Governance and Corruption in Transition: The Challenge of Subverting Corruption.\textsuperscript{A}

By
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1. Introduction

Corrupt behavior, commonly defined as abuse of public office for private gains, has no regard for borders or cultures. Although corrupt practices are universal phenomenon, their pervasiveness varies widely across countries. In some countries, the incidence of corruption is low and limited to petty corruption, in others corruption is grand, systemic distorting incentives, eroding institutions, redistributing power and wealth to the undeserving.

Corruption appears to be inversely correlated with the level of economic development—affluent societies are less corrupt than poor societies. There are reasons to believe that corruption paralyzes political development and preserves non-democratic regimes (Whitehead, 2000: 108). Recent research has produced empirical estimates of its negative impact on economic growth. Hence, no matter whether one deals with petty, grand or systemic corruption, governments committed to increasing economic welfare have to address this issue.

But corruption is not the cause of poor governance. The causative link appears to be reverse: these are rather dysfunctional institutions, lack of transparency in political decision-making, and the expectation of high payoffs combined with the absence of behavioral ethics that breed corruption and corrode the political system. Measures restricting the role of the state in the economy by removing excessive government controls and simplifying administrative procedures can both improve governance and reduce corruption. On the other hand, measures increasing criminal penalties for bribe taking or pay rises to public officials without addressing problems that plague country’s institutional landscape are not likely to reduce the incidence of corruption.

In the absence of institutional reforms, new laws and regulations aimed at curbing corruption often have perverse effect. In regimes not fully based on the rule of law, they may contribute to the increase in the potential for corruption. Under the conditions of non-democratic regimes, they have often been used as the instrument of selective repression and an alternative to reform (Huntington, 1968: 66). Politics rather than observance of the spirit and the letter of law would drive their use. Examples abound ranging from the current experience of People’s China in fighting corruption to the earlier experience of Soviet-style communist countries. Both cases have provided ammunition to the observation that corruption cripples political development and perpetuates non-democratic regimes.

The last two decades have witnessed worldwide convergence in what constitutes the right institutional design and policies for survival and development in the contemporary Global Economy often referred to as the Second Global Economy in contrast to the late nineteenth century world economy. The institutional design has democracy as a way of political organization of society and markets as a way to organize economic activity. Democracy, once regarded as an impediment to accumulation and growth, is now conceived as improving the quality of decision making and, more generally, governance. Opening to the world and maintaining macroeconomic stability is among shared policies regarded as necessary to take advantage of opportunities offered by globalization. Last but not least, governments are willing to accept external disciplines on some areas of their economic policy making in return for benefits derived from participation in various international organizations (e.g., World Trade Organization).

Paradoxically, the shift towards democracy and markets creates more demanding tasks for governance. Markets cannot deliver in terms of economic performance if not supported by complex institutional arrangements assuring competition, predictability, and enforcement of property rights and, in consequence, low transaction costs. Similarly, democracy will fail to deliver improvement in the quality of governance if not supported by expanding civil society, powerful mass media, and accountability of those in power. The two outcomes are interconnected: improvements in governance will usually lead to more competitive and open markets. The constitutional design of the state should be such as to make sure that the political
environment is conducive to citizens’ participation and the development of civil society, and that the economic environment encourages private business activity.

While mature democracies have most ingredients assuring high quality of governance, their existence cannot be taken for granted in developing countries including societies in transition from Communism. They still lack developed civil society and independent mass media (TV in particular). In consequence, accountability of those in power leaves in most cases much to be desired. But getting the governance structures underlying institutional design right remains their most important task.

Governance is used here in a broad sense of assuring functioning of a market-based democracy—better governance means more competitive markets, decreasing prospects of higher taxes in the future, stronger civil society, greater accountability of those in public service, less obscure rules separating public from private sphere. Corruption is a symptom of poor governance. Fighting symptoms is always less effective than directly addressing their roots. Establishing a national anticorruption agency may be a good way to fight corruption (Pope and Vogl 2000), but only to the extent that its mandate is limited to a well defined area of public policy (e.g., public procurement). Success in containing corruption does not necessarily bring improvement in governance if its underlying institutional design curbs efficiency and innovativeness.

Thus, the emphasis in designing anti-corruption strategies, especially in transition societies, should be first and foremost on the improvement in governance. Its main objectives should be defined as the modernization of governance structure conceived as (1) development of an efficient, accountable system of governance; and (2) building of institutions supporting the development of competitive markets. These two objectives are interrelated. In fact, when complemented by outward-oriented policies, they constitute what according to the emerging consensus on economic development is the best response to the twin challenges of globalization and governance that reflect respectively “… the constraints resulting from international exchange and property rights.” (Mercada 2000, 1337).

While the paper addresses the issue of governance and corruption in general terms, examples are drawn from postcommunist countries and they serve as its frame of reference. They are clearly not a homogenous group. Central European countries (hereafter CEECs) have made much larger progress towards establishing market-based democracies than former republics of the Soviet Union (hereafter CIS) excluding the Baltic States. The level of corruption is significantly lower in CEECs than in CIS economies (World Bank 2000, p. XI).

The reminder of the paper is structured as follows. Section 2 examines links between governance and corruption in the context of strategic political and economic decisions made during transition from central planning. Section 3 discusses political underpinnings of capture of public policies and administrative corruption. It presents ingredients of an anticorruption strategy. Section 4 links the current rise of the issue of corruption to prominence in various international forums to the convergence of economic thinking on what policy measures lead to sustained economic growth combined with the re-discovery of the role of institutions in economic growth. It argues that the alternative to globalization and improved governance is a ‘vicious cycle’ of economic devolution and corruption Section 5 concludes.

2. Corruption, governance and transition

Corruption is part of a larger phenomenon typical of any organized social activity. All purposeful social action depends for its success on the will of participants to conform to the rules

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1 CEECs include 10 Central European applicants to the EU: Czech Republic, Estonia Hungary, Poland, Slovenia (the so-called Luxembourg Group), and Bulgaria, Latvia, Lithuania, Romania and Slovakia (the Helsinki Group).
adopted by the organization or norms and modes of behavior prevailing in societies. Conformity to rules is a necessary condition for the survival of a social order—no matter whether this is an economic order governed by the market or a political order governed by the state. Organizations seek to assure individual and group conformity by using a combination of positive incentives, basic motivation and negative incentives. The balance may be difficult to strike as the use of one set of incentives may undermine other organizational goals by deterring, for instance, the will to produce. But to do it properly effective instruments of control must be in place. And—as Amartya Sen reminds—so do norms of conduct, whose “... importance maybe particularly attached to the conduct of people in positions of power and authority.” (Sen 2000, p. 277)

When individuals and groups in an organization follow other objectives than those formally established the organization finds itself in crisis. A private company must assure that participants cooperate to achieve its overall objectives; when they lose from sight its basic mission and start following their own interests, the negative impact on profits will soon become visible. The same is true of any other organization, be it the army, church, or an academic institution. Corruption belongs to the broad category of phenomena when formal institutional rules become inactive and people’s activities become guided by concerns external to the organizational mission.

We discern corruption within this category be reserving the concept for the public domain. To speak meaningfully of the public domain, there must exist a distinction between the public and the private. The public domain has to emerge as an autonomous institutional system effectively claiming loyalty and obedience on the part of citizens. This aspect of the problem has been well grasped by Samuel P. Huntington. According to him, “Corruption is one measure... of the absence of effective institutionalization. Public officials lack autonomy and coherence, and subordinate their institutional roles to exogenous demands.” (Huntington 1968, p.59). Thus, whatever the root of the problem is, the occurrence of corruption always indicates weakness in the institutionalization of the public sphere. The public sphere becomes invaded or “captured,” as World Bank publications call it, by interests and motives alien to it—personal, family or private clique.

A mature political system with a well developed system of rules and rule-enforcement is indispensable for economic development, simply because property right must be protected, contracts guaranteed, administrative powers over the private sector limited, their use predictable, and last but not least the overall cost of public administration tolerable. In the economic sphere, the state then acts—to borrow apt terms from Shleifer and Vishny (1998)—as the helping hand rather than the grabbing hand. Corruption undermines the ability of the state to deliver such services. Corruption means that public officials prey on the private sector, while some businessmen comrade with public officials to prey on public means. This is a product of bad policy environment and a major impediment to its improvement.

The problem of creating a rule-governed polity and economy is, therefore, threefold. First, there is the question of constitutional design of the state, second—of the political culture of the society, and third—of the maturity of the civil society. All three areas are inter-related. In all of them postcommunist societies suffer from serious weaknesses, though—as we shall see below—their intensity varies across countries reflecting their different historical experience. This section begins with an assessment of pervasiveness of corruption in postcommunist societies followed by an examination of its roots and links with the progress in implementation of a new constitutional design of the state.
2.1. Corruption in postcommunist societies and progress in transition

There are strong public perceptions of pervasive corruption in CEECs and CIS countries alike. As the collapse of Communism also involved the contraction—if not outright collapse—of central controls that were already strongly eroded during the final stages of central planning in the 1980s, corruption has been bound to increase following its demise. The institutional vacuum created by the collapse of the communist state and the slow emergence of a ‘new’ state compatible with market economy has established a fertile environment for public-sector corruption and, in many cases, private-sector crime.

The double transitions in political and economic realms opened unprecedented opportunities to those in power to enrich themselves in the environment mostly devoid of any rules defining the boundaries between private and public interest. The two were fused under the communist regime, and the notion of “conflict of interest” had not been part of the political code of conduct. To the contrary, in line with the Soviet tradition of uniting political and economic power, public officials saw nothing wrong in occupying political office and own newly privatized companies (Coulloudon 1997). They also perceived shifting public resources to themselves and their cronies as a standard practice in democracy. Private greed has dangerously undermined the credibility of public institutions in most postcommunist societies.

Perceptions of corruption

Various measures of corruption seem to confirm these perceptions, albeit postcommunist countries are by no means a homogenous group. First, there is a clear-cut difference between CEECs and CIS. The index assuming the values between 0 (no corruption) and 1 (maximum corruption) and summarizing 12 different measures of international corruption indices suggests much higher corruption in CIS than in CEECs (WB 2000, p. XIV). In fact, the CIS as a group has the highest value of this composite index among eight groupings of countries. OECD (excluding its most recent entrants—Czech Republic, Hungary, Korea, Mexico and Poland) has the lowest perception of corruption. CEECs rank third after OECD, Southeast Asia, and Middle East and North Africa, but the difference between CEECs and the latter two regions is minuscule. Other regions included in the analysis were in the order of ranking Latin America, Sub-Saharan Africa, and South Asia. Hence, CEECs as a group seems to have levels of corruption in line with those in most other developing countries, whereas CIS countries stand out.

Second, there seems to be a significant variation in terms of perception also within both groups of countries. In terms of Transparency International’s Corruption Perception Indices, the levels of corruption are significantly lower among countries of the Luxembourg group, i.e., first five CEECs invited to negotiate accession to the EU than of the Helsinki group (see Table 1).

Within the latter, Romania stands out with the perceived level of corruption putting it in the same league as ‘less-corrupt’ CIS countries. While no CPI values are available for three Central Asian republics—Tajikistan, Turkmenistan, and Uzbekistan—one suspects that together with Azerbaijan and Ukraine they would be at the bottom of the list.

Third, postcommunist transition societies do not emerge as clusters in the Transparency International rankings of corruption perception. If anything, their respective ratings seem to be mostly determined by the level of development in terms of GDP per capita, albeit with some qualifications. Some of them rank higher than their GDP per capita would predict. For instance, Estonia, ranked 27th in terms of CPI (corruption perception index), Slovenia (ranked 28th) and Hungary (ranked 32nd) are regarded as ‘cleaner’ than two more prosperous EU members—Greece (ranked 35th) and Italy (ranked 39th). On the other hand, Russia (82nd) and Ukraine (89th) are in the same league as Nigeria, Kenya or Angola, i.e., countries with significantly lower GDP per capita.
Hence, it seems that the communist past of transition societies cannot be discerned from the values of CPI indices. This would be surprising considering that the communist institutional design fused economy and polity, and rejected organizational principles that provide powerful checks on corruption, i.e., the rule of law, democracy and civil society. Communist regimes had sought actively to eradicate skills and motives determining society’s capacity to self-organize and make institutions based on democratic accountability work (A. Kaminski 1991). The existence of these institutions is crucial to subvert corruption. Their absence breeds corruption.

This legacy of communism explains the ranking of Russia or Ukraine on a par with countries at a much lower of economic development, but it does not explain the rankings of CEECs from the Luxembourg group. Russia and Ukraine with two decades more under communist regime than CECCs have considerably higher levels of corruption than countries at a similar level of economic development. This is clearly not the case of CEECs.

The level of GDP appears to be a relatively good predictor of the perceived corruption in CEECs. The legacy of communism can be only traced through the extent to which central planning suppressed economic development and thereby institutional development. This seems also to undermine Mancur Olson’s explanation of the collapse of central planning. According to his argument, centrally planned economies imploded because the scale of corruption became so great that the ‘center’ ran out of resources, as interest groups (e.g., state enterprise managers colluding with their superiors and with other managers) organized and diverted resources away from productive economy (Olson 2000). Since central planning disintegrated most in such countries as Hungary and Poland, they should have faced the greatest challenge of corruption after the collapse of central planning. Evidence available suggests that they did not.

Beyond perceptions: World Bank’s diagnosis of corruption

But perceptions are merely perceptions, and as such they may not necessarily reflect the actual reality. Moreover, they are usually based on opinions of external observers and investors rather than those of locals. But as we shall see below, they converge largely with corruption diagnosed using data from surveys of locals. Last but not least, perception indices do not unbundle various patterns and forms of corruption.

Several World Bank studies make an attempt to go beyond mere perceptions. They identify forms of corruption, and seek to capture qualitatively the extent of corruption (World Bank 2000, Hellman, Jones, and Kaufman 2000). The authors use data from the 1999 Business Environment and Enterprise Performance Survey collected from interviews of firm managers and owners in CEECs and CIS countries. The data are used to capture two kinds of corrupt behavior: administrative corruption as revealed in the percentage of firms revenue allotted to illicit, illegitimate payments to public officials, and state capture measured by the percentage of firms directly affected by the ‘sale’ of laws and regulations. The index of state or economy capture is a simple average of shares of firms directly affected by the ‘sale’ to private interests of parliamentary votes, Presidential decrees, Central Bank mishandling of funds, court decisions in commercial cases, court decisions in criminal cases, and illicit contributions to political parties and election campaigns (Hellman, Jones, Kaufman 2000, p. 9).

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2 For an extensive discussion of structural features of the institutional design of communism (or state socialism) along these lines, see B. Kaminski (1991).
3 There is clearly a correlation between the country’s level of corruption and development. But there are large variations in the incidence of corruption among countries at a roughly similar level of economic development (Kaufman 1997).
4 Depending on the size of a country, the sample varied between 125 and 550 firms. For details of the survey, see Hellman, Jones and Kaufman (2000).
Three interesting observations can be derived from examining both indices of corruption presented in Table 1. First, contrary to expectations that countries would be clustered in two extreme quadrants—low/high administrative corruption and low/high state capture—they split almost evenly into four quadrants divided in terms of high/low levels of administrative and high/low levels of state/economy capture—7, 5, 4, and 5 (Figure 1). Not surprisingly, five CEECs from the Luxembourg group are in the South-West quadrant (low administrative corruption, low state capture). And so is Belarus that is yet to begin a journey towards competitive markets, and Lithuania from the Helsinki group. At the other extreme, there are five countries scoring very high on both indices of corruption—two Transcaucasian economies (Azerbaijan, Georgia), Ukraine, Romania and Moldova (North-East quadrant). Captor economies include Bulgaria and Slovakia from the Helsinki group, Croatia, Latvia and Russia, although the latter is a border case with administrative corruption slightly below 50 percent (South-East quadrant). Economy capture in two Central Asian countries (Kazakhstan and Uzbekistan) and Albania and Armenia is relatively low whereas administrative corruption is very high (North-West quadrant).

Second, it seems that the incidence of corruption in countries located in North-East and South-East quadrants is much more serious and more difficult to eradicate than in countries located in the North-West quadrant. High scores on both states capture and administrative corruption indices (North-East quadrant) indicate “systemic” corruption cutting across all levels of government. High scores on state capture suggest that system acts massively and deliberately to set the rules of game in ways maximizing rent-seeking behavior for those enjoying political power. Under these circumstances, corruption feeds on itself by fueling counterproductive, corruption-generating, regulations.

Third, almost all transition economies faced after the collapse of communism the task of building entirely new governance structures and mechanisms. With their policy capacity unbalanced and accountability structures underdeveloped, one would expect them score high on both counts of corruption—decentralized administrative corruption and centralized state capture. Weak state structures seem to favor both kinds of corruption, whereas strong centralized states should create more fertile ground for state capture than for administrative corruption. “Decentralized” bribe taking seems to fit countries with weak states—Albania and Armenia. The reasons for low state capture in Uzbekistan and Kazakhstan may relate to high concentration of political power combined with relative autonomy of central government. However, one would expect that low levels of administrative corruption should accompany effective central controls. But this is so if society and the authorities do not regard bribe taking as a serious offense.
<table>
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<tr>
<th></th>
<th>EBRD (2000) Indices of progress in transition ¹</th>
<th>Corruption Perception Indices, 2000²</th>
<th>State Capture Indices³</th>
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<th>Aggregate Corruption Index⁵</th>
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**Notes:**

¹ indices of progress in transition in CEECs and CIS derived from EBRD 2000. For each country, eight “grades” (ranging between 1 and 4+) of the progress in creating foundations for competitive markets were summed with “pluses” and “minuses” treated as plus or minus 0.5. For each assessed area the maximum grade (4+) reflects the standards typical of advanced industrial economies. The index was normalized in terms of a most advanced country among transition economies. The higher the value of the index the more advanced a country is in terms of transition to mature market economy.

² Corruption Perception Indices (CPI) as reported by Transparency International multiplied by 10 and inverted. The value of index equal to 100 denotes a country (among CEECs and CIS) with the highest perception of corruption.

³ the measure of administrative corruption (bribes as a share of annual revenues of firms) as reported in Hellman, Jones, and Kaufman (2000) inverted and multiplied by 100 and standardized in terms of the most “corrupt” country. The closer the value of index is to 100, the more corrupt a country is in relation to other CEECs and CIS economies.

⁴ the aggregate corruption index is the simple average of CPI and administrative corruption index.
It is interesting to note that “bundled” corruption indices, i.e., the averages of administrative corruption and state capture give assessments of corruption incidence across transition economies very similar to those generated by Transparency International CPIs. This suggests that foreign investors—major respondents to Transparency International surveys—have largely adequate assessments of ‘friendliness’ or ‘hostility’ of business environment and FDI inflows may provide a relatively good indication of the business climate including governance.

Indeed, as empirical research shows, foreign investors avoid countries characterized by high corruption (Smarzynska and Wei, 2000). The last column of Table 1 gives values of foreign direct investment in terms of percent of GDP in purchasing power parity. While the data are only for one year and include also foreign investment in natural resources that tend to be much less sensitive to business climate, they clearly show that Luxembourg Group attracts relatively more foreign investment than other groups with much higher incidence of corruption. Within the Luxembourg Group three countries that are clearly at the top—Hungary, Czech Republic, and Estonia—are also ranked with the lowest levels of incidence of corruption. Therefore it would appear that foreign investors have pretty good knowledge which countries should be avoided because of high corruption.

**The incidence of corruption and progress in transition**

Corruption is a symptom of bad governance and a simple juxtaposition of EBRD transition indicators and World Bank corruption indices demonstrate this point. Table 1 gives aggregate indices for each country based on EBRD “grades” (with pluses and minuses treated respectively as +0.5) in the following areas of governance: enterprises (large-scale privatization, small-scale privatization, and governance and enterprise restructuring), markets and trade (price liberalization, trade and foreign exchange system, competition policy), and financial institutions (banking reform, securities markets and non-bank financial institutions). We treat the sum of “grades” as an indicator of an overall progress achieved by a country. The values shown in Table 1 are normalized in terms of the best performer (i.e., the country with the highest total of scores) in 2000 that is set at 100.

EBRD indices measure only the institutional aspect of the transition, i.e., the progress in building institutions and implementing policies supporting competitive markets. Since they do not include assessments of sustainability of macroeconomic policies and taxation, they do not catch all aspects of governance. Yet, since transition economies have mostly restored macroeconomic stability, the ‘total’ index provides an overall assessment of progress achieved on the path to establish market-friendly institutions and policies.

Similarly, the extent of state capture should be positively correlated with slower progress in institutional development. But the values of state capture index do not seem to offer a good indication of actual or past resistance to market reforms. Even a perfunctory examination of the values of EBRD index and those of the state capture suggests great discrepancies. Kyrgyzstan scores extremely high on both measures of corruption, but has—according to the EBRD—one of the most advanced economic regimes among CIS countries. Armenia has a much lower incidence of state capture than Georgia does, but Georgia seems to have moved faster in implementing market reforms. On the other hand, Belarus and Uzbekistan clearly belong to a different realm of

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5 The value of the correlation coefficient is 0.88. The regression line \( y = 0.85x + 7.9 \) explains 77 percent of the variation.
6 Two countries stand aside—Slovenia with both low corruption and foreign direct investments and Azerbaijan with both high corruption and foreign direct investments. The latter attracts “energy” capital, whereas the former has deliberately followed the policy of keeping foreign investors at bay.
7 In terms of cumulative foreign direct investment over 1990-99 per capita, Hungary with US $1,792 tops the list, Czech Republic was second (US $1,512) and Estonia was third (US $1,217).
authoritarian regimes with administratively run economies. Both countries rank very low in terms of progress in transition relative to other transition countries. But they also rank low in terms of corruption, especially in terms of state capture.\(^8\) The regression line for all countries excluding Belarus and Uzbekistan gives a poor fit with R-square of 33 percent. The value of correlation coefficient of \((-) 0.58\) is also low.

The absence of concurrence in the values of state capture index and EBRD index of progress in transition does not erode its usefulness as a diagnostic tool. Consider that an “uncaptured” state, provided there is strong commitment within the political class to reform the administration and to eliminate corruption, will achieve these objectives without much difficulty. While the unbudling of corruption offers interesting insights into factors blocking reforms and development, two measures of corruption might be used together when assessing the weight of corruption in impeding liberalization. Administrative corruption provides an indirect indication as to the state capacity to implement reform. If it is weak, then no matter whether the state is “captured” or not, the state administration will ignore the reform measures. Hence, in order to address a question whether corruption blocks reforms, one should use both indices simultaneously.

**Figure 2: Progress in transition (governance) and corruption**

![Graph showing the regression line with y = -1.3144x + 154.75 and R² = 0.6301](image)

**Source:** Derived from data in Table 1.

Have countries with lower levels of corruption as measured by the combined, “bundled” corruption indices, i.e., the averages of administrative corruption and state capture also made greater progress in transition toward competitive markets as captured by the EBRD “total” index? Even a quick examination of data in Table 1 suggests that the two sets are correlated with exception of Belarus and Uzbekistan. If these two countries are excluded, the value of correlation coefficient is negative and high (0.88), i.e., the higher progress in transition accompanies lower levels of corruption. The regression line offers a good fit with R-square of 63 percent (Figure 2).

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\(^8\) In the case of Belarus the accuracy of the World Bank assessments raises doubts. First, President Lukashenka and his cronies run the state as a private domain, which may represent an extreme case of state capture. Second, according to one of these authors’ interviews with businessmen with sound experience in Belarus, the TI Index does not adequately capture the incidence of corruption there.
Different measures of corruption levels in transition economies point to three different clusters of countries: least-affected, intermediate, and seriously affected. The least-affected group includes the Luxembourg Group and Croatia; the intermediate group includes four countries from the Helsinki Group (excluding Romania) and Kazakhstan; and the seriously affected group includes other CIS economies and Romania.

The differences between “corruption” ranking and “transition” ranking are interesting in terms of discrepancies between the two, as they may reveal weaknesses in both classifications. Using the EBRD aggregate index, Slovakia is part of the group most advanced in transition (above or equal 84%), Georgia advances to the intermediate group (above or equal 76%), and Kazakhstan drops to the least advanced group among transition economies (below 75%). It may be that firms participating in the World Bank survey overstated the incidence of corruption in Slovakia, whereas the EBRD overstated the progress in transition achieved by Georgia. Clearly, something is missing in World Bank and EBRD assessments of corruption and progress in transition respectively.

**Ignored dimensions: “take-over” of state and criminalization of the economy**

Neither World Bank corruption measures nor EBRD transition indices seem to perform well when dealing with extreme cases of extreme corruption. The EBRD indices fail to catch the real meaning of privatization when the state itself has been privatized. This seems to have been the case in Russia when following the 1996 presidential election the oligarchs—the product of ill-designed privatization—had “… captured Yeltsin, his successive governments, and the political process.” (Wolosky 2000, p. 25). But other CIS countries also witnessed the fusion of criminal, political and business worlds (Ellman 2000, p. 134). Under these circumstances, indices of state capture also lose their relevance as the issue ceases to be one of the extent—there is nothing left for sale when everything has been acquired.

Similarly progress achieved, for instance, in interest rate or price liberalization—areas graded in EBRD indices—have little meaning when the economy is criminalized, i.e., when there is the rule of lawlessness, when businessmen hire criminals for contract enforcement and have to buy “protection.” Securities markets may be established and banks may be reformed and thus obtain high scores in EBRD transition measures. Yet, if banks do not enjoy trust of their clients, this index conveys little information. If without bribing local officials a firm can not survive, price liberalization will do little to boost competition and economic growth.

The broader point is that state bureaucracies, albeit often barely functioning, do not provide “public goods” but create “public bads.” The examples of the latter include conditions allowing officials to prey on business and, on the other hand, to collude with businessmen to make money by eliminating competition—domestic and foreign alike. In consequence, the most corrupt are also the most successful under these conditions (Aslund 1998).

Thus, without taking into account political economy circumstances peculiar to each country, both World Bank and EBRD indices can be often misleading. For instance, Azerbaijan ranks highest in the incidence of corruption and—excluding Belarus and Uzbekistan—lowest in terms of progress towards establishing competitive markets. Yet, not a single banker or businessman was killed in business disputes, and its high ranking officials were not arrested in the West with million of dollars in their pockets. In other words, the economy seems to be much less criminalized than in many other CIS countries including Russia and Ukraine and the state has not been taken over by a group of oligarchs.

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9 The Russian banking system provides a good illustration. For an excellent study of its fall and demise in the 1990s, see Johnson (2000).
2.2. Strategic political choices during transition

The shifts from central planning toward markets and democracy—provided that accompanied by the establishment of rules separating res publica from res privata—tend as a rule to reduce the potential for corruption by undercutting the opportunities to abuse public office for private gain. The shift to “market” establishes conditions for the emergence of civil society—ultimately the most effective device to control corruption. This shift, if properly designed, replaces a myriad of counterproductive regulations designed to create opportunities for rent seeking and bribe-extraction with a core of laws and regulations establishing the framework for a rule-based public-private interface. This involves among others removing assets from state ownership and eliminating direct state intervention in the economy.

None of these, however, reduces corruption by default. In fact, ill-designed economic reforms responding to the vested interests of corrupt elites may significantly increase corruption. Examples include “gradualism” in removal of central controls or hasty privatization in many transition economies. Similarly, political transitions may fail to trigger the emergence of public activities independent from state controls, i.e., the vibrant civil society. The common denominator of the failure to downsize corruption is continued penetration of the economic realm by politics. Its most visible symptom is the pursuit of material gains through political rather than business career. Douglas C. North sees the danger inherent in such a situation in that it may lead to pirate capitalism.

"The kind of skills and knowledge that will pay off will be a function of the incentive structure inherent in the institutional matrix. If the highest rates of return in a society are piracy, than organizations will invest in knowledge and skills that will make them better pirates..." (North, 1993: 63)

The choice of the approach to political and economic transitions sheds light on the variation in corruption incidence and the quality of policy environment. Strategic choices that countries faced in the aftermath of the collapse of communist regime can be divided in two groups. First, the decision, which approach—radical or gradual—to take towards the first generation of economic reforms, falls into the first group. Two choices concerning the constitutional structure of the state belong to the second group: (1) the choice between the presidential and the parliamentary government; and (2) the choice of the system of representation. Strategic choices made in a given country depended on the strength of the opposition, i.e., the support it had in society, as well as on the prevailing pattern of relationships between the communist regime and society.

Radical versus gradual approach

“Gradualism versus shock therapy” was a hotly disputed issue in the early 1990s. Advocates of gradualism criticized “shock therapy” for allegedly excessive costs that this approach would impose on the economy and population. According to this view, slow liberalization of prices, conditions in entry to private sector, and in conditions of access to domestic markets would prevent the collapse of output and assure a smooth shift to a market-based economy.

Subsequent developments have demonstrated that this was a false dilemma at least in the case of the approach towards first generation reforms aimed at assuring macrostability and the shift from “supply-constrained” to “demand-constrained” economy, to borrow Janos Kornai’s terms. Hyperinflation, falling output and external crisis eventually compelled countries that had initially rejected this approach to adopt similar measures as those implemented by radical reformers.
While reform measures in CEECs’ stabilization-cum-transformation programs differed, they all—excluding Romania—opted in favor of radical approach toward first-stage reforms rather than that of gradualism pervasive among former Soviet republics during the initial stages of transition. With the stroke of a pen they liberalized prices, privatized distribution, introduced small privatization, removed quantitative restrictions on imports and liberalized tariffs. More importantly, the best performers—that is, Czech Republic, Estonia, Hungary, Poland, and Slovenia—have successfully resisted temptation to reverse the introduced liberalizing measures. With some exceptions (Slovak Republic and Bulgaria), they have steadfastly stayed the reform course.

Thanks to adopting radical approach to macrostabilization and economic reforms, most CEECs have avoided the systemic rent-seeking trap. There were some exceptions, which, however, confirm the existence of a link between corruption and slow progress in establishing liberal economic regime. For instance, reversals in price liberalization and stalled economic reforms in Bulgaria in 1994-96 under the guise of populist promises corrupted privatization and resulted in significant transfers from state budget to rent seekers. Romania was also privy to similar developments. Deep economic crisis has helped overcome the opposition of vested interests in Bulgaria and put the country on reform track (World Bank 2001).

Former Soviet republics (excluding Baltic States) initially adopted the doctrine of gradualism. However, spiraling inflation and prolonged recession eventually compelled them (except Belarus and Uzbekistan) in the second half of the 1990s to follow the earlier path of CEECs thus demonstrating that gradualism had never been a viable policy approach to first generation reforms.

Neither has it been a viable option for second generation, structural reforms aimed at establishing a public-private interface supporting market economy. In fact, gradualism has created fertile ground for systemic rent seeking and has been responsible for the emergence of powerful vested interests opposing liberalizing reforms. It has created a vicious cycle of partial reforms contributing to economic deterioration and growing opposition to reforms. In transition economies that followed gradualism, the winners effectively suspended the economies in ‘bad’ equilibrium offering them spoils at the expense of high costs imposed on their respective societies (Hellman 1998).

Incomplete liberalization of prices—usually justified in populist terms to protect the poor—has created opportunities to obtain trade licenses to export subsidized goods by those well-connected to political elite. Since the difference between domestic prices and world prices were often huge, this created opportunities to make large rents by those with good government connections. Similarly, central controls over credits and interest rates allowed enterprises to borrow at attractive rates—thus obtained funds could be siphoned-off to related private enterprises or used to finance purchases of subsidized goods to sell them in international markets.

The result of the emergence of this rent-seeking regime was twofold: rent seeking became more profitable than productive activities with all negative consequences for economic growth so aptly described by Krueger (1974); and the emergence of powerful interest groups with a stake in preserving existing economic regime. Although corruption and side-payments clearly subsist also in CEECs, in CEECs that adhered to a radical approach to first generation reforms rent seeking did not crowd out activities aimed at restructuring inefficient industries or starting up new companies competitive in domestic and international market.

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10 Bulgaria initially adopted a radical approach to stabilization and then reversed. The financial crisis in 1996 led to the change of government and the change of approach to economic reforms in 1997.
Yet a good initial choice of taking a radical approach to first generation reforms does not make necessarily second-generation reforms (regulatory and government reforms) immune to bad governance and rent seeking. To the contrary, second generation reforms are much more difficult and complex. Their crux is the establishment of a rule-based public-private interface. This task involves at least five critical steps. First, one has to establish a framework for sustainable macroeconomic stability. Among other things this involves introduction of transparent, financially sound revenue and expenditure mechanisms in public finance. Second, it entails privatization of state assets and elimination of state micromanagement. Third, it requires creating the framework for guiding private sector behavior and enforcing property rights. Fourth, it requires making the framework effective by improving the capacity, integrity and oversight of the civil service as well as of the judicial.

Box 1: The 1997 Czech foreign exchange crisis and governance

Despite success in creating stability and predictability in macro-policy environment and transferring assets to private sector, continued direct state intervention through the banking sector combined with the absence of well-designed laws protecting private property and regulating capital markets contributed to the exchange crisis of 1997 followed by the economic recession.

The exchange rate of koruna, set against a basket of currencies (German Mark-65 percent, and US dollar-35 percent) displayed minimal variation between 1991 and March 1996. Following the adoption of a wider band, volatility in the exchange rate of koruna dramatically increased. At its peak in February 1997, the koruna rose to 6 percent above its central parity, and fell to its trough of 15 percent below its previous parity in November 1997.

What caused this huge swing? It might be tempting to blame the foreign exchange crisis on speculative attack by international short-term investors on the koruna. But this would fall well short of addressing the underlying causes of the crisis. Leaving aside domestic demand pressures, which under more favorable circumstances might have been financed by foreign capital inflows, the run against the koruna in Spring 1997 was due to the emerging consensus that structural microeconomic reforms had advanced much less than it was generally assumed. The sharp decrease in portfolio equity flows was triggered not only by the apparently overvalued koruna, but also, if not predominantly, by the slow progress in microeconomic restructuring and establishing well-functioning financial markets.

Portfolio investors lost confidence in spite of koruna depreciation, which should make more attractive purchases of Czech assets. Two factors seem to account for the declining interest of portfolio investors: the narrowing range of attractive investment opportunities and institutional weaknesses in institutions supporting financial markets. The two are connected, simply because an active and well functioning capital market helps ensure the efficient behavior of firms.

But the way that the Czech capital markets were initially set made impossible to fulfill this standard function. Stock trading was occurring in three separate markets. With shares dispersed and flaws in institutional design of the Czech-equivalent of mutual funds, the Investment Privatization Funds, an effective supervision of management was unlikely. Their other weaknesses included lack of transparency, massive insider trading and poor protection of minority shareholder rights (Mertlik 1998, Turnovec 2000). These clearly pointed in the direction of microeconomic restructuring and rent-seeking opportunities as the major causes of the malaise.

Furthermore, for many large firms, previously state-owned, the banking sector had replaced the state budget as a source of financing (Buch 2000). With banks still controlled by the state, political criteria rather than straight economic considerations related to a firm’s creditworthiness and its anticipated profits drove this financing.

One might thus conclude that the koruna crisis was the result of an earlier misreading by international investors of the reform process in the Czech Republic. Despite rhetoric to the contrary, sizable parts of the economy had not been restructured. Despite privatization, a weak direct monitoring by shareholders and non-transparent capital markets had failed to change managerial behavior in large firms. Moreover, a large amount of key assets remained in the hands of the state, including banks, public utilities and remaining stakes in privatized and strategic enterprises. Subsequent contraction in the GDP suggests that institutional shortcomings of Czech reforms had slowed down industrial restructuring and weakened productivity gains.
Given its institutional complexity, the establishment of a rule-based public-private is time consuming. Considering political resistance and a different set of winners and losers that each of these steps is bound to produce, it cannot take place with the stroke of a pen. Each of these steps changes the distribution of power and most of them (especially privatization) offer enormous opportunities for both enrichment and impoverishment. Failure or policy mistake in one step usually has negative impact on a country’s economic performance. Even one of the boldest reformers among CEECs—Czech Republic—has not avoided the reversal in economic growth due to incomplete regulatory reforms (Box 1).

While the choice of the approach to the first generation economic reforms has turned out a major determinant of subsequent path of transition, other policy decisions have clearly played a role. In addition to the earlier discussed case of factors accountable for the 1997 Czech crisis, an example is the approach taken to decentralization of the state and corresponding reform of public finance. The establishment of viable tax base for local governments combined with transparent rules of local finance have created pro-business climate in local communities in Poland (Hicks and Kaminski 1995). Assured of predictable share in corporate and personal income tax revenues, local governments have actively sought investment and avoid erecting barriers to private business activity. This has contrasted rather sharply with predatory behavior of local governments dependent fully on centralized financing in several CIS countries as well as in some CEECs.

To summarize, the policy of massive institutional change imposed upon the society within a short span of time permits to overcome the problem of systemic friction that a gradual approach must face. The “shock therapy” provided that the group that initiates it has a clearly defined set of goals and actively seeks a broad popular support will generate a virtuous cycle of reforms. 11 Gradual approach to first generation reforms, on the other hand, has produced a vicious cycle of reforms. It has given an opportunity to the privileged of the old regime to retrench and successfully re-adapt to the new conditions. They were also able to enrich themselves through exploiting opportunities created by partial liberalization and privatization. With the economic situation deteriorating and growing gap between rich and poor, public opinion would turn against reforms forming coalitions with nouveaux riches to stall the reform process.

**Political choices: electocracies and democracies**

The declared objective of simultaneous political and economic transitions in most postcommunist countries was market-based democracy. Communism and central planning, or whatever was left of it, was to be replaced by the greatest institutional innovation of the eighteenth century that has provided solution to the opposition between public and private interests. The innovation was Adam Smith “invisible” hand combined with Montesquieu’s system of checks and balances among the legislative, executive, and judiciary branches of government (A.Kaminski 1991).

But within these broad institutional guidelines, there is a large room for diverse solution. The most general concern the distribution of power between legislative and judiciary and the choice of an electoral system. The solutions chosen have impact on the quality of decision making and the policy environment. Strategic thinking manifests itself in the readiness of the designers of the new political system to take into account the criteria of accountability and legitimacy together with governability. It is interesting to note that these crucial decisions for the future of postcommunist societies were usually made in a haphazard way without any deeper reflection about their long-term consequences under the specific historic and social conditions. Thus, the most important societal decisions received in most cases the least attention. While it

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11 For instance, the Balcerowicz’s team during it first term in office in 1989-91 possessed a good sense of what it wanted to achieve. It initially also had strong public support that, however, not cultivated quickly vanished.
remains one of the puzzles of the transition from communism, the absence of constitutional debate probably negatively affected political transition.  

The balance of influence of various political groups that raised to prominence following the collapse of communism shaped strategic choices. In several countries political transition unfolded under particular duress. For instance, ethnically fueled territorial conflicts and violent domestic crises affected political developments in three Transcaucasian states—Armenia, Georgia, and Azerbaijan. Russian-supported separatist movement in Transdniester province has made Moldova largely non-viable as a state. Although the threat to Central Asia from Islamic rebels has not led there (except in Tajikistan) to the ethnic strife and political volatility characteristic of the Transcaucasian states, it had probably contributed to the progressive institutionalization of authoritarian, one-man rule in the region. Last but not least, except in Slovenia, the bloody disintegration of what was Yugoslavia did not create environment friendly to democracy. These adversities notwithstanding all but two postcommunist countries (Tajikistan and Turkmenistan) have held at least one largely free and fair election.

But not all countries have made overall progress that would be deemed sufficient to sustain democratic transition. In particular, not a single CIS country seems to have reached this phase. They are “electocracies”—to borrow an apt phrase from Dawisha (2000)—rather than democracies. Federal Republic of Yugoslavia and Former Republic of Macedonia seem to be in transition from electocracy to democracy. These two countries have made recently first strides in this direction.

In contrast, other CEECs have met political conditions (viable democracy and protection of minorities) necessary to be included in two pan-European projects—the expansion of NATO and enlargement of the EU. Moreover, the prospect as well as the process of accession to the EU.

Two aspects of political evolution have had a particular bearing on the path of transition and consequently on the quality of governance and the potential for corruption: electoral system and type of political regime as captured by the balance between executive, judiciary and legislative.

Electoral system

The choice of the system of representation, the mode of electing representatives to the parliament, is one of the decisions that are considered as constitutional, whether they are part of such a document or not. This choice predetermines the relationship between polity and state and has a crucial impact on the development of the party system. The accountability of the rulers to the ruled and the legitimacy of the political regime depend to a large extent on it. The choice of electoral system is crucial for the process of transition. It determines the ability of society to choose and control its leaders and, pari passu, its government. ”Not only are electoral systems the most manipulative instrument of politics; they also shape the party system and affect the spectrum of representation” (Sartori, 1994: IX).

There is no universal prescription for the good electoral regime.  

At the general level, we tend to prefer a plurality or majoritarian (first-past-the post) system to proportional representation (PR) system. The fundamental choice here is between environment creating greater opportunity

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12 Bruce Ackerman aptly remarked that: “Work on the text of the constitution provides the winning movement with the opportunity to engage in collective effort aimed at defining basic principles and mobilizing wide social support for key initiatives” (1992:51).
14 Among the authors who have taken a similar position on this issue are Max Weber (1921), Schumpeter (1948), Popper (1988), and Sartori (1994), to name just a few.
for minority parties and proportionality of representation (whatever this may mean) and that favoring quick shift to the two-party political system. The plurality system is more likely to produce stability and accountability of government but frequently at the cost of alienating significant fragments of society (Lijphart, 1994: 144; Norris, 1997: 301; Pinto-Duschinsky, 1998).

Under certain conditions in transition societies, however, adoption of the majoritarian system may turn out to be detrimental to democracy. This is so when the society is disintegrated and new, non-communist parties are weak. Majoritarian formula then assures that a well-organized postcommunist party (usually calling itself “socialdemocrat”) can stay in power for a long time at a significant cost to the development of democracy. The majoritarian system becomes viable only if the civil society is sufficiently well developed. Then, its qualities may come to the fore.

PR system suffers from several weaknesses especially during the initial stages of transition. First, it offers disproportional influence to small parties. This in turn contributes to instability in government and reduces its effectiveness of government when it must implement difficult structural changes (Bakerowicz, 1992:108). Second, it increases the potential for corruption, as officials owe their careers to the party hierarchy rather than voters. Their pay back is finding ways to fund their political parties. The inherent danger of this arrangement is perpetuation of conditions friendly to rent seeking though “corrupting” laws and regulations, i.e., enacting laws expanding opportunities for corruption. These factors may injure the overall credibility of the system damaging its legitimacy in the eyes of the society. These considerations are behind the rising movement in Poland against the PR system.

Political circumstances unique to a country rather than well-considered arguments were decisive in the choice of a formula. In the strong institutional presence of the communist party single member districts and majoritarian formulae were selected as an electoral solution. On the other hand, high social mobilization combined with lack of trust in elites favored PR electoral systems. Most governments (eighteen of twenty-seven postcommunist states) chose total or partial PR rather than majoritarian formulae (Dawisha 2000, p. 296).

From the perspective of the particular interest of leaders of political parties, PR is a very attractive proposition. Consider that while the plurality system provides stability in government during its term in office, it also allows for the change in election outcomes with much greater ease than the PR does (Pinto-Duschinsky, 1998). Hence, during periods of uncertainty and high social mobilization PR may assure greater predictability of outcomes for political elites. Furthermore, when memories of the communist system bring about unfavorable associations, communist-successor parties prefer PR for it saves them the embarrassing confrontation with their own history.

Within the PR system, the problem with far reaching implications for the development of political parties concerns the choices of the level of threshold, i.e., percentage of votes required to have any representation in parliament, the size of electoral districts, and the method of “transforming”. Low thresholds increase the number of parties in parliament and contribute to the healthy evolution of the party system, the point of considerable importance for societies in transition from authoritarian regimes.

Poland began with no threshold in 1991, with the net result of nearly thirty parties in the parliament and a government coalition consisting of five parties. The problem with governability led to new elections in 1993, this time with the five-percent threshold (7% for a coalition of small parties). Poland was no exception, Between the first and second parliamentary elections, across

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15 These countries included Central Asian states, Belarus, Former Republic of Macedonia, and Ukraine.
all postcommunist countries; the average threshold increased from 3.9 percent to 4.6 percent (Dawisha 2000, p. 297).

So did the percentage of voters’ casting votes on parties that do not receive a single seat in the legislature. The average of almost 17 percent of wasted votes, as compared with six percent for all proportional representation elections held in Western Europe in the postwar era, is striking for one major reason: A significant proportion of these voters may lose faith in the democratic process. Trust in the system is then eroded.

Furthermore, by giving postcommunist parties much larger clout than implied by the proportion of the total vote they received (e.g., in elections in Russia), they have indirectly contributed to the emergence of strong presidencies in several CIS countries. As Karen Dawisha notes (2000, p. 300), “... the institutionalization of postcommunist parties, while not foreordaining the failure of democracy, nevertheless does little to strengthen the prospect of its success.”

The usual choice in method of transforming votes into seats it that between d’Hondt and Sainte-Lague formulas. Large districts, like low thresholds, favor small parties at the cost of big ones. The d’Hondt formula favors the big parties, whereas the Sainte-Lague formula tends to over-represent the small ones. In consequence, small parties favor low thresholds, large electoral districts and Sainte-Lague formula, whereas big parties, to the contrary, opt for high thresholds, small districts and d’Hondt formula. Let us note that the more effectively the interest of the big parties is manifest in the adopted solutions, the more the composition of the parliament will approach the effects of the plurality system without, however, increasing the accountability of government.

Thus, on the one hand, to enable the government to function, the parliaments had to adopt thresholds, and on the other hand, administrative constraints imposed on electoral competition by political elites in most postcommunist countries had produced a massive waste of votes. According to some views, this choked development of democracy and institutionalized postcommunist parties. The latter has blocked the space that otherwise might have allowed genuine social democratic parties to emerge.

Non-communist parties that won first democratic elections in CEECs did not possess stable constituency. While the communist-successor parties had a fairly large apparatus in the regions, and an initially narrow but stable electorate. Their popularity grew only as a result of mistakes committed by their competitors. For the parties established outside of the communist party system, the strategic choice was either to seek support from local and regional civic groups and associations or to communicate their message to the electorate at large through the mass media. The PR system together with large electoral districts favors the second option. Parties with unstable electorate prefer media message to direct negotiations with grass root organizations. Media campaigns are costly, and money is a problem.

Thus, party financing has become the soft belly of political parties in the postcommunist world, and elsewhere too. Pressed with this problem, parties use the privatization policies, public procurement, and the political control over the public administration to create new illicit sources of financing. Violation of legal norms is an unavoidable practice in the struggle for power, while political power offers ways to cover-up these violations. In this respect, all political parties are willing to cooperate not to disclose their practices (A.Kaminski, 1997: 106-108).

What implications does this discussion have for combating corruption and improving governance? While specific answers vary depending on political economy circumstances of a
country, sacrificing stability in governance associated with plurality systems for fuller representation achieved under PR (with low or zero thresholds) may be indispensable for the emergence of democracy supported by buoyant civil society. Low thresholds, large electoral districts and Sainte-Lague formula would increase the accountability of government.

At the local level, a better solution is the majoritarian formula with relatively small districts provided that two conditions are met. First, that decentralization of government accompanied transition and second, public was redesigned to reflect transfer of power from central to local governments. This was the solution in place in Poland over 1991-98, which combined the majority representation with decentralization of public finance (Hicks and Kaminski 1995). Recently observed deterioration in the quality of management of local finances (“excessive” salaries, embezzlement of public funds, etc.) has coincided with the change in electoral procedures. While prior to 1998, constituencies of less than forty thousand elected their representatives under the majority electoral formula, the majority rule now apply to districts with fewer than 20 thousand people. It appears that the extension of the scope of proportional electoral procedures has led to the decrease in voter turnaround, the increase in the incidence of corruption, and the fall in the quality of self-governance.

Presidential vs. parliamentary government

The choice between the presidential and parliamentary systems of government was the most natural that faced political elites in the postcommunist states. But there was no single case of serious constitutional debate. The outcome came by default indicating the weight of history and special features of political landscape in each of postcommunist countries. Its most striking feature is that CIS countries together with countries of the former Yugoslav space, with the notable exception of Slovenia, have adopted a presidential system of government, whereas CEECs (excluding Romania) moved towards parliamentary government. Under conditions of strong political pluralism articulated through the institutions of parliament, it was very difficult to establish a strong presidential regime.

The duality of the parliament and presidency characterizes many presidential regimes in CIS countries. The president, as a chief executive, is largely independent of the parliament, and has the right to issue decrees that need no legislative approval. Communists and nationalists—in large part because of the adopted proportional representation formula—control the legislature, which, usually expressing the popular sentiment, opposes liberal-democratic reforms. More recently, the alliance of “winners-take-all” from transition with communists, both groups opposed to reforms that would increase domestic competition erect barriers to reforms. This may be a highly unstable equilibrium, as Russia’s experience shows. However, as long as the parliament serves merely as a valve for venting social frustration while the president is able to perform his role effectively, this potentially unstable solution may survive and eventually result in the emergence of genuine democracy due to gradual evolution of social norms and values. But in many cases the parliament does not limit itself to passive voice. This, if combined with the ineffective executive power, leads to an irresponsible parliament and corrupt presidential power.

Implications for corruption

Three points are worth emphasizing. First, presidential systems existing in CIS countries operate in the institutional environment with weak legislatures and civil society institutions. The parliament has no sufficient support to resist the aspirations of strong presidents in charge of powerful administration involving the army and security services—both untouched by serious reforms. The president’s office has become the last line of defense for the administration against the unpredictable intrusion of political parties. The constitution was imposed upon the parliament
by the president. It is impossible to find there any mechanism of checks and balance: the powers of the president exceed by far those of the legislative and the judiciary combined. But despite the concentration of power in the executive branch, “presidential” states remain relatively weak in their capacity to implement reforms and revive the economy. This combined with unsound civil service, criminalization of the economy and strong anti-rule-of-law constituencies (Holmes 1997) breed corruption and does not augur well for good governance. Under these circumstances, fight against corruption easily becomes the mechanism of selective repression serving as a tool of political infighting.

Second, transition has created embryonic ties between the emerging private sector and state administration. Examples abound especially in CIS countries where leading “businessmen” made their fortunes “… in collusion with [bureaucracy], which shielded them from competition.” (Aslund 1998). Both would be opposed to any attempt at eliminating sources of their wealth.

Third, the political evolution in the postcommunist world seems to give credence to Juan Linz’s view that parliamentary governments are more effective than presidential ones in establishing stable democracy. Parliamentary democracies also seem to coincide with lower levels of corruption, although they require complex and mature institutional arrangements assuring accountability of political elite to society writ large.

Yet, the universality of this proposition may be debatable. The success of parliamentary government should not mislead anybody into thinking that this has produced a responsible and efficient system of the rule of law. In many cases, this has rather resulted in the situation of weak executive power, weak legislative, and weak political parties with very strong informal cliques in control of the system. The institutional weakness is due to the fact that these fundamental parts of the state organization, overwhelmed by informal party connections, have been unable to gain sufficient autonomy to develop their own missions and procedures. Under conditions of such an excessive informality, corruption becomes a natural way of solving conflicts of ideal and material interests. In both cases, these political systems are far from an ideal situation of a strong civil society in a state with strong executive and legislative powers.

2.3. Conclusion

The communist political, economic and cultural project was anti-Western, both in the logic of its intellectual content and in its ideology. Due to its revolutionary nature, communist regime had either physically or socially eliminated the old intelligentsia, that is, the social class most attracted by and most familiar with the Western civilization. It also eliminated, or drastically curtailed, the most active elements in other social classes, albeit the level of devastation varied across postcommunist countries. In consequence, postcommunist societies were poorly endowed with institutions and human capital capable of handling the economic or political dimension of transition (Kaminski 1994). On the other hand, however, they had some important assets in terms of overall educational levels of their respective population vis-à-vis countries at similar levels of economic development.

Nevertheless, transition was difficult throughout the postcommunist world especially for countries devoid of civil society in the period preceding communist take-over and those with longer periods of communist rule. The liberal-democratic transition in CEECs was, in cultural

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17 It is often emphasized that the civil society in East-Central and Eastern Europe had never been strong, with the possible exception of Czechoslovakia. This opinion seems to be wrong-headed at least in respect to CEECs (with the possible exception of Romania) and former European republics of USSR. If we only take into account history of the region during the 19th century, then there is no doubt that Germany as a whole, and Prussia as a dominant part of it, were able to develop an effective, albeit authoritarian, version of the rule of law. The Austrian Empire made an impressive progress towards a parliamentary central government combined with decentralization of the state and a full-
and psychological terms, easier than in CIS countries. An additional boost to the effort was given here by close interest of West European countries in promoting progress of political and economic stability in the region close to its borders. The goal of joining NATO and the EU—enjoying high levels of popular supports in CEECs—has become the „strategic” goal of governments compelling them to comply with “Western” institutional standards.

Yet, one should not conclude from the above that the improvement in governance and combating corruption should be removed from the agenda of CEECs. First, with the collapse of central controls during the last stage of communism existence, these societies have become highly vulnerable to corruption. In fact, the extent of corruption in postcommunist countries may be relatively higher than indicated by various discussed measures. Consider the following. They had all gone through unprecedented in scope privatization programs—their legacy in many countries is mistrust to government and, often, corruption of politics. Most of them still cope with the legacy of legal acts designed to use the “rule of law” as a tool of exercising power by ruling elites. In practically all of them, institutions are weak, competence of public administration wanting, and anti-rule-of-law constituencies relatively strong. In few of them, “enforcement of property right” abdicated by the state, has been take over by criminal groups. These institutional weaknesses have opened ample opportunities to small, well-knit informal groups capable of exploiting their strategic positions in the government to enrich themselves and to strengthen their hold over power.

Second, CEECs have to cope with the legacy of issues overlooked during the initial stages of transition. They mostly ignored the fact that liberal democracy is a concept that embraces both the organization of economy and of the polity. As Douglas C. North observed, “…it is the structure of political and economic organization which determines the performance of an economy at the incremental rate of growth in knowledge and technology” (1981:19). Postcommunist reformers should have thus paid at least as much attention to the design of the political system as they did to the problem of privatization and economic transformation. They did not, however (Ackerman, 1992:46), as the organization of the state, the condition of public administration, and of the judiciary was of no interest to the reformers. Only recently, with prodding from the European Commission (EC 1999), they have begun to realize that in a liberal democracy economy and polity is closely related.

A sound administration is an invaluable asset for such a complex task as the transformation of a postcommunist economy. Of course, this quality was absent in the post communist administrative landscape, but a lot more could have been done had the reformers been aware of how important an efficient and reliable administration is.

3. Governance and combating corruption

The development of an efficient, accountable system of governance goes beyond reforms aimed at uprooting corruption in public administration or public finance. It calls for the change in governance structure to ensure that public interest is not captured by narrow private interest. While the capture of policy by narrow private interests occurs in mature democracies, societies with weak, recently established, structures are particularly prone to it. This is so because the level blown local self-government. The Russian Empire succeeded in reforming the public administration. It also created a fairly sound judiciary as well as an effective educational system. If one can easily accept the thesis about the economic and social backwardness of Russia, the importance of this country to the development of arts and sciences in the 19th and 20th centuries, as well as the intellectual quality of its elite can not rejected. Russia before the World War I was part of Europe, and by and large followed the European path. The southern part of the postcommunist space, the Balkans, is another problem: it had had a long history of subjection to the Ottoman rule. But also here the model to follow was the west of Europe, and the European example influenced Turkey as well. Thus the trends in Europe of the turn of the nineteenth century were more uniform than perhaps ever after.
of constraints placed on the behavior of public officials and politicians by civil society as well as
mass media, judiciary, etc. remains low. And so does the penalty levied on politicians for
decisions benefiting their private interest at the expense of broader public interests.

Another reason is often the weakness in major branches of the government compounded
by limited administrative capacity. Weak parliaments are unable to impose upon the participants
its own rules protecting the public interest and monitor the executive branch. The simultaneous
weakness of the legislative and the executive favors a party system that constitutes a network of
informal cliques preying upon the public sector rather than institutions designed to represent
interests of the electorate. Under such conditions, accountability of public office holders becomes
doubtful, at best, and wanting, at worse.

The absence of accountability of politicians and public officials may also erect a strong
barrier to the emergence of institutions effectively supporting the development of competitive
markets. Competitive markets reward the best performers, whereas distorted markets reward
those with political influence. Without the sanction of ballot, they will bloc measures that threaten
to remove market distortions thanks to which they thrive. In transition economies that followed
partial reforms (most members of the Commonwealth of Independent States and Bulgaria until
1996), the biggest winners rather than losers sought to “… stall the economy in a partial reform
equilibrium that generates concentrated rents for themselves, while imposing high costs on the
rest of society.” (Hellman 1998, p. 204-5). They would find support among losers, as they
objected to liberalization of the economy that would undermine their monopolistic positions.

With the political system effectively immune to popular pressure (voice), only a rapid
deterioration in the economy and the involvement of external actors can tip the economy from its
state of partial reform equilibrium. Economic crisis usually forces the government to seek
external assistance. But this does not automatically guarantee the shift from a bad equilibrium.
For starters, it will depend on conditionalities attached to assistance and government’s
commitment to their implementation. Both are often wanting, and the room for maneuver for
external actors is limited. Furthermore, they can not act as a substitute for government. Without
its involvement, no meaningful progress can take place.

Successful transition from central planning to competitive markets entails the shift from
fusion of monopartisan state in control of society and economy, which has been characteristic of
communist regimes to rule-based interaction between public and private sector enforced by the
law.\footnote{For a discussion of fusion as a major characteristic of the state socialist institutional design, see B. Kaminski (1991).} It requires several tasks all aimed at changing the public-private interface. They all share
one common denominator—separation of the public sphere from private sphere and establishing
the rule of law.

The process of postcommunist transition requires the simultaneous reorganization of the
state and of the economy. Within the former, conditions must be created to allow for a plurality of
political parties to compete for control over the government, for establishment of legislative
controls over the executive, and emergence of an independent judiciary. In the economic domain,
there are at least four interwoven tasks that are necessary to institute a viable public-private
interface. The first and the most immediate task relates to the establishment of stability and
predictability in the macro and policy environment. Second, the transfer of assets from state
ownership to private ownership combined with the elimination of direct state intervention based
on ad hoc rules. Third, the building of the political framework with laws, regulations, and
administrative procedures immune to “capture” by narrow interest groups and supportive of
competitive markets. The minimization, if not removal, of state capture that was discussed earlier
falls into this task, although we shall give it a broader interpretation. The fourth task is to make
sure that the framework work, i.e., that policies are implemented and rules observed. This can be accomplished through increasing the capacity, integrity and oversight of the civil service, and its credibility vis-à-vis society writ large. Subverting administrative corruption belongs to this task. In the postcommunist transition economic and political transformations go hand in hand.

Crucial to the establishment of viable governance structures is to establish the framework that would assure competition in both political and economic spheres and separate the two through well-defined rules. This is probably the most critical step in building a good governance structure. This is also an important step in curtailling opportunities for corruption. The common denominator of the failure to downsize corruption is continued penetration of the economic realm by politics, and of the political realm by business interests. Its most visible symptom is the pursuit of material gains through political rather than business career, and in parallel, achieving profits due to political connections. The solution to this problem requires an adequate institutional design with underlying culture that permits the distinction and endows it with a normative meaning. The competition system must be designed in function to the objectives it should serve.

Once the institutional design effectively mediating between various competing vested interests is in place, two other issues emerge. The first one relates to policy implementation—unaccountable officials may be tempted to abuse their position for private gain and distort the process of policy implementation. The second relates to the existence of viable external checks on public officials. Some of these checks may work at the office level, other may be provided by specialized control agencies. Civil society including mass media can help subvert corruption and improve quality of decision-making at all levels of government.

3.1. Capture of policies by narrow interest groups: democracies versus electocracies

Money in politics is always corrupting. Generally one cannot prove quid pro quos. It is obvious that legislators are more attentive to the views of those who give money, and those with money have plenty of reasons to support or obstruct legislative initiatives. Otherwise, they would not pay. The challenge is how to minimize the chances that policies will be captured to the detriment of national welfare.

The classic Madisonian tradition of American democracy perceives interest-groups, which Madison called “factions,” not only as natural but also, when specific institutional conditions are met, as agents potentially beneficial to democracy because they tend to check and balance each other. The division of powers within the state, plurality of political parties competing for power, and a multitude of interest groups seeking to influence public decision-makers prevents any single majority faction from dominating the state. This is the essence of the mechanism of checks and balances—a dynamic political equilibrium. To work, it requires a well-structured system of competition, i.e., a mature constitutional democracy.

What will happen, however, when the political space is filled with groups that approach the state in an instrumental fashion, as an external entity that may be preyed upon? These groups may have all appearances of political parties, but deprived a republican tradition, they treat the idea of raison d’etat or of public good as an empty phrase. In order to function in politics they need money that they raise by preying upon the state. They compete in elections, but once the time of electoral campaign has passed they closely cooperate with their adversaries in engaging in illegal deals. Each party knows enough about others to feel safe, and each knows that collecting “dirt” on others is the most effective insurance policy. The “dirt collection” mechanism operates not only in relations between political parties, but also in the selection of party cadres: to trust a colleague one must have “dirt” on him. This is a checks and balance system of sorts, but it works in ways different from the one devised by Montesquieu and Madison. Under such a system,
although politicians are elected, their accountability to the electorate is very limited. The social environment in which they function makes them act against the public interest.

The picture described above characterizes, albeit to a varying degree, a number of postcommunist states, CEECs and CIS alike. There is a constitutional division of powers; there are competitive elections, an independent judiciary, and relatively free press. In constitutional terms, most of the postcommunist states, particularly among the CEECs, could be considered mature democracies, but the least we can say is that they are not mature. Karen Davisha (2000) has mockingly called them “electocracies”. The idea that the term conveys is formality of the procedure.

At the root of the problem is the starting point of the postcommunist transition. As we have mentioned time and again, communism is a system that never tolerated autonomous centers of power. Under communism politics is a zero-sum-game: acquisition of autonomy by any outside center implies a loss of power to the party. Not only formal organizations and associations were supposed to be under full control of the party, but also individuals were supposed to be at the party’s full disposal: whether he or she was a judge, a mediciné, a priest, or a taxi driver he or she owed loyalty first of all to the party. This ideal has nowhere been fully achieved. The closest to the ideal was the USSR between 1930 and 1953. Nonetheless, communism never tolerated self-organization. Thus, the demise of communism came to societies hardly prepared for a life in a democracy. Poland and Hungary may have been different in this respect, but not enough to make transition an easy task.

Thus, at the start of the transformation the postcommunist countries had weak civil societies, old institutional system in demise, and the new one *in statu nascendi*. There was the state administration, the system of justice, and there were parliamentary elections. The state administration was in many respects shaped by the communist past, but it still maintained some bureaucratic values. The judiciary was surely mutilated by the old regime, though it still claimed respect for the traditional values of the institution.

Coalitions that came to power in the aftermath of free elections were composed—depending on a country—of different mixes of new faces and old-timers, but usually with little organizational experience. Many administration officials with former communist connections were replaced with people without any administrative experience or skills. In most postcommunist countries no effort was made to develop programs aimed at establishing competent civil service. Instead, each party and coalition in power tried to infuse administration with its protégés. This resulted in politicization of administration and in growing corruption. Bad administration makes implementation of any policy difficult. It also seeks protection in a legal mess to which it willingly contributes thus strengthening the hand of anti-rule-of law constituencies (Holmes 1996).

The new regimes have also neglected the state of judiciary. In most postcommunist countries justices formally were guaranteed immunity, while their salaries were kept at a very low level. Professional autonomy serves well the exercise of justice but only when legal corporations are strong enough to assure the maintenance of professional standards. In the absence of effective professional controls, autonomy of the judiciary procedures and immunity of the judges will not protect the legal community against corruption. An opportunity for impressive gains facilitated by weak controls made many judges responsive to the temptation of fast enrichment. In consequence, the system that was supposed among other things to uphold contracts and property rights has remained ineffective even in most CEECs (EC 1999).

Furthermore, the public prosecution is often part of the state administration and manifests all the drawbacks of the system as a whole. In most cases, chief prosecutors with wide powers of...
control over activities of the subordinate prosecutors are politicians. Such interference leads to the decline of professional standards and demoralization of the personnel.

One common problem for many of the postcommunist states is how to reform the judiciary. On the one hand, the justice system must be protected against any external interference. On the other hand, how is it possible to avoid external interference when corporate control mechanism does not function?

Thus, the question emerges what can be done to minimize state capture. In other words, how to change established rules of behavior? In the absence of commitment of the political class to reform itself, it would seem that the change could come from two sources—civil society and external actors. External actors should support voice of grass root movement. Once corruption has become the norm and permeated decision making structures, civil society may play important role in subverting state capture. But outside-state activities are likely to have a more immediate impact in “democracies” rather than in “electocracies.” In the absence of civil society, external actors seem to be the most important source of influence for the latter.

As for external actors, the distinction has to be made between CEECs seeking accession in the EU and CIS countries. EU candidate countries are subject to annual assessments of progress towards accession. The Commission is often highly critical. For instance, EC (1999) states that “… corruption, fraud and economic crime are widespread in most candidate countries, leading to a lack of confidence by the citizens and discrediting the reforms.” Individual country reports usually voice similar complaints about low quality of public administration, overloaded and corrupt judiciary, etc. Convergence to the acquis communautaire is another lever of improvement in quality of governance. For instance, procurement and state aid (extra-budgetary revenues and expenditures) are among domains particularly vulnerable to corruption: once they are brought under EU rules, the opportunities for rent seeking will drastically fall.

Yet, in spite of the Copenhagen political criteria for accession (functioning democracy and protection of minorities) subsequently enshrined in Treaty of Amsterdam, no serious analysis of flaws in political structure of candidate countries has so far accompanied these assessments. It seems that a detailed appraisal of political arrangements including the degree of freedom of mass media from the point of view of good governance and opportunities for corruption (i.e., mainly state capture) could set in motion a virtuous circle of change in candidate countries.

Other external actors with potentially huge impact on quality of governance in both CEECs and CIS are multilateral financial institutions. Since around 1997 both institutions have recognized the importance of subverting corruption and improving governance.19 Programs of both institutions have included measures liberalizing the economy, strengthening the budgetary process and the treasury system, establishing independent central banks, privatizing state-owned assets, and improving legal systems. By slashing various state-run preferential schemes, excessive regulation of private business activity, non-transparency and non-accountability, these measures have improved management and limited opportunities for bribes or kickbacks.

But in the absence of strong government commitment to establish good policy environment and viable judicial system, their immediate impact is rather negligible, as the persistently high level of corruption in many postcommunist countries seems to indicate. The system of justice presents a particularly pressing problem. First of all, the commercial courts—which are the key to functioning of a market economy since they are responsible for enforcement of contracts and private property rights—are generally perceived as either highly corrupt or

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19 For instance, the World Bank has produced at the request of governments a number of countries studies assessing corruption, provided loans for public administration reforms (including tax and customs), and kept the issue alive through its research and publications and policy dialogue with member-countries. Both institutions provide technical assistance to improve governance in their respective areas of expertise (Wolf and Gurgen 2000).
inefficient, or both. Second, the system of justice is a critical factor in fighting corruption in all other areas of the state and the economy. Without it, effective sanctions for corruption are unlikely to materialize.

While the only effective way to deal with state capture is to establish effective system of checks and balances with strong three branches of government (executive, judiciary, legislature) as well as clear rules of public-private interface, there are several “small” measures that may reduce corruption. These may include, for instance, full disclosure of personal finances by public officials; disclosure of sources of contributions to political campaigns; the ban on public officials and civil servants to combine political/administrative positions with positions in business including firms in which state has equity; and the ban on simultaneous participation of an elected official in other branches of government.20

Addressing corruption at the center seems to be of paramount importance in addressing state capture. As Amartya Sen (1999, p. 278) succinctly noted, “Corrupt behavior in ‘high places’ can have effects far beyond the direct consequences of that behavior, and the insistence on starting at the top does have reasoning behind it.” Values and norms propagated from top count and the disappearance of corrupt behavior there can weaken the hold of corruption elsewhere. Furthermore, the ensuing collapse in supply of laws and regulations generating opportunities for corruption. “In trying to alter a climate of conduct, it is encouraging to bear in mind the fact that each vicious circle entails a virtuous circle if the direction is changed.” (Ibid.). But the question remains whether the direction can change without addressing the institutional design itself.

3.2. Combating administrative corruption

Most postcommunist countries face the problem of a large, inefficient and underpaid civil service with weak professional incentives. Weak state administration cannot defend its integrity and impartiality in the face of political pressures. Personnel policies, based on political rather then meritocratic criteria, promote partisanship and incompetence. The difficulty is even more acute at the level of the self-government administration since decentralization of a corrupt system of government brings about decentralization of corruption. The situation becomes, therefore, even less manageable. In what follows our focus is on the identification of measures that address the issue of reducing the potential or opportunities for corruption.

While it takes a lot of effort and time to uproot corruption sustained from above by state capture, the political elite already committed to combat corruption may push for implementing strategies focusing on selected areas of public domain. Courses of action may differ depending on the issue-area. But to be effective, they all should depart from addressing opportunities or the potential for corruption due to regulatory environment and motives for corruption. The potential for corruption increases with the expansion in the supply of regulations, and is also a function of their wording, and complexity.

Because of the legacy of overregulation, taking stock of the existing laws and regulations is the first step of the “deregulation” effort.21 They should be subject to several tests. These among others might include. What purpose do they serve? Do they unnecessarily hinder business activity? Do they provide protection to firms as well as citizens against harassment by the State?

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20 For instance, Member of Parliament serving in the executive branch blurs the boundary between legislative and executive functions. In consequence, the democratic mechanism of control of legislative over executive may become weaker and—with the absence of a clear dividing line between bureaucratic and political elites—the opportunities for corruption become more pervasive.

21 Aslund and Dmitriev (2000) note that in Russia more than 60 agencies inspect businesses and virtually all economic activities are subject not to one but multiple licenses. These regulations serve as a tool to extract bribes.
Do they offer easy mechanisms of appealing administrative decisions? Are they endowed with procedures limiting excessive discretion of the administration? Are they simple and transparent?

Because of the legacy of the misrule of law and weak administrations in postcommunist countries, reviewing the existing laws from the point of view of their wording in terms of offering excessive discretion to administration is a good point of departure. Excessive official discretion derives from loose wording of laws and regulation, the absence of clear criteria for administrative practices, and complex regulations.

The same concerns should apply to new laws and regulations. They should be subject to similar scrutiny taking into account opportunities for corruption, administrative costs involved in them to both firms and individuals while simultaneously seeking to minimize the opportunities for rent seeking. This involves observing a couple of rules. First, introducing regulations only when they are needed for important reasons to assure competition, protection of health, environment or, in general, to prevent production of “public bads.” Another reason may relate to commitments under international treaties signed or because of participation in various international organizations. Aside from these, “de-regulation” should bring considerable economic benefits through, at least, transforming a shadow economy into a formal economy and improving business environment (De Soto 1991, Kaufman and Kaliberda 1996).

Second, the wording should be clear and procedures transparent. Clear wording and transparency should go a long way to reduce the potential for corruption. Whenever it applies, the regulations should clearly specify the responsibilities of administrators. For instance, the regulation concerning issuance of a license to conduct business activity should specify areas that are excluded (rather than those which are included) and set the timetable that the administration has to observe in issuing the document. By infusing more predictability into the policy environment, these simple rules positively influence economic activity.

Third, simplicity reduces the potential for rent extraction. Complex tax regulations, for instance, offer opportunities for tax evasion and provide incentives to elicit payments. For instance, the elimination of various tax incentives (exemptions) and using the savings to reduce corporate or personal income tax rates and simplify tax code is not only a measure reducing opportunities for bribe extraction. It also improves business climate because of its limiting impact on the exercise bureaucratic discretion. The reduction in tax rates minimizes administration and compliance costs and thus contributes to efficiency in the allocation of resources. One may thus expect higher foreign investment inflows as well as the increase in domestic business activity.

Broadening the tax base through lowering tax rates and eliminating special exemptions tend to make tax liabilities transparent, decrease the compliance cost of taxpayers, make tax calculations easier and also reduce the discretionary power of tax inspectors (World Bank 1999). In brief, tax simplification does not only limit opportunity for extracting illicit payments but also increases economic efficiency.

Simplicity entails greater neutrality of applied measures and therefore reduces distortions. A good example of measures that simultaneously contribute to greater allocative efficiency and helps country to take advantage of opportunities offered by global markets is uniform tariff structure. The best foreign trade policy, especially for a small developing economy, is that of free trade. The second best option is a uniform tariff structure with preferably low value of a tariff rate. Both options—if enforced by special constitutional arrangements removing tariff policy from realms of current policy—are also superior on other grounds. Because of administrative

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22 Some of them may be quite demanding especially those related to membership in the WTO. For the advanced countries with systems compatible with international conventions the WTO merely obliges them to apply their domestic rules fairly at the border. This is clearly not the case for most developing countries including CEECs and CIS members of the WTO. For a discussion of resource barrier that they face, see Finger and Schuler (1999).
simplicity, they reduce (or almost completely eliminate with a zero tariff rate) the potential for 
administrative corruption. And, if the commitment to the principle of uniformity is legally 
binding, it also discourages firms from shopping around for protection through tariffs. In other 
words, the potential for policy capture is by a protectionist lobby is then significantly curtailed. 
(For a more detailed discussion, see Box 2).

**Box 2: Good economics and corruption reducing measure: the case for a uniform tariff structure**

<table>
<thead>
<tr>
<th>The introduction of a uniform tariff structure with a preferably low value of a tariff rate is mainly informed by the following considerations:</th>
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<tr>
<td>1. <strong>It equalizes distortions associated with tariffs across sectors of the economy since it affords the same level of protection to all firms.</strong> In other words, it offers the same protection to, for instance, a producer of computer chips and that of computers. This is very important in the case of a small transition economy facing readjustment to world markets. High tariffs on products of sectors which seemed to have had comparative advantage (that is, were competitive) before the war would only halt the process of adjustment.</td>
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<td>2. <strong>It is transparent and administratively simple.</strong> This is in turn reduces the administrative burden of customs by simplifying clearing procedures. A uniform tariff rate also helps preventing losses in customs revenue due to misclassification of imported goods. While it is not a universal remedy for corrupt practices, it certainly improves administrative capacity to monitor customs revenues.</td>
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<td>3. <strong>It reduces drastically the scope for unproductive lobbying activities for higher tariffs provided that a government is firmly committed to the principle of a uniform tariff rate.</strong> This commitment can be achieved by a legally adopted requirement that the principle of a uniform tariff rate can be only overturned by a majority or, even more effectively, super-majority (e.g., two-thirds majority) vote in a parliament. The reduction in lobbying activities is due to the fact that lobbying activity is driven by prospects of gains bestowed upon a small group of firms. The uniform tariff rate gives the appearance of equal protection to all import competing sectors of the economy.</td>
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<td>4. <strong>It compels decision makers to take into account interests of not only producers (as is usually the case with the exception of some countries which set up institutions to conduct a full cost/benefit analysis of new foreign trade policy measures— e.g., in Australia) but also consumers and users of imports.</strong> This is so because the change in a tariff rate affects all import competing and export industries and, therefore, users of imports are likely to countervail lobbying efforts to change a tariff rate.</td>
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<tr>
<td>5. <strong>The adherence to the principle of a uniform rate tariff effectively removes tariff decisions from the realm of current politics, which is usually destructive to economic efficiency and business climate.</strong> Consider for instance the following. Many countries are tempted to offer higher tariffs to attract foreign direct investment. Leaving aside the fact that an international experience suggests that this is not effective to attract high quality investment, this may lead to significant disagreements and fiscally irresponsible competition between regional authorities. Note also that the principle of a uniform tariff rate seems to be particularly well suited to institutional arrangements existing in countries with weak administrative capacity and vulnerable to producers lobbying. By establishing clear rules of the game, it reduces, if not entirely eliminates, the potential friction over the use of tariffs to protect specific industries or attract foreign investment.</td>
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Hence, any action plan to address the intrinsic problems related to corruption in tax and customs administration as well as in government procurement should also first consider measures designed to reduce the potential for corruption both at the policy and its implementation levels. Government procurement offers enormous opportunities for corruption. Note first that its focus lies in the shady area between private and public sectors. Second, the market for government is
huge amounting often to more than one-fourth of a country’s GDP. Soft tendering procedures or single tendering procedures under which no competitive bidding is initiated offer opportunities for misappropriation of public funds and raising the cost of public services to taxpayers. Despite some steps toward making the public procurement system more transparent and, therefore, less prone to corruption, effects are far from satisfactory even in EU candidate countries.\(^{23}\)

As for tax and customs administration, simple tax code with low rates and wide tax base and relatively uniform tariff structure on imports are ways to start anticorruption campaign in tax and customs administration.\(^{24}\) This should be accompanied by the introduction of non-discretionary penalties for non-compliance. Elimination of administrative discretion in setting penalties removes one source of corruption.

Simplification and expansion of nondiscretionary rules alone will not uproot corruption. These have to be supplemented by measures addressing motives. Addressing motives is most effective if simultaneously taking place through four different channels: basic motivation (elite ethos combined with mission statements); supply-side elements (effective sanctions for bribe payers and publicity for penalties); positive incentives (autonomy, competitive base pay, non-arbitrary reward procedures); and negative incentives (effective sanctions for corruption).\(^{25}\)

To be effective, these measures should be accompanied by reforms in organization and management as well as establishment of external mechanism increasing accountability of respective branches of administration. The former includes setting performance standards that can be captured by an effective management information system, whereas the latter involves offering voice through independent surveys, citizen reviews and oversight.

Hence combating administrative corruption boils down to several steps. As for laws and regulations, these include, first, setting tough constraints on the supply of regulations, and second, making sure that they be transparent, simple, and that they limit discretionary powers of officials. To be effective, they have to be accompanied by measures aimed at enhancement of the transparency, accountability, and capacity of public administration; at increasing robustness to lobbying and outside political influence; and at development and implementation of clear criteria for personnel management decisions in the civil service. In addition, adequate institutional capacity should be in place for financial management, including effective agencies for internal and external audit, the treasury system, and for public procurement. Mass media and civil society provide important external checks increasing accountability and tracing corruption.

3.3. NGOs and independent media

The level of consciousness about “the cancer of corruption” has dramatically expanded worldwide. So has the number of national anticorruption programs often supported by international organizations. A large number of studies sponsored mostly by international

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\(^{23}\) The WTO Agreement on Government Procurement provides sets of rules opening procurement to foreign competition as well as establishing detailed rules to enhance the transparency of tendering procedures. This agreement, although negotiated under GATT auspices is plurilateral, i.e., applies only to signatories. Bulgaria is the only postcommunist member of the WTO that joined this agreement.

\(^{24}\) Tax and customs administration has been notoriously corrupt in most postcommunist countries, especially in CIS economies. Anecdotal evidence from customs administration provides a good illustration of World Bank’s state capture (policies are formulated explicitly to create opportunities for rents) and administrative corruption (complex regulations offer customs officials significant discretion in setting border charges). Despite meager salaries, positions in customs border control are highly sought after (illicit payments to obtain this position are equivalent of the total of 50 years salaries).

\(^{25}\) For an extensive discussion of major components and their implementation in World Bank-financed programs in several countries, see World Bank (1999).
organizations and NGOs have identified major issues and steps that should anti-corruption campaigns contain.26 Their review would go beyond the format of this paper.

While we shall draw on a number of their observations, the approach that we take here differs subtly in its emphasis on institutional underpinnings of governance and on putting explicitly governance first rather than corruption *per se*. In the absence of civil society and political accountability, even the best designed anticorruption programs are not worth more than the paper they were written on, simply because the privileged will do their best to undermine their implementation.

NGOs and free and open media help suppress the level of both types of corruption (*state capture* and *administrative* corruption) by uncovering and exposing abuses. Both may raise public awareness about corruption and the need to subvert it. Their full independence from state is the necessary condition of their effectiveness in anticorruption campaign.

Media and many NGOs remain still within state’s reach in most postcommunist countries. This is so either because of funding arrangements (NGOs) or conflicts of interests created by ownership arrangements or corruption within both. State controls through issuing licenses or allocating frequencies have weakened mass media’s (especially television and radio) contribution to check corruption. NGOs often remain weak unless supported by government. In fact, an illustration of their weaknesses of NGOs may be that they have “… proven to be most effective when the government treats [them] as a particular ally.” (World Bank 2000, p. xxiii). When NGOs are strong and independent, the government, whether it wants or not, must listen to their *voice* rather than choose to treat them as an ally.

By the same token, the conventional measure of robustness of the civil society in terms of the density of the non-governmental organizations may be highly misleading. Some NGOs in postcommunist countries are so closely related to the government that they have almost become fused with it. Some may perform some analytical functions while offering incumbent politicians the chance of earning additional income, others simply offer employment opportunities to politicians who are temporarily without employment. The irony is that in the postcommunist world, these NGOs—let us call them for the lack of a better term: semi-official NGOs—are often best financed, and most praised by media and public officials. These are NGOs belonging to a new variety of NGOs with strong political commitments.

But in some countries there emerges another category of civic associations, which appear to be much more valuable at least in terms of strengthening democracy. They resemble more traditional “civil society,” as described by Putnam (1993), with its commitment to civic responsibility and community service. These are organizations founded by groups of citizens concerned with the state of local or regional affairs—we shall refer to them as ‘spontaneous NGOs’. People who form these associations are brought together not by political ambitions or the prospect of improving their standard of living, but by the sense of public duty and civic responsibility. These people do not receive any income for their activity. To the contrary, they materially support their associations by paying membership dues. This category of civic associations is a much better indicator of the maturity of the civil society. In contrast to semi-official NGOs with their strong political commitments, they also contribute to the growth in social cohesion and development of social capital (Putnam 1993).

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26 World Bank (2000) provides probably the most comprehensive discussion of design of anticorruption strategies under various categories defined in terms of two aspects of corruption (state capture and administrative corruption). While the report focuses on postcommunist countries, its strategy recommendations are fairly general and applicable to a large number of developing countries. Assis (2000) from the World Bank Institute examines best ways to build coalitions to fight corruption. Wolf and Gurgen (2000) summarize principles underlying the IMF’s effort to curb corruption.
Unlike the ‘semi-official NGOs’, ‘spontaneous NGOs’ often tend not to be popular with political parties, nor are they accepted by the public administration, which they criticize for its shortcomings. Both central and local government tend to disregard their existence wherever possible. In some postcommunist countries, ‘semi-official’ NGOs give cold shoulder to ‘spontaneous’ NGOs, which comes as no surprise as the former benefit from state capture. Therefore, ‘spontaneous’ NGOs are much important for democracy and uprooting corruption (especially state capture) then their counterparts. If they exist, reformers, both domestic and external, should actively seek their involvement in the reform process.

3.4. Concluding comment

The common denominator of the failure to downsize corruption is continued penetration of the economic realm by politics in most postcommunist countries. Its most visible symptom is the pursuit of material gains through political rather than business career. Corruption is a severe hindrance to sustained growth and effective management of public services. All countries appear to suffer from state capture and relatively high administrative corruption.

Corruption revealed in state capture presents a particularly hard problem. Developing a strategy to combat solely administrative corruption without addressing one of its sources, i.e., lack of constraints on the supply of laws and regulations offering opportunities for rent seeking (state capture) would be ineffective, if not counterproductive. The change of climate can only come from the top, and this can only set a needed virtuous circle of change. The root of state corruption is the absence of well-developed formal and informal checks and balances. Accountability is further constrained by underdeveloped expenditure controls, close personal links between the leading politicians and businessmen and by the executive's dominance over other branches of government in CIS countries. Civil society, NGOs and the media are still feeling their way towards real influence. This, together with pervasive ‘control’ activities of government entities, weakens responsiveness of the Government to public and businesses concerns. The civil service needs to become more professional and meritocratic, and better able to resist pressures from powerful interest groups.

While achievements have been considerable in many postcommunist countries, in most of them policy capacity remains unbalanced and accountability structures underdeveloped. In effect, there are shortcomings in both the supply and the demand for good public policy. On the supply side, the capacity to generate good policy options remains limited by endowment of institutional structures and skills in the aftermath of the collapse of communism, unsuited to the needs of a nation-state and a market-oriented economy.

On the demand side, the existing political arrangements (including electoral procedures) still suppress voice. Without opening the political system to more intense competition, the chances for significant reduction in the level of corruption are slim.

4. Corruption and development: policy convergence

Although corruption is as old as government and as the distinction between private and public, until recently international organizations and national governments studiously avoided addressing this phenomenon. And whenever the international organization did, they would use a “less offensive” term: rent-seeking. But this changed around the mid-1990s, first with the establishment of the Transparency International in 1993. Ever since corruption has become one of the main themes on the agenda of all major international organizations. For instance, combating corruption was the main issue at the annual World Bank/IMF meeting in Hong Kong in 1997, and both organizations have spared no effort to raise consciousness about its negative impact on economic performance. Both of them have encouraged and assisted country effort to fight it.
Organization for Economic Cooperation and Development joined as well with its own programs designed at combating bribery in international business transactions by imposing on its member-states the duty to penalize acts of corruption of foreign officials by business executives who are their citizens (OECD Convention of 1997), and developing of codes of sound business practices (OECD 2000). Together with its national chapters, Transparency International has become highly visible working at a grass-root level to raise awareness of corruption and remove its most evident symptoms.

Not a single factor can be pinned down as responsible for the emergence of interest in corruption. In fact, several developments have contributed to it. First of all, the end of the Cold War made it possible to bring an end to the practice of buying the support of corrupt political leaders from developing countries for the Western cause. Simultaneously, demise of communism took off the agenda the need to protect corrupt center-right governments in the West against the danger of communist electoral victory. Italy is the case in point (Meldolesi, 2000).

The last two decades have also witnessed convergence in thinking about what constitutes the right package of policies to enter the path of sustainable economic development (Marcedo 2000, Sachs and Warner 1995). While in the 1960s and the 1970s, it was assumed that developing countries should pursue policies widely divergent from those in highly developed economies; this view began to change following the World Debt crisis of the early 1980s. The earlier emphasis on inward-orientation, financing development through inflation and the direct involvement of state in economic activity gave way to foreign trade liberalization and macroeconomic stability. However, the experience of reforming economies in Latin America in the 1980s or postcommunist transition economies in the 1990s has demonstrated that macrostability alone was not sufficient to trigger economic growth and attract foreign investors. Nether would a competitive exchange rate spur export-led growth because, for instance, “… inefficiency and corruption paralyzed the ports…” (Naim, 2000, p.93). It turned out that even the best-designed legal framework to guide private economic activity mattered little, if the capacity to implement it was lacking.

Thus, it became apparent that development could not be tackled without establishing sound institutions assuring high quality governance together with macroeconomic stability and economic openness. The re-discovery of the importance of institutions for economic performance was bound to trigger interest in corruption—clearly a symptom of poor governance. Subsequent research has provided strong empirical evidence that whereas high corruption stifles economic growth, low levels of corruption have beneficial effects on economic growth. Mauro (1997) shows that corruption decreases investment as a share of GDP. Correspondingly, the decrease in corruption significantly increases both the investment rate and annual growth rate of per capita GDP.

Second, the world economy has changed dramatically over the last two decades. Integration into the production and marketing arrangements of the MNCs rather than the pursuit of an autarchic national development strategy appears to offer the most efficient way to take advantage of growth opportunities offered by the global economy. Managerial, know how and technological requirements of successfully competing in international markets have become simply too high to accomplish through reliance on country’s own resources. Foreign participation—in form of either ‘outsourcing’ or direct investment—offers direct access to global networks of a parent company as well as to its know how. Technology has made possible fragmentation of production process, i.e.; dividing the industry’s value chain into smaller functions that can be contracted out to independent suppliers (Borrus and Zysman, 1997). This possibility of ‘dividing up the value chain’ of production has resulted in —to borrow an apt
phrase from Feenstra (1998)—integration of trade and disintegration of production in the global economy.\(^{27}\)

Globalization, fueled by revolutionary changes in technology and information as well as by liberalization in international economic exchanges, has redefined the formula for economic success. Economic success of the so-called third tier of East Asian economies—Malaysia and Thailand—has hinged heavily on opening up to foreign investment and participation in the new division of labor based on fragmentation of production. Attracting long-term foreign capital to invest in upstream production activity is justifiably regarded as a necessary condition for tapping opportunities offered by the Global Economy (Arndt and Kierzkowski 2000). This, however, requires not only adequate physical infrastructure but also above all a “low corruption” environment that is friendly to private business activity.

Thus, two findings of empirical research that high corruption depresses the magnitude of foreign direct investment (Wei 2000) and lowers their quality in terms of research-and-development intensity (Smarzynska and Wei 2000) are not counterintuitive. Yet, they provide strong ammunition to the argument about to the importance of low levels of corruption for economic growth in contemporary global economy.

In a similar vein, few empirical studies that have been undertaken to determine the effect of institutional factors including among others include property rights, government regulation, political and civil rights, rule of law, governance and public administration, legal reform, political risk on growth in transition economies testify to their importance. While they have not tested explicitly the ‘corruption’ variable, they nonetheless shed light on the importance of good, non-corrupt governance. For instance, an empirical study tracing the role of institutional factors in the growth of transition economies has found that property rights and political stability are particularly important for per capita growth, while an indicator of credibility (a simple average of five indicators – predictability of rules, political stability, property rights security, judiciary reliability and corruption) – was highly significant for both FDI and per capita growth (Brunetti et al 1997). Campos (2000) has found that the rule of law was the most important institutional dimension (compared to accountability of the executive, quality of bureaucracy, transparency and accountability, and strength of civil society) in terms of its effects on per capita income and school enrollment. Havrylyshyn and van Rooden (2000) found that while among institutional factors legal reform was the most important,\(^{28}\) their effect is not as strong as that of macroeconomic stability or structural reforms.

Last but not least, since both Latin American and Postcommunist transitions have involved not only the shift towards a new market-based economic regime but also democratization, these ‘double transitions’ have changed institutional factors underpinning corruption and might have temporarily increased corruption. With the party state authority ebbing, an outburst of corruption accompanied the disintegration of Communism. Transition has created huge opportunities for corruption especially in countries that adhered to partial reforms (Hellman 1998). While reforms in Latin America called for less radical measures because of initial conditions less remote from market economy, corruption there may not have increased. But its perception has probably increased as democratization has brought corruption to public debate and legal investigations that had been suppressed under authoritarian regimes.

\(^{27}\) For an extensive discussion of fragmentation of production and trade, see contributions in Arndt and Kierzkowski’s (2000) edited volume.

\(^{28}\) Havrylyshyn and van Rooden tested nine institutional variables for 25 transition economies for the period 1991-98. Their basic equation regresses GDP growth on inflation, structural reform index (contemporaneous and lagged) and initial conditions. They found that adding an institutional variable added little explanatory power. Legal reform was found to be the most significant institutional factor. They concluded that good economic policies remain the dominant statistical determinant of growth.
5. Conclusion

The recent upsurge in interest in corruption stems from discovery of the importance of institutions and governance in the context of the current global economic and political environment. The emphasis on good institutions and good governance illustrates convergence in policies among countries seeking to exploit opportunities created by the ongoing technological revolution and globalization. Its common denominator has been the rejection of authoritarianism and centralization, represented in the past by bureaucratic central planning, as conducive to effective industrialization and social stability. Two waves of democratization, witnessed over the last two decades in Latin America in the 1980s and in the former Soviet bloc in the late 1980s and early 1990s coincided with the dramatic change in economic policies. Because of initial conditions, the postcommunist transition has brought to fore the issue of institutions and governance more prominently than transitions in Latin America.

It has also brought to fore the realization that good governance, macroeconomic stability and integration into global markets through opening of economy are necessary conditions for sustainable economic growth. The cost of doing nothing in terms of improving the quality of policy environment and subverting corruption is extremely high. It spells economic devolution and expansion in poverty, simply because growth opportunities offered by the Second Global Economy remain untapped. Economies that are overregulated and overprotected are unlikely to attract high quality FDI that would assist domestic producers in integration into global markets. Neither are they likely to increase intensity of competition domestically. They are also unlikely to trigger sustainable economic growth and improve efficiency in allocation and the use of resources.

If sustainable growth becomes the objective of a government, then the issue of establishing good policy environment should move to the top of a reform agenda. How to improve governance? Our argument offers two recommendations. First, while the dominant body of literature suggests a combination of measures addressing motives and organizational environment, this study argues is that the best course of action is to establish conditions for competition not only in the economy but also in polity. The main argument here is that the political systems including electoral procedures matter and that democracies are not handicapped in terms of creating good governance structures with the low incidence of corruption. They also seem to be better endowed to deal with corruption. While more research is needed, there is a clearly a link between quality of governance and electoral procedures. Unfortunately, the linkage has yet to receive more attention from international organizations and policy think tanks. Electoral proportional procedures with very low or no thresholds and relatively large districts favor the emergence of a strong multiparty democracy at the national level. However, at the local level majority formula seems to assure greater accountability of local government officials to their constituencies as well as their stronger involvement in local governance.

Second, the reliance on penalties to combat corruption may be a good solution for societies with sound governance structures robust to policy capture by private interests, but this would be a wrong approach to countries with poor policy environment controlled by narrow private interests. Instead, the point of departure is to identify vulnerabilities to corruption and reduce the potential for corruption. Overcontrolled economies provide an ideal breeding ground for corruption. Therefore, the initial effort should focus on reducing the potential for corruption. Simplicity and transparency go usually hand in hand with good economics and governance.

Privatization of state or Res Privata, as caught by the World Bank state capture index, does not augur well for the improvement in governance. Most CIS countries seem to fall into the category of countries with corruption perpetuated from above. Under these circumstances, internationally supported programs focusing on one particular policy domain strike one as a waste of resources. Instead, international effort should focus on the development of ‘good civil society.’
References:


