the Vitality of Politics and the Issue of Corruption, *International Social Science Journal*, vol. 48, September 1996, pp. 321-335.

⁴ According to this point of view, western governments became freer to criticize corrupt governments, because they no longer needed them as anticommunist allies. See A. A. Goldsmith, Slapping the Grasping Hand: Correlates of Political Corruption in Emerging Markets, *American Journal of Economics and Sociology*, vol. 58, No. 4, October 1998, p. 867.

Finally, the paper discusses democracy and its (usually) accompanying system of “checks and balances” such as judiciary, civil society, transparency and press freedom. In all cases, special attention is paid to transition economies and, where possible, data are provided to illustrate various concepts and to suggest associations between corruption and other variables.

Sources of corruption

While it is not possible to measure corruption or observe it directly – it is not clear what exactly should be measured and corruption is after all a criminal activity - many corruption indicators are available. Cross-country measures of corruption such as country risk assessments and surveys are provided by private firms - often rating agencies that sell information to businesses. Recently, non-governmental organizations such as Transparency International also started publishing cross-country corruption rankings (Box 1). With each institution using different techniques, the methods range from analysts providing the data, surveys of executives to “poll of polls” techniques where many surveys are averaged. While the methods differ, corruption ratings from different sources are typically highly correlated, indicating that approximate agreement exists on how corrupt various countries appear to be. Thus, despite many problems with the indices – they are inherently imperfect and subjective - it is believed that indicators of perceived corruption represent a useful and potentially insightful tool for social scientists and policy makers alike.

Although today much more is known about corruption than five years ago, it is still not exactly clear what causes corruption and what causes it to be higher in one country than another.⁵ Nevertheless, the most frequent source of corruption is government because government restrictions on economic activity tend to either generate rents or transfer them (to one group at the expense of some other).⁶ Price controls, international trade restrictions such as tariffs or quotas, industrial policies and multiple foreign exchange regimes are all examples of rent creation by government policies. As the state creates (or distributes access to) excessive profits and, at the same time, “designates” politicians and civil servants to allocate them in a (to a varying degree) discretionary manner, the governments are obvious culprits.

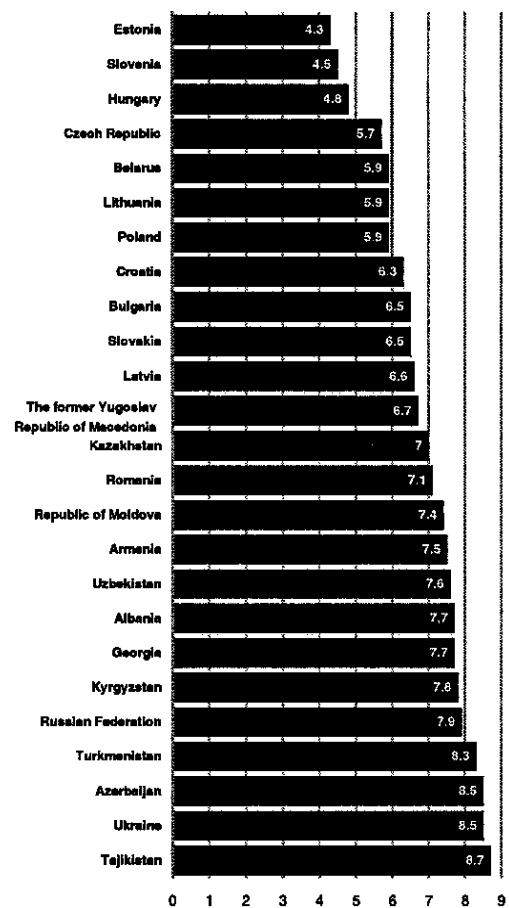
⁵ The first systematic empirical test of corruption was undertaken in the mid-1990s. While corruption research is a growing endeavour, the above-noted interrelated, complex and simultaneous determinants and consequences of corruption make it very challenging. As a result, the “causes” discussed below should not be interpreted strictly as such, but rather as likely sources or contributors to corruption. Similarly, the “consequences” should be thought as implications likely originating with corruption or associated with it.

⁶ It should not be ignored that government activities also reduce economic rents and private business is source of most (if not all) of the bribe money.

BOX 1

Transparency International Corruption Perception Index

According to Transparency International, in 2000 Estonia was perceived to be the least corrupt transition economy – scoring 4.3 out of 10 points which placed it 27th on the list of over 100 countries. In contrast, most other countries of the former USSR are perceived to be the most corrupt and appear at the bottom of the ranking – among transition economies as well as among all surveyed countries. For example, Azerbaijan, Ukraine and Tajikistan placed almost at the very bottom of the overall ranking.



Source: Transparency International, *Corruption Perception Index, 2000*, www.transparency.de.

Note: Scale 0-10 (highly corrupt=10, highly clean=0). Throughout this paper, the original TI ratings have been inverted using the “10-x” formula. All data for 2000, except 1999 data for Albania, The former Yugoslav Republic of Macedonia, Georgia, Kyrgyzstan. For Tajikistan and Turkmenistan 1997 data from G. Abed and H. Davoodi, *Corruption, Structural Reforms, and Economic Performance in the Transition Economies*, IMF Working Paper, WP/00/132, p.13.

While it is rarely questioned that governments’ monopoly and discretionary powers are associated with increased corruption, the relationship between the state and corruption is not straightforward. Commonly, economists analyze it in the “principal-agent” framework where a public servant (the agent) who is entrusted to carry out some function for society at large (the principal) engages in some malfeasance for his own benefit (which is difficult for the principal to monitor). In this

framework, the three parties involved - the public, bureaucrats and firms - have different objectives and motivations, use different instruments to achieve them and face different constraints resulting in a highly interdependent and opaque interaction.⁷ In contrast, sociologists emphasize the link between cultural values and business practices. For example, one sociologist has described a cultural profile of a corrupt country to be characterized by "high uncertainty avoidance, high masculinity and high power" (ie., countries where their citizens feel threatened by unknown situations, focus on material success more than quality of life and where decisions are made on the basis of favour and loyalty, and not merit).⁸

The contrasting human motivations and complex interactions point to the difficult task of disentangling the causes and effects of corruption. As a result, there have been many economic typologies of corruption proposed. Some have discussed "factors that promote corruption" such as regulations, taxation, spending decisions, provision of goods and services at below market prices, financing of parties, quality of bureaucracy, public sector wages, penalty systems and transparency.⁹ Others have classified the causes of corruption into payments that equate supply and demand, incentive payments for bureaucrats and cost reducing bribes.¹⁰ In a transition context, some observers have emphasized the desire to earn extra income as well as plentiful opportunities for corruption. The latter include high monopoly rents, largely unchecked discretion of public officials and systemic weaknesses in institutional capacities such as poorly defined and changing rules, weak accountability, restricted political competition and civil liberties and ill-prepared legal institutions.¹¹

The communist countries entered the transition with varied political and economic legacies and these differences likely account for the current individual differences in the extent of corruption. However, the overall scale of corruption in transition economies appears extraordinary. To optimists, its visibility is a sign of progress. After the decades of living in totalitarian regimes where positions of public trust were routinely used for private gains, the citizens of post-communist

countries today can distinguish more clearly between what is public and what is private. To pessimists, the "sudden and explosive appearance" of corruption, coinciding with unprecedented fundamental changes, has confirmed their worst fears about the transition to market-based and democratic systems. In general, however, corruption in the post-communist world is related to the legacies of the communist past or the still lingering attitude summarized in a Soviet-time expression "if you are not stealing from the state, you are stealing from your family".

In many countries, one source of law-abiding behaviour is a strong government that efficiently punishes illegal acts, but - what is taken for granted - the self-interest of the individuals is a parallel force behind lawful behaviour and law enforcement. In a market economy with private property and good institutions, economic actors have selfish reasons to discourage violation of the law and to assist in its enforcement. Moreover, when "market contrary" economic policies exist - aligning the interests of both corrupt parties - corruption usually flourishes. In this context, the current extent of corruption in transition economies is not surprising. The communist regimes allowed very little private property so the self-interest was not at hand to prevent theft and to aid the government in apprehending it.¹² Moreover, "market-contrary" activity was the norm in the communist countries encouraging everyone not "to steal from their families".

Corruption and the state

While culture, history and morality undoubtedly matter, the desire for financial enrichment is a predominant motivator behind corrupt behaviour. Moreover, as noted above, governments often create favourable conditions.¹³ Not surprisingly, economists have tested "the state and corruption" relationship starting with the simplest one that relates the size of the state (as measured by the budget relative to GDP) with corruption. There have also been attempts to link the government's distributive capacity (ie, transfers and subsidies) with corruption. Both approaches have weak theoretical underpinnings resulting in contradictory empirical results. The link between "state structures" such as federal and unitary states and corruption have also generated results that are neither uniform nor robust. Overall, the theoretical problems and mixed empirical results suggest that the relationship between the state and corruption is not as simple as the bigger the state the more corrupt it is. "What kind of government contributes to corruption?" appears to be a more probing question.

⁷ Voters do not have perfect control over the politicians they elect and the agencies they set up (i.e., informational asymmetries exist). Moreover, the public's objectives are never completely clear while bureaucrats - instead of acting as a veil - usually have a separate agenda. Finally, private firms and individuals - acting as profit and utility maximizers - comply with or disobey rules and regulations depending on the costs imposed upon them and the extent of monitoring they are subjected to.

⁸ B. W. Husted, Wealth, Culture and Corruption, *Journal of International Business Studies*, 30(2), Second Quarter 1999, pp. 339-360.

⁹ Tanzi (1998), pp.10-20.

¹⁰ S. Rose-Ackerman, *Corruption and Government: Causes, Consequences and Reform*, Cambridge University Press, 1999.

¹¹ C. Gray and D. Kaufmann, Corruption and Development, *Finance and Development*, March 1998, pp. 7-10.

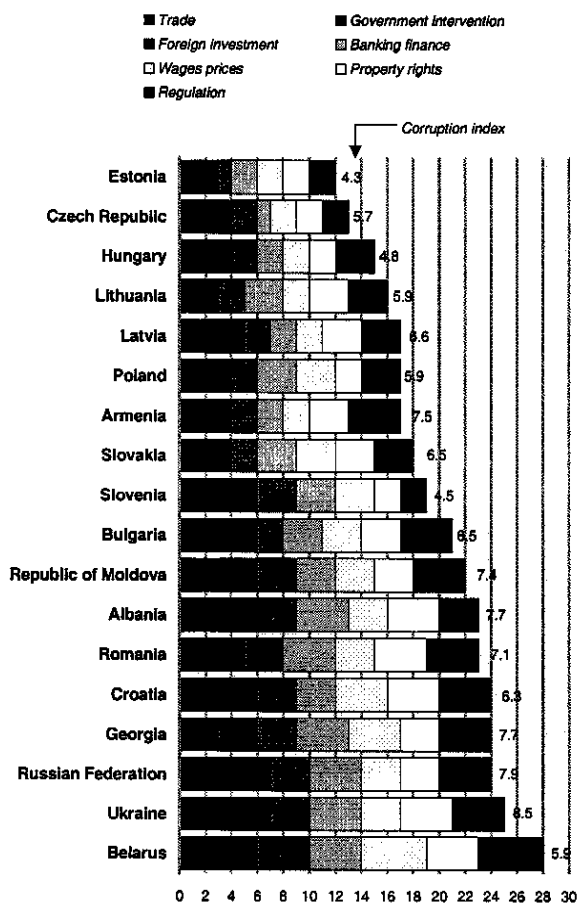
¹² M. Olson, *Power and Prosperity, Outgrowing Communist and Capitalist Dictatorships*, Basic Books, 2000.

¹³ Those not in agreement with this framework of analysis would comment "and the law creates favourable conditions for crime?"

BOX 2

Does more economic freedom result in less corruption?

Since 1995, the Heritage Foundation has published its Index of Economic Freedom or examination of the factors that contribute to prosperity. Fifty economic variables are studied and grouped in 10 categories (only seven shown here). The Foundation defines economic freedom as "the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself".



Source: The 2001 Index of Economic Freedom, Heritage Foundation, www.Heritage.org.

Note: Scale 1 - 5 for each of seven categories (1 - an institutional or consistent set of policies that are most conducive to economic freedom, 5 - a set of policies that are least conducive). For corruption index information see Box 1.

Correlation coefficient between corruption and lack of economic freedom (without Belarus) = 0.75; one represents perfect correlation. (Note that the rating of "trade" considers corruption within the customs service; "foreign investment and finance" rating includes consideration of corruption; "property rights" rating includes corruption within the judiciary; and "regulation" takes into account corruption within the bureaucracy.)

In this vein, economists have analyzed the types of activities in which governments engage and their impact on corruption. The overall premise of this direction of research is "the less competitive the economy, the greater the opportunities for corruption".¹⁴ It is believed that increased competition - or a potent dose of economic freedom - will lower the incentives for corrupt behaviour because competition reduces the potential gains associated with economic distortions (Box 2). To support this view, it has been shown that corruption is higher in countries where a small number of firms dominate the economy or where domestic economies are sheltered from foreign competition. Industrial policies have also been found to be a significant contributor to corruption.¹⁵ The empirical results between corruption and "competitive features" of governments are not one-sided, however. There is some empirical evidence that discretionary government policies may be largely powerless in combating corruption.¹⁶

The corrupt acts related to government activities can be classified into two groups. The first involves the way the government carries out its routine activities such as tax collection, customs and licensing. The second involves politicians, legislators or high level decision-makers in areas such as legislation, contracting and privatization. These two types of state activities are associated respectively with two kinds of corruption: administrative and political (state capture).

Bureaucratic or administrative corruption

Routine government actions give public officials a power to allow a certain activity to take place. For example, government officials are in charge of authorizing business registrations, issuing driver licences or house-building permits. This "monopoly" power, often accompanied by discretion, non-transparent or ambiguous procedures, permits the officials to refuse, delay or generally obfuscate with the purpose of extracting bribes from the public. As a result, the citizens, often facing numerous and unclear procedures, are forced to spend inordinate amount of time dealing with bureaucrats. To

¹⁴ Economists, have essentially used a country's openness to trade (ratio of imports or trade to GDP) as a proxy for "competitiveness" or the number of years the economy is considered to be "open" (judged by existence of high trade tariffs, non-tariff barriers to trade, multiple exchange rates, or state monopoly on major exports). The immediate criticism of such approach is the fact that in many "closed" economies domestic competition compensates for low trade openness.

¹⁵ A. Ades and R. Di Tella, National Champions and Corruption: Some Unpleasant Interventionist Arithmetic, *Economic Journal*, vol 107, July, 1997, pp.1023-1042 and A. Ades and R. Di Tella, Rents, Competition and Corruption, *American Economic Review*, vol. 89(4), September, 1999, pp.982-993.

¹⁶ A country's basic characteristics such as size, location and languages spoken ("natural openness") has been found to explain corruption. By contrast, everything else in this study, including discretionary government policies, has been found to have no additional effect. S-J Wei, Natural Openness and Good Government, *NBER Working Paper Series No. 7765*, June 2000. D. Treisman, The Causes of Corruption: A Cross -National Study, *Journal of Public Economics*, vol. 76, 2000, pp.399-457, comes to a similar conclusion arguing that policy decisions are either not significant or work very slowly.

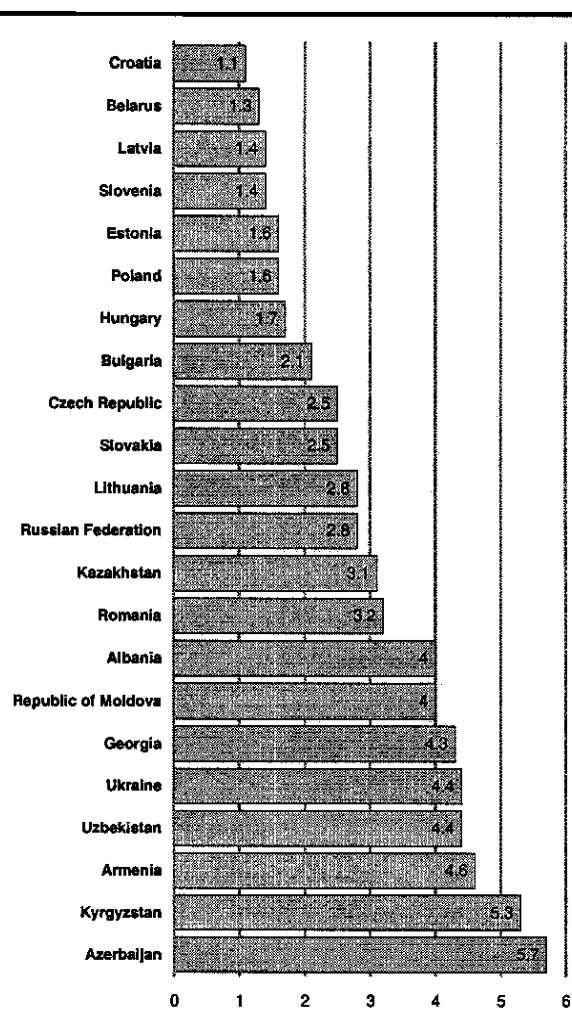
BOX 3

The cost of bribes needed to get around various impediments to conduct business

A recent World Bank study has developed an aggregate measure of administrative corruption in transition economies. The study defines administrative corruption to be "the intentional imposition of distortions in the prescribed implementation of existing laws, rules, and regulations to provide provision of private gain to public officials." According to the study, average payments "to get things done" constitute 3.7 per cent of firm revenues across the CIS and 2.2 per cent in Central and East European countries. In relative terms, these payments represent up to 25 per cent of firms' profits.

Administrative corruption

(Per cent of revenues paid in unofficial payments to public officials)



Source: J. Hellman, G. Jones and D. Kaufmann, "Seize the Day, Seize the State", State Capture, Corruption and Influence in Transition, *World Bank Policy Research Paper*, No. 2444 (Washington, D.C.), p.7.

Source: The World Bank, *Anticorruption in Transition: A Contribution to the Policy Debate*, Washington D.C., September 2000, p. xvii.

minimize it, they frequently choose to pay a bribe (Box 3). In Georgia, for example, a businessman "can start up a company after going through 12 procedures in 70 business

days and paying \$270 in fees, or he may hire a legal advisor company that will complete the start up process for \$450 in three business days".¹⁷

Administrative corruption is, therefore, bribery associated with the implementation of laws and regulations and it occurs when public officials design programs or apply the law in ways to maximize bribe revenues. Clearly the economic costs of administrative corruption are higher than just the costs of paying up.¹⁸ That is why administrative corruption is not solely a distributional issue, but it has also efficiency implications. The most immediate is the time spent away from productive activities such as managing a business to deal with red tape.¹⁹ Moreover, while paying a bribe can shorten the waiting time it also creates incentives to those with discretion to continue to introduce vaguely specified rules to generate more payoffs (Box 4).

Administrative corruption usually benefits bureaucrats at the expense of businesses or individuals, but international trade regulations provide an example of bribery that is beneficial to both cheating parties. Non-uniform import tariff rates make possible for governments to maximize revenues, but they also allow custom officials to misclassify imported goods. For example, the recent tariff schedule consolidation in Russia was designed in part to minimize tariff circumvention where corrupt custom officials would misclassify imported goods so they would fall into lower rated categories.²⁰ Russia's customs authorities do not appear to be alone facing this problem. At least one global study has confirmed that highly diversified tariff schedules and corruption are closely associated.²¹

¹⁷ The World Bank as quoted in S. Djankov, R. La Porta, F. Lopez de Silanes and A. Shleifer, *The Regulation of Entry*, unpublished manuscript, second draft, August 2000, p.7.

¹⁸ The amount of bribes paid is a good indicator of the severity of regulatory and tax regimes. In 1996, for example, more often than not each visit by fire, health of tax inspectors in Russian and Ukrainian enterprises had to be accompanied by bribes of between \$42 and \$250. D. Kaufmann, *The Missing Pillar of a Growth Strategy for Ukraine: Reforms for Private Sector Development*, Table 2, p. 242, in P.K. Cornelius and P. Lenain (eds), *Ukraine: Accelerating the Transition to Market*, IMF, Washington D.C., 1997.

¹⁹ D. Kaufmann and S-J. Wei, Does "Grease Money" Speed Up the Wheels of Commerce?", *NBER Working Paper* No. 7093, April 1999 have found that "firms that pay more bribes are also likely to spend more, not less management time with bureaucrats negotiating regulations, and face, higher, not lower, cost of capital".

²⁰ Chicken meat (30 per cent import tariff) was widely believed to be classified as turkey (15 per cent) while cut flowers would become green plants for custom related payments. After the unification of chicken and turkey tariffs in April 2000, a custom official reported a 5-fold increase in chicken imports. Custom to Lower Tariffs on Imports, *The Moscow Times.com*, 1 December 2000. Similarly, Turkish tomato paste is often imported into Poland under false certificates of origin and qualifies for lower preferential rates decreasing state revenues five-fold. Some claim that Hungary and Slovakia ship more tomato paste into Poland than they produce. *Przecier przecieka przez granice* (Paste leaks through the borders), *Rzeczpospolita*, 21 February 2001 (Warsaw).

²¹ R. Gatti, Corruption and Trade Tariffs, or a Case for Uniform Tariffs, *World Bank Working Paper* No. 2216, Washington D.C., November 1999.

BOX 4

Why does it take 50 days and 25 per cent GDP per capita to register a business in a transition economy?

A recent research looked at 75 countries asking how many formal steps are needed to establish – legally and without bribes – a new company in a country, how long it takes and what it costs. The research provides evidence that excessive entry regulation (to start a legal business) is inconsistent with “helping hand” theories of benevolent regulation. In other words, stricter regulation is not associated with socially superior outcomes. On the contrary, this evidence supports the “grabbing hand” view of regulation where the regulations benefit politicians and bureaucrats. The researchers have also found that the countries with more open access to political power, greater constraints on the executive and greater political rights have fewer required procedures for entry regulation. If better governments regulate less, entry is regulated because it benefits the regulators.

Procedures, time and cost of registration of new companies
(Numbers; dollars; per cent)

	Total number of procedures	of which Screening procedures	Number of days	Cost (dollars)	Cost In- per cent of GDP per capita
Latvia	7	5	20	622	28
Kyrgyzstan	9	7	23	76	20
Slovenia	9	8	35	650	7
Poland	10	6	26	981	28
Hungary	10	7	53	3 648	81
Bulgaria	11	8	20	200	17
Ukraine	11	6	21	193	20
Romania	11	8	68	176	11
Czech Republic	11	8	97	1 268	25
Kazakhstan	12	8	31	175	13
Georgia	12	8	70	270	28
Slovakia	12	7	111	475	13
Lithuania	13	6	66	142	6
Croatia	14	8	58	1 369	34
Russian Federation	16	12	69	1 146	38
Average above	11	7	51	759	25
Memorandum items:					
Canada	2	1	2	281	1
Bolivia	20	11	82	2 690	163
75 countries surveyed	10	6	63	3 212	34

Source: S. Djankov, R. La Porta, F. Lopez de Silanes and A. Shleifer, *The Regulation of Entry*, Second Draft, unpublished manuscript, August 2000.

Note: Number of different steps that a start-up company has to comply with in order to obtain legal status. “Screening procedures” are steps which are not related to safety and health issues, the environment, taxes or labour. GDP per capita in current (1997) US dollars.

Source: S. Djankov, R. La Porta, F. Lopez de Silanes and A. Shleifer, *The Regulation of Entry*, unpublished manuscript, second draft, August 2000.

While the obvious policy measure to counteract administrative corruption is to eliminate the redundant regulations and generally emphasize market-based mechanisms (realizing that the state is often called upon to deal with market failures), these reforms are ultimately

pointless if corruption is pervasive at the highest political levels.

Political corruption

Political leadership has the potential to bring about a substantial dysfunction to the three branches of power: legislative, executive and judicial. When well-connected firms or individuals influence – illegally and non-transparently – the formation of laws, regulations or government policies with the aim of reaping private benefits, political corruption (state capture) is said to occur (Box 5). This type of corruption is common in both transition economies and in the developed, democratic countries. (The latter appear, by comparison, to be more successful in enforcement of laws than in reducing the non-transparent or illegitimate influence on the process of enactment of those laws).

In transition economies political corruption has communist roots. An economic performance of a Soviet-type system was dependent on the flow of information and, naturally, everyone had the incentive to misrepresent it. As a result, the production difficulties were overstated and the potential production targets understated, but the competition and mutual monitoring among officials offset the negative impact of these incentives. Nevertheless, the incentives to misrepresent the information never disappeared. Both the bureaucrats and managers secretly and increasingly colluded to reduce competitive pressures to perform and this collusion over time has become solidly institutionalized.²² With the collapse of communism, the official institutions broke down, but these embedded relationships have survived. Currently, the corrupt networks and unofficial relationships continue to exist and they have supported endemic political corruption throughout the transition region.

Pervasive political corruption causes a society to incur large social costs. Aside from the immediately obvious efficiency losses and unfair distribution of rewards towards those who pay bribes, this type of corruption has a much more widespread impact. In the main, political corruption fundamentally inhibits the development of basic rules and institutions. Firms and individuals benefiting from payoffs resist reforms while their “associates and counterparts” within the state bureaucracy oppose efforts designed to make the economy more open and competitive. Eventually, the government works for the selected few; reforms aimed at the population at large are skewed to benefit particular interests and the move towards the development of the full-fledged market economy stalls.

²² The extraordinary inefficiency of the state enterprises at the end of communism illustrates vividly the existence and destructive effectiveness of corrupt, insider lobbies. M. Olson, *Why Poor Economic Policies Must Promote Corruption: Lessons from the East for All Countries*, *Rivista di Politica Economica*, 86(3), March 1996.

BOX 5

Reported direct impact of state capture on the firm, 1999
(Per cent of firms)

	Parliamentary legislation	Presidential decrees	Central bank	Criminal courts	Party finance	Overall capture index
Uzbekistan	5	4	8	5	4	6
Armenia	10	7	14	5	1	7
Hungary	12	7	8	5	4	7
Slovenia	8	5	4	6	11	7
Belarus	9	5	25	-	4	8
Estonia	14	7	8	8	17	10
Czech Republic	18	11	12	9	6	11
Lithuania	15	7	9	11	13	11
Kazakhstan	13	10	19	14	6	12
Poland	13	10	6	12	10	12
Albania	12	7	8	22	25	16
Romania	22	20	26	14	27	21
Georgia	29	24	32	18	21	24
Slovakia	20	12	37	29	20	24
Croatia	18	24	30	29	30	27
Bulgaria	28	26	28	28	42	28
Kyrgyzstan	18	16	59	26	27	29
Latvia	40	49	8	21	35	30
Russian Federation	35	32	47	24	24	32
Ukraine	44	37	37	21	29	32
Republic of Moldova	43	30	40	33	42	37
Azerbaijan	41	48	39	44	35	41

Source: J.S. Hellman, G. Jones and D. Kaufmann, *Seize the State, Seize the Day, State Capture, Corruption and Influence In Transition*, World Bank Policy Research Working Paper No.2444 (Washington, D.C.), 1999, p.9.

In transition economies, large incumbent firms with formal ties to the state tend to inherit influence as a legacy of the past and enjoy more secure property rights. New firms, in contrast, turn to bribes to compensate for weaknesses in the legal and regulatory framework. This implies that the lobbying power in transition economies is held by precisely those enterprises that need to be replaced by new or foreign firms.

Source: J.S. Hellman, G. Jones and D. Kaufmann, *Seize the State, Seize the Day, State Capture, Corruption and Influence in Transition*, World Bank Policy Research Paper, No. 2444, September 2000, p.3.

In addition, the re-distribution of the state-owned assets into private hands - the central feature of transition from plan to market - is also closely linked to political corruption. In fact, the main goal of privatization was to sever the link between firm managers and politicians in order to de-politicize the economic decision-making and place priority on efficiency.²³ Corruption however is one

²³ The political influence - whether corrupt or not - was the fundamental cause of inefficiency in the communist countries. Technically, the major source of inefficiency was the misalignment of control rights (how to use an asset) and cashflow rights (benefits generated by the asset). Because of this misalignment politicians goal was not to maximize the asset's profits but to achieve general political goals such as employment maximization, popularity, prestige or the appeasement of narrow interests. See M. Boycko, A. Shleifer and R. Vishny, *Privatizing Russia*, The MIT Press, 1995.

of the reasons why the success of privatization programs in minimizing the political interference has been mixed. In practice, therefore, privatization could be both an anticorruption instrument and a new potential source of corrupt gains.

Corruption and privatization

Privatization programs in transition economies had various goals and involved many different stakeholders with conflicting aims often in the context of volatile political scenarios.²⁴ In light of this, no "optimal" privatization strategy was ever expected from reformist governments, but corruption that accompanied privatization in transition economies seems to have been unsurpassed. One source of corruption in privatization was its unprecedented scale. By some estimates, over 50,000 enterprises (excluding small firms) were privatized in transition economies in the first half of the 1990s. Unfortunately, the magnitude of the task at hand was not matched by the required resources. As a result, financial and technical constraints often made it impossible to adequately prepare, implement and oversee the privatization programs.²⁵

While the scale of privatization has inadvertently contributed to corruption, many argue that in the absence of a market and without a system of checks and balances, distribution of property rights is likely to preclude the development of a competitive market and may even threaten the existence of the state. In this line of reasoning, the absence of institutional framework will fuel corruption and, by doing so, corruption in privatization will threaten to undermine the market economy that privatization programs were designed to promote. Thus, if a government does not perform its functions well - there is no effective regulatory, legal or judicial framework in place - it is not sensible to privatize.²⁶ Clearly not everyone subscribes to this point of view. Many economists have pointed out that it is illogical to expect the required institutions to exist before the property rights themselves exist.²⁷ Others, while not

²⁴ Maximizing government revenues, increasing firms' efficiency, attracting foreigners and distributing the state property equitably are some examples of conflicting objectives.

²⁵ In privatization programs of the three Central European countries these constraints played a considerable role. Agencies responsible for privatization lacked qualified staff. Transparency standards were poor: purchase criteria were frequently not revealed, secret deals existed and standardized procedures were not used leading to discretion in choosing the winning bids. Asset valuation relied on many techniques, which resulted in valuation ranges and thus discretion in choosing the divestiture price. M. Bornstein, *Framework Issues in the Privatization Strategies of the Czech Republic, Hungary and Poland*, *Post-Communist Economies*, vol. 11, No.1, 1999, 65-70.

²⁶ M. Celarier, *Privatization: a case study in corruption*, *Journal of International Affairs*, vol. 50, no.2, Winter 1997, pp.531-543.

²⁷ "Economic institutions cannot possibly precede the reallocation of property from the government, because people do not care about these institutions until, as property owners, they have an economic interest. With slow and deliberate reform, this interest would not have come about, and neither would the institutions." M. Boycko et al. (1995), p. 154.

denying that privatization in transition economies may have provided opportunities for corruption, assert that the incidence of corruption is, or would be, larger without privatization.²⁸

This debate is likely to remain unresolved, but political corruption continues to have devastating consequences in transition economies. If presidents, politicians and judges are corrupt, systemic reform – involving the creation of a more competitive (ie., more democratic, more accountable and more transparent) political environment – is called for.

Political competition: democracy

Democracy has the potential to constrain powers of politicians and thereby reduce the likelihood of corruption because competing politicians have an incentive to expose corrupt incumbents. Political competition opens up the government, reduces secrecy and increases transparency of decision-making, so it can reduce corruption (Box 6). Democratic systems, however, are not immune to the influence of narrow interest and neither do the demand for bribes and their supply automatically cease to exist in democracies. Moreover, competitive politics usually escalates the demand for campaign funds which, in turn, may be linked to future access or preferential treatment. As a result, electoral competition may create incentives for corruption.

While democratic elections are necessary, they are not sufficient to combat corruption. A complementary system of effective “checks and balances” must be present to ensure that power and its exercise can be monitored and constrained (by being subjected to clear rules). Well-organized legislative and executive processes as well as an independent judiciary must complement democratic governments. In addition, effective “accountability mechanisms” such as participation by the population in oversight of the state (civil society) and better system of public administration must also be in effect. In summary, corruption will flourish if it is not limited by internal government structures and by outside pressure from the public.

Civil society and judiciary

The legal system is one of the fundamental pillars of a market economy. The courts are responsible for upholding private property rights, enforcing contracts and settling disputes. An independent judiciary can limit the power of politicians and thus reduce potential for corruption but, by itself, it is not sufficient. Moreover, the effectiveness of judicial systems in fighting

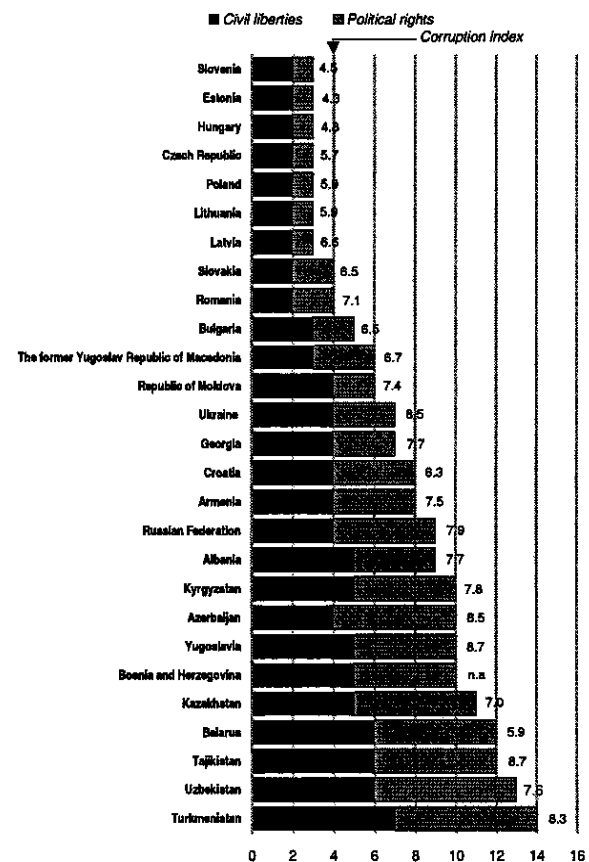
²⁸ “[E]ven in its relatively corrupt incarnations, privatization is likely to contribute positively to the long run movement from a bankrupt and essentially corrupt economic system to a freer and more democratic one.” D. Kaufmann and P. Siegelbaum, Privatization and Corruption in Transition Economies, *Journal of International Affairs*, vol.50, no.2, 1997, p.458.

BOX 6

The more democracy, the less corruption?

For over 30 years, Freedom House has provided an annual evaluation of political rights and civil liberties throughout the world. Political rights enable people to participate freely in the political process including the right to vote and to compete for public office. Civil liberties include freedoms to develop views, institutions and personal autonomy apart from the state. Correlation coefficient between lack of political right/civil liberties rating and corruption (without Belarus) = 0.77; one represents perfect correlation. (Note that one of 14 questions posed to determine the extent of civil liberties asks: “Is there freedom from extreme government indifference and corruption?”)

Corruption, civil liberties and political rights, 2000



Source: Freedom House Comparative Measures of Freedom, 2000/2001, www.freedomhouse.org.

Note: Scale 1 - 'the most free' to 7 - 'the least free'. For Corruption Index information see Box 1.

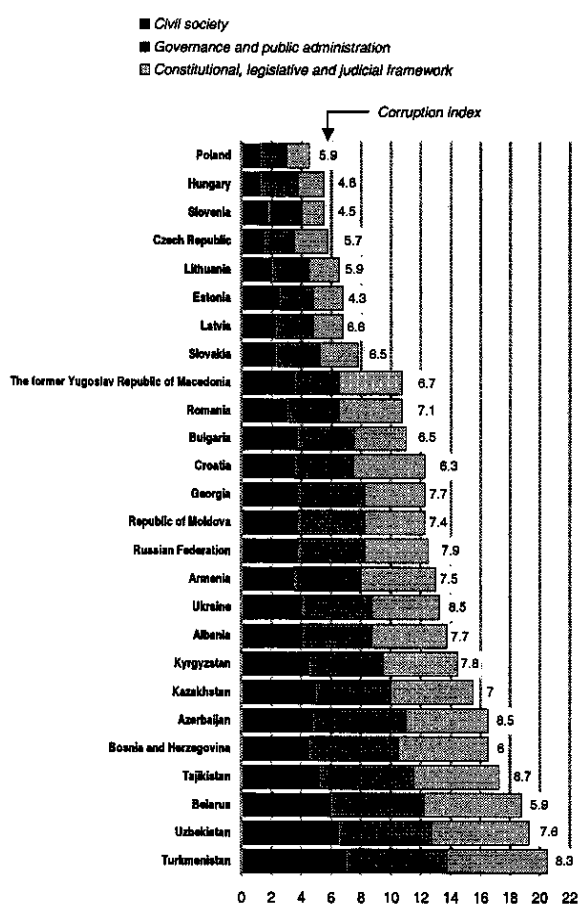
According to one empirical study, the fact that a country is democratic today makes little difference to how corrupt it is perceived to be. What does matter, however, is whether or not the country has been democratic for *decades*. It is suggested that countries with at least 40 years of consecutive democracy have enjoyed small, but significant “corruption dividend”.

Source: D. Treisman, The Causes of Corruption: A Cross-National Study, *Journal of Public Economics*, vol. 76, 2000, pp.399-457.

BOX 7

Civil society, governance, judiciary and corruption

Many transition economies are experienced with neither democratic traditions nor independent judiciaries. They had been shaped by decades of discretionary power and arbitrary justice because the communist-authoritarian governments were not constrained by legal rules (ie., law and justice were not respected as ends in themselves but as practical tools to force compliance with the state objectives). Today, unaccountable public institutions and a badly functioning legal system – one that does not provide security of persons and property, does not enforce private contracts and does not allow the people to hold their government accountable - still remain a characteristics of many post-communist countries.



Source: Nations in Transit, 1999-2000 Ratings Summary, Freedom House, freedomhouse.org.

Note: Scale 1-7 (one represents the highest and seven the lowest level of democratic progress). For corruption index information see Box 1.

Correlation coefficient between civil society, governance and judiciary ratings and corruption (without Belarus) = -0.76; one represents perfect correlation.

corruption depends, on the one hand, on the ability and willingness of the authorities to enforce the relevant laws, and, on the other hand, on the level of acceptance, by the society, of the judgements rendered by the country's institutions. In the transition context, these two aspects of judicial systems are related to the institutional legacies such as the existence of pre-communist judicial

administration or public service and, in some cases, may take years to develop to appropriate standards (Box 7).

With respect to internal government structures, more corruption can be expected when civil servants are not selected based on merit, when they receive inadequate pay and when there is little transparency and accountability in government operations. To many, civil service reform is an indispensable starting point in the fight against corruption, but government reforms such as reducing the size of the civil service, paying competitive salaries and establishing effective incentives to induce officials to be honest and perform efficiently are costly, complex and do not guarantee results.²⁹ Moreover, judging by the experience of well established democracies, obtaining an honest and effective government takes a long time, especially in countries where competence is in short supply and competitive private markets offer much more attractive conditions of employment. Internal government structures must also have other features that ensure a corrupt-free allocation and use of public resources. These include financial accountability systems such as detailed accounting reports how and on what each public institution spends money. Typically, an office of independent auditor is charged with reviewing government programs to reinforce expenditure control by increasing the risk of exposure and subsequent sanctions.

Corruption also appears where demarcation lines between the state and the market are not clear and when regulations are obscure or applied capriciously. Opacity and lack of effective institutional controls lead to corruption. Non-transparent rules and non-transparent implementation breed corruption and the innate secrecy surrounding corruption sustains it. Greater transparency, therefore, through clear rules, less discretion and more disclosure, is a necessary condition to control corruption. In fact, transparency is capable of generating a significant deterrent effect and that is why it appears to be a tailor-made solution for corruption.

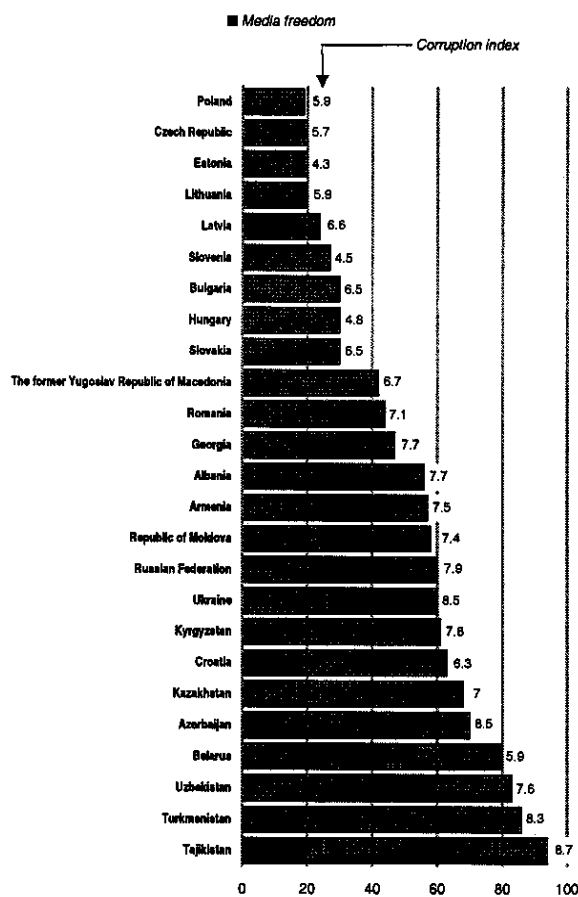
The public can be an important check on the arbitrary exercise of power by government provided the government makes information on its actions available. When governments do not make the pertinent information public, there is need for access to information legislation. Access laws vary, but typically, they establish a statutory, enforceable right of access to information under the control of government institutions. The basic principles are that government information should be available to the public and any necessary exceptions to the right of access should be limited and specific. Access to information legislation is one of many tools for ensuring a more transparent government and greater integrity in public life.

²⁹ For a review of issues see C. Van Rijckeghem and B. Weder, Corruption and the Rate of Temptation: Do Low Wages in the Civil Service Cause Corruption?, *IMF Working Paper*, WP/97/73, June 1997.

BOX 8

The freer the press, the less corruption?

Free speech makes open and transparent government possible. Investigation and reporting by the media is one of the key methods by which corruption is brought to light. At times, the threat of libel suits or even fear of physical intimidation may prevent reporting. Conversely, at times, the flow of corruption stories may continue but no action is taken. The press does not address systemic failures that caused particular corruption scandals - it is up to the governments to offer and implement any remedial action. In conclusion, a free press effectively deters corruption but is of little use if the state does not respond to criticism and if judiciary does not follow up in the results of investigative reporting.



Source: Nations in Transit, 1999-2000 Ratings Summary and Press Freedom Survey 2000, Freedom House, freedomhouse.org.

Note: Scale 0-100. Points reflecting laws, political pressures and economic influences on print/broadcast media content, as well as repressive actions. The lower, the freer. For corruption index information see Box 1.

Correlation coefficient between media freedom index and corruption (without Belarus) = -0.8; one represents perfect correlation.

The legal framework, transparency and internal system of checks and balances are indispensable for a country's good governance, but they do not automatically bring about greater accountability. An important aspect of transparent governance is the presence of civil society

- individuals and organizations that analyze, discuss and contribute to policy formulation. Mature democracies offer a variety of formal and informal mechanisms such as free press and mass media through which citizens articulate their interests. The media facilitates public discussion as well as uncovers and sheds light on abuses. Unfortunately, governments in transition economies have often introduced limitations on them through administrative pressures, censorship, judicial orders or even purchasing them outright. As a result, political and economic reporting is often pro-government, while independent outlets avoid covering sensitive topics (Box 8).

Consequences of corruption

Corruption does not have a net positive economic effect despite suggestions that in some "second best" situations it may improve efficiency and help growth.³⁰ The arguments in favour of corruption efficiency effects are essentially based on the logic of mutually beneficial exchange where parties internalize all externalities through a type of "Coaseian bargaining process". Specifically, it has been suggested that corruption allows entrepreneurs to work around the red tape; it speeds up bureaucratic "processing" by favouring those for whom time is most valuable; and it enables the most efficient firms to win government contracts.

Economists have extensively addressed all these arguments. First, distortions such as pervasive and cumbersome regulations are not exogenous. As noted above, discretionary powers on part of bureaucrats and politicians - who create and interpret cornucopia of counterproductive regulations - are often specifically used to generate corruption. Moreover, in cases of policies that serve productive social ends - building codes, environmental protection or prudential regulations of the financial system - corruption could not be allowed. But in practice, if corruption were helpful, it would be difficult to limit it only to the areas where it is allegedly economically beneficial. Second, contrary to the "speeding up" argument, bureaucrats have often little flexibility to make the bureaucratic process move faster. By contrast, they can always slow down the "queue processing". Third, contracts based on corrupt practices are not enforceable in courts and thus they are likely to be more costly - due to the moral hazard and secrecy necessary to avoid detection and punishment. Finally, those who pay the highest bribes are not necessarily most efficient. Instead, they are the ones who are most successful at rent-seeking. All of this leads to doubt that

³⁰ But corrupt processes may have proffered historical turning points. For references to historical events such as the substitution of "patronage, bribery, and corruption for the previous method of bloodletting" in the XVII century England and XX century Mexico or the positive contribution of corruption to economic growth in Europe and the United States see P. Bardham, Corruption and Development: A Review of Issues, *Journal of Economic Literature*, vol. XXXV, September 1997, p.1329.

corruption, in theory, can be economically justified.³¹ There is also growing empirical evidence indicating that corruption has a negative effect on the economic growth by distorting incentives to allocate resources, reducing investment and by contributing to fiscal imbalances. While empirical studies have mainly focused on economic efficiency, corruption also has regressive distributional consequences.³²

Corruption is costly because it distorts the allocative efficiency by changing incentives and by acting as an arbitrary tax. At the simplest level, finding those to be bribed, negotiating bribes and ensuring secrecy takes time away from productive activities. At a more sophisticated level, corruption misallocates talent by inducing capable individuals to go into rent-seeking activities as opposed to more socially productive professions.³³ In empirical studies, corruption lowers investment and therefore reduces growth. It has been shown that high levels of corruption are associated with lower ratios of investment to GDP. Also, there is some evidence that bureaucratic efficiency actually contributes to higher investment and growth. Moreover, corrupt countries tend to under-invest in human capital by spending less on education - perhaps because education provides less lucrative opportunities for corruption.³⁴

Corruption also affects economic growth through investment because it acts like a tax. The higher the level of corruption, the lower the FDI (Box 9). But corruption is more distortionary than a tax because it is arbitrary, non-transparent and not enforceable. As a result, the less predictable corruption is, the greater the negative impact on FDI.³⁵ The impact on investment, however, will also depend on the nature of corruption.³⁶

³¹ But it may be unavoidable, however. If government intervenes to redress market failures, corruption may emerge as an unpleasant side effect of necessary intervention. See D. Acemoglu and T. Verdier, *The Choice Between Market Failures and Corruption*, *American Economic Review*, vol. 90, no. 1, March 2000, pp.194-211.

³² Corruption increases income inequality and poverty through lower economic growth; biased tax systems favouring the rich and well-connected; poor targeting of social programs; lower social spending; and unequal access to education. S. Gupta, H. Davoodi and R. Alonso-Terme, *Does Corruption Affect Income Inequality and Poverty?*, *IMF Working Paper*, WP/98/76, Washington D.C., May 1998.

³³ K. Murphy, A. Shleifer and R. Vishny, *The Allocation of Talent: Implications for Growth*, *Quarterly Journal of Economics*, May 1991, pp. 503-530 and V. Tanzi and H.R. Davoodi, *Corruption, Growth and Public Finances*, *IMF Working Paper*, WP/00/182. Washington, November 2000.

³⁴ P. Mauro, *Corruption and Growth*, *Quarterly Journal of Economics*, 1995, pp. 681-712 and P. Mauro, *The Effects of Corruption on Growth, Investment and Government Expenditure: A Cross-Country Analysis*, in K. A. Elliott (ed.), *Corruption in the Global Economy*, Institute for International Economy, Washington DC, 1997.

³⁵ S-J. Wei, *How Taxing is Corruption on International Investors?*, *NBER Working Paper* No. 6030, May 1997 and S-J. Wei, *Why is Corruption So Much More Taxing Than Tax? Arbitrariness Kills*, *NBER Working Paper* No. 6255, November 1997.

³⁶ Some distinguish between "centralized" corruption, which is less distortionary than "decentralized" one (where various government agencies compete to maximize their own revenues). "Centralized"

At a firm-level, corruption reduces FDI and shifts the ownership towards joint ventures as local partners are more useful in corrupt systems.³⁷ In sum, corruption lowers growth by discouraging foreign and domestic investment.³⁸

Corruption also distorts fiscal expenditures and thus affects economic growth. It has been found that corruption encourages excessive public infrastructure investment. The higher the corruption, the more public investment, but of lower productivity. High corruption is also associated with lower levels of operating and maintenance expenditures and consequently poorer quality infrastructure. While higher levels of public expenditures have ambiguous impact on economic growth, infrastructure's lower quality and its distorted composition reduce private sector productivity and therefore leads to lower growth.³⁹

Corruption also has negative fiscal implications because it increases revenues to public officials at the expense of public revenues. When firms produce for the unofficial economy, they underreport economic activity or avoid the state entirely. A recent survey of firms in five transition economies has found that legally registered companies underreport their sales from 5 per cent in Poland to 41 per cent in Russia (Table 1). Moreover, a significant statistical association has been found between the underreporting of sales and the bribing of corrupt officials. This result suggests that the size of unofficial economy is partly due to predatory behaviour of government officials. Firms hide output to avoid bureaucratic corruption or they pay bribes because they are in the unofficial sector. In either case, corruption encourages or condones business to operate in the unofficial sector in violation of tax and regulatory laws. Generally, countries with more corruption have higher shares of the unofficial economy.⁴⁰ The conclusion that firms go underground to reduce the burden of bureaucracy and corruption has been supported by other research.⁴¹

corruption will still be more distortionary than taxation due to costly efforts to avoid detection and punishment. A. Shleifer and R.W. Vishny, *Corruption*, *Quarterly Journal of Economics*, vol. 108 (3), August 1993, pp.599-617.

³⁷ B. K. Smarzynska and S-J. Wei, *Corruption and Composition of Foreign Direct Investment: Firm level Evidence*, *NBER Working Paper* No. 7969, October 2000.

³⁸ In transition economies, it has been estimated, high levels of corruption lower domestic investment by some 20 per cent. The World Bank, *Anticorruption in Transition: A Contribution to the Policy Debate*, Washington, September 2000, p. 19.

³⁹ V. Tanzi and H.R. Davoodi, *Corruption, Public Investment and Growth*, *IMF Working Paper*, WP/97/139, Washington, XXX 1997.

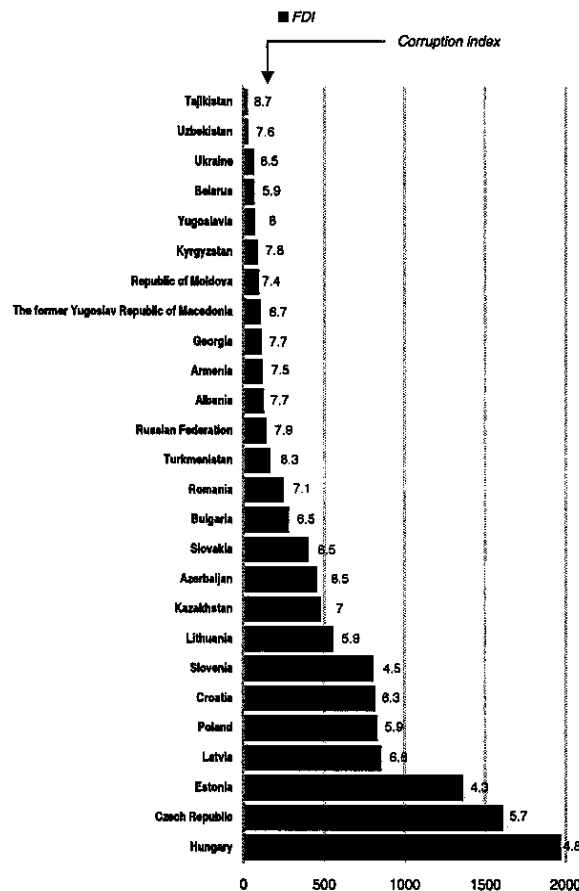
⁴⁰ S. Johnson, D. Kaufmann and P. Zaido-Lobaton, *Regulatory Discretion and the Unofficial Economy*, *American Economic Review*, 1998, 88(2), pp.387-392.

⁴¹ E. Friedman, S. Johson, D. Kaufmann and P. Zoido-Lobaton, *Dodging the Grabbing Hand: the Determinants of Unofficial Activity in 69 Countries*, *Journal of Public Economics*, vol. 74, 2000, pp. 459-493.

BOX 9

FDI and corruption

While conventional wisdom and some empirical studies suggest that corruption lowers a country's attractiveness for investment, this relationship is not straightforward. For example, the presence of natural resources in some transition economies has often been a motivating factor behind foreign investment, but capital intensive natural resources are themselves associated with higher levels of corruption.



Source: UN/ECE secretariat based on national balance of payments statistics.

Note: Cumulative per capita FDI inflows, 1988-1999. For corruption index information see Box 1.

Correlation coefficient between cumulative FDI inflows and corruption (without Belarus) = -0.8; one represents perfect correlation.

Source: C. Leite and J. Weidemann, Does Mother Nature Corrupt? Natural Resources, Corruption, and Economic Growth, *IMF Working Paper*, WP/99/85, July 1999.

In the transition context, corruption is particularly damaging because the state and its institutions are still being constructed. Corruption reduces public revenue and destroys the ability of public institutions to deliver essential services or it makes the state weak in the areas where it should be strong. In contrast, the disproportionate and discretionary state control

(combined with corruption) increases the costs of doing business. This makes the state too strong in the area where it should be limiting its functions to building legal and regulatory foundations for competitive markets as well as prudential supervision of financial markets. As a result, this intrusiveness induces a large part of private sector's activities to move "underground" (Box 10). This rational response to higher costs and the unpredictability of government measures can be debilitating for a transition economy as a whole. As the size of the unofficial economy increases, more taxes go unpaid further impairing the government's ability to provide public goods such as law and order. The state's inability to perform its basic functions, in turn, encourages more corruption. The functioning of this vicious circle is not uncommon. In fact, in transition economies, the relationship between corruption, taxes and the regulatory environment and the size of the unofficial economy is sizable.⁴²

TABLE 1
Shadow economy
(Per cent)

	Poland	Slovakia	Romania	Russian Federation	Ukraine
Per cent of:					
Sales not reported	5	7	6	29	41
Salaries not reported	6	6	5	36	42
Managers time spent on government/regulatory matters	10	12	8	18	25
Who thinks firms make extralegal payments for government services	20	38	20	91	87
Firms saying that firms make unofficial payments for licences	19	42	17	92	88

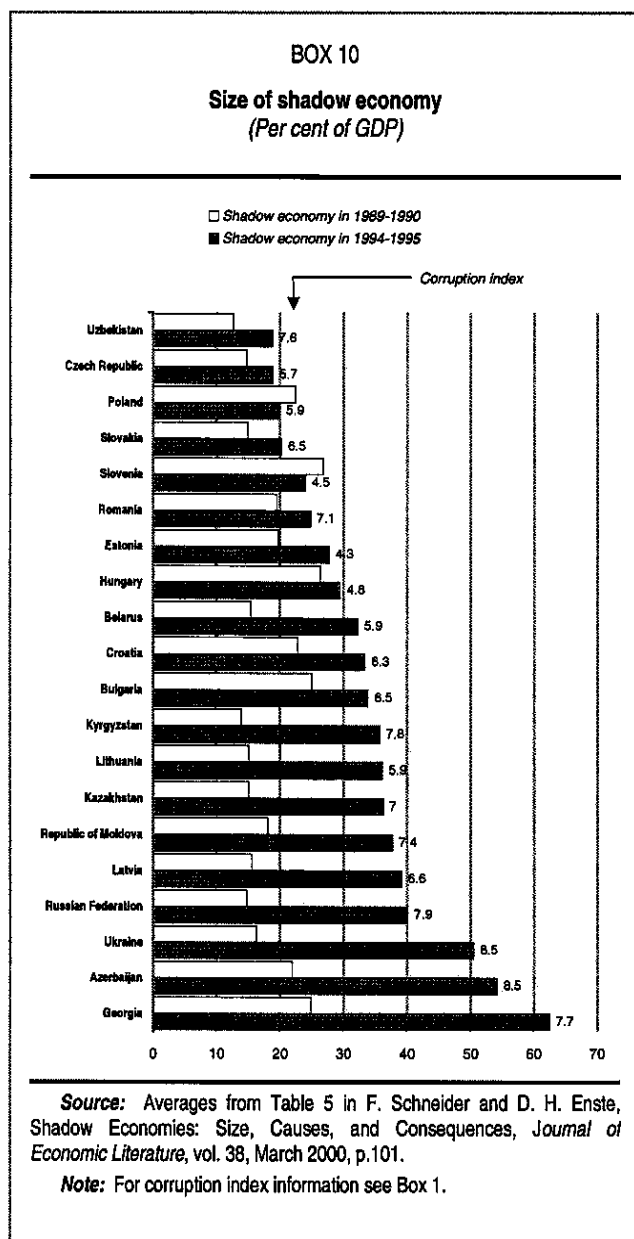
Source: S. Johnson, D. Kaufmann, J. McMillan and C. Woodruff, Why Do Firms Hide? Bribes and Unofficial Activity After Communism, *Journal of Public Economics*, vol. 76, 2000, pp.502-503.

Note: Based on replies by registered firms.

Finally, small and medium enterprises (SMEs) are considered an important contributor to economic growth. By consequence, any obstacle that impedes the growth of SMEs will make the economy less competitive and will tend to slow its growth rate. In this context, it is claimed that for SMEs corruption is "cost-increasing" because the payments they make do not contribute to profitability but are necessary for survival. In contrast, for large enterprises corruption is usually cost-reducing. To support this hypothesis, there is evidence that smaller firms pay bribes more frequently and they are relatively higher as a percentage of their revenues.⁴³

⁴² S. Johnson, D. Kaufmann and A. Shleifer, The Unofficial Economy in Transition, *Brookings Papers on Economic Activity*, Washington, 1997.

⁴³ V. Tanzi and H.R. Davoodi, Corruption, Growth and Public Finances, *IMF Working Paper*, WP/00/182, Washington, November 2000, pp.7-9.



Conclusions:

Corruption usually exists alongside policy distortions. It is present in the non-transparent environments and/or those characterized by low economic and political competition. Specifically, corruption is a sign of institutional malfunction and it usually flourishes in an environment of excessive regulation, high discretion in economic activity and when governments rather than markets allocate scarce resources. Its occurrence is also related to likelihood of disclosure and/or punishment and the level of salaries in the public sector. The causes of corruption are complex, overlapping and driven by cultural factors. Moreover, some causes of corruption are also its consequences. Its complexity aside, corruption is damaging. It distorts the operation of free markets, suppresses economic growth and regressively increases hardship of the poor. Corruption also discourages the creation of new, legitimate private businesses and often forces the existing ones to hide "underground". Finally, it increases capital

flight and keeps foreign investors and their much-needed capital away.

Policy proposals aiming at reducing corruption can be broadly classified into three categories: the lawyer's approach, the economist's approach and the businessman's approach. Respectively, they correspond to tougher new laws and more effective enforcement of existing laws, to increasing the level of competition in the economy among firms and public servants and to paying higher wages to bureaucrats.⁴⁴

The lawyer's approach stresses the importance of the legal and judicial framework within which corruption exists. Clearly, the law is indispensable in the fight against corruption because law contains the rules on how individuals should interact with each other and the framework for the settlement of disputes.⁴⁵ In transition economies, governments have generally followed this approach to fighting corruption. Laws were often rewritten and enforcement mechanism strengthened, but in many transition economies, ambitious anticorruption programs failed at the implementation stage and, in others, politicians used anticorruption schemes to attack and embarrass their rivals.⁴⁶ It appears that partly as a result of neglecting the underlying economic incentives to pay and receive bribes, the overall success of anti-corruption programs in the post-communist countries has been decreased.

Fight against corruption must be linked to the reform of the state and in the transition context that fight ought to stress both the legal and economic aspects. For example, it has been demonstrated that corruption is not as important to economic growth, once structural, economic reforms (or their lack) are taken into account.⁴⁷ Similarly, there is empirical evidence that - while corruption does not prevent growth when other factors are favourable - policies that boost economic growth are likely to reduce corruption in the long run.⁴⁸

In this context, economic reforms aiming at a solid and stable basis for the increased and vigorous competition should be given their overdue priority. Economic distortions and administrative controls, in particular those that involve high discretion such as

⁴⁴ A. Ales and R. Di Tella, The New Economics of Corruption: A Survey and Some New Results, *Political Studies*, vol. XLV, 1997, pp. 496-515.

⁴⁵ For more on the lawyer's approach see W. Paatii Ofosu-Amaah, R. Soopramanien and K. Uprety, *Combating Corruption*, The International Bank for Reconstruction and Development/The World Bank, 1999.

⁴⁶ The World Bank, *Anticorruption in Transition: A Contribution to the Policy Debate*, Washington, September 2000, p. XV.

⁴⁷ In transition economies, "superior economic performance is related fundamentally to the achievement of (the necessary) structural and institutional reforms and only incidentally to the degree which corruption may have been reduced". G.T. Abed and H.R. Davoodi, Corruption, Structural Reforms, and Economic Performance in the Transition Economies, *IMF Working Paper*, WP/00/132, July 2000, p.5.

⁴⁸ D. Treisman (2000), p. 440.

issuance of licences, permits, quotas, customs documentation and tax exemptions should be eliminated or radically simplified. While many regulatory and spending programs have strong social justifications – and thus cannot be eliminated - there is need to clarify and streamline them to reduce bureaucratic discretion and arbitrariness.

With respect to political corruption, strong and committed political leadership must be supported by broad, domestic coalitions and complemented by even more radical economic reforms. Political corruption however will not disappear without democratic governments and effective democratic institutions such as honest bureaucracy, fair judiciary and vibrant civil society.

While effective democratic institutions – those that take into account local circumstances - take long time to develop, democracies are the critical and necessary component of long run economic growth.⁴⁹ Democracies, by providing a strong emphasis on individual rights, allow societies and individuals to thrive. Sustained growth creates prosperity, which in turn, creates a more literate and educated society and with it, the demand for deeper democratic reforms and through them the necessary institutions to check corruption. Democratic institutions also build mechanisms for accountability and transparency, so corruption, if it appears, cannot last long. Prosperous economies can also afford to pay their civil servants well – satisfying those who would prefer to apply the “businessman’s approach” to fighting corruption. In summary, this virtuous circle - a potent and still unexplained combination of the lawyer and economist’s approaches – should be the long-term aim of transition economies, not only to fight corruption but also to build a foundation for prosperity and justice.

⁴⁹ M. Olson, Dictatorship, Democracy and Development, *American Political Science Review*, vol. 87, No. 33, September 1993, p.574.