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Six Propositions and Recommendations  
on bureaucratic corruption in government organizations  
of Less Developed Countries, with focus on India

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# 1. Introduction

Most new institutional economists (NIE) focus on capitalistic institutions: the market and the firm (Coase, 1937; Williamson, 1985; Milgrom and Roberts, 1990; etc.). Yet there is by now an increasing literature in NIE on the institutional environment, which includes the state (Lin and Nugent, 1994). There have been some convincing studies on market preserving federalism (Weingast, 1995) and other institutions (Greif *et al.*, 1994) designed to prevent the misuse of power by the state, but it appears that there is yet insufficient understanding of the design of institutions needed to prevent one of the major correlates of government failure in LDCs - bureaucratic corruption.

Bureaucratic corruption in government organizations has to be distinguished, at the outset, from the issue of influence costs and corruption which Milgrom and Roberts (1990) have touched upon. According to them, the reason why firms cannot expand beyond a point is primarily related to the power of *discretionary intervention* that bureaucrats possess. Bureaucrats are seen as intervening in two stages: (a) directly, i.e., on their own volition, which can be counterproductive due to bounded rationality, and (b) indirectly, i.e., motivated by the political activity within the organization and disinformation received primarily from within. This political activity imposes influence costs which includes *internal corruption* or bribe giving to superiors, in order to further one's self interest. Thus, in the situation that they discuss, corruption is used as a tool to influence decisions *within* an organization. They do not discuss the fundamental problem of LDCs, that of corruption as a tool of misappropriation of rents from the *citizens* whom the bureaucracy was designed to serve.

Corruption, if defined very generally, would include all kinds of opportunistic behavior, where a particular agent breaks certain rules in order to gain a private advantage. However, we restrict corruption to mean, for purposes of this paper, "the use of *public office* for private gain" (Bardhan, 1996). Even further restrictions are imposed, viz., we exclude political leaders who hold public office.

The topic of bureaucratic corruption has been touched upon in *public choice* literature, but their analysis has been largely bereft of institutional content, by which I mean that they have largely ignored the institutional environment in which the bureaucracy operates. Further, the focus of attention of public choice theorists has been on the government and bureaucracy of the West, whereas I would like to focus on LDCs. It is useful to note that there is no presumption made here that some, or perhaps all, of these discussions, might not be relevant to developed nations. Bureaucratic corruption in government is a global phenomenon.<sup>1</sup> To justify this claim of possible applicability of the discussions of this paper to all bureaucracies, a few recent news reports on corruption in developed nations are placed in Appendix I. Even in the USA, "the level of government

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<sup>1</sup> See the following Transparency International web site:  
[http://www.transparency.de/introducing\\_ti/global.html](http://www.transparency.de/introducing_ti/global.html)

corruption has increased dramatically” (Frederickson: 6). At the same time, it is generally admitted that (a) corruption is more rampant in LDCs in terms of *frequency* and the *number of bureaucrats* involved in this activity, and (2) it has more immediate effects in the distorted economies of most of these LDCs, in terms of negative influence on the motivation of entrepreneurs and investors.<sup>2</sup>

Bureaucratic corruption in LDCs has in fact become a major topic of research in international organizations, which find that their efforts in promoting development in the Third World have been largely neutralized by the misuse of funds and their diversion away from the projects for which these funds were intended. Some examples of the organizations working in this area of research are given below:

1. The recent thrust has been given by the World Bank and the G-7 to reduce corruption world-wide (see Appendix II for press reports on recent efforts in this direction, as well as the World Bank’s official approach to controlling corruption).
2. Transparency International<sup>3</sup> (TI), a non-governmental organization was established three years ago to promote academic as well as policy research in strengthening the rules which prevent corruption or are designed to raise the deterrence against corruption.
3. The project on Institutional Reform and the Informal Sector (IRIS), at the University of Maryland deals, among other issues, with corruption in developing countries.

In this paper, I adopt an eclectic approach, hoping to capture the results of various streams of economic thinking. I have tried to carry out a brief literature survey in Section 2 leading to six Propositions on the causes of corruption. The Propositions have been written with the hope that these can be ultimately tested, empirically. I have tried to justify the Propositions with some arguments and wherever possible, case studies and illustrations. Section 3 considers some of the solutions to the problem of bureaucratic corruption, wherein I suggest six Recommendations. Section 4 concludes the paper.

## 2.

### **Behavior of the bureaucrat and bureaucratic corruption: theories and evidence**

At the outset I try to determine the characteristics of bureaucratic corruption, and also propose a tentative classification of the types of corruption.

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<sup>2</sup> Wei, Shang-Jin (1997).

<sup>3</sup> Their web site is: <http://www.transparency.de/index.html>.

## 2.0 Bureaucratic Corruption

### 2.0.1 Characteristics of corruption

We must first of all distinguish between corruption and gift taking. It is well-known that there is a tradition of gift-taking in most LDCs, where the giving of gifts is considered to be a mark of respect to authority. This tradition is in the nature of an informal rule and is a long-standing institution in these countries, and one should distinguish it from corruption. The TI Advisory Council Chairman Olusegun Obasanjo has clarified the difference: “a gift is a token; it is not demanded; the value is in the spirit of the giving, not the material worth. The gift is made in the open for all to see, never in secret. Where a gift is excessive it becomes an embarrassment and is returned”(cited by Peter Rooke, Transparency International Australia, in an e-mail to the TI newsgroup) [underlined phrases, mine].

Some of the characteristics of corruption can therefore be deduced from this (we will use the words briber and bribee, for convenience, throughout this paper):

1. Corruption is related to demand from the bribee (obviously, this demand is supported by some credible threat to do harm, or the ability to provide an illegal gain). This does not mean that corruption is coercive, however. It still remains voluntary, and is different from robbery, or extortion.
2. Corruption is related to material worth. It is true that in some cases (as per the Tullock paradox, discussed later), the size of the bribe seems to be of a trifling amount compared to the benefit (or reduction in loss) provided by the corrupt official. However, in most cases it would appear to be an amount greater than an ordinary gift.
3. Corruption is a clandestine activity often performed in secret, away from the public eye. It is in any case unheard of for a public official to declare that he is receiving the corrupt amount in any press conference (which would be true in case of a social honor or award). In fact, corruption is illegal in all societies. Corrupt “contracts” cannot be brought to court for purposes of enforcement. For many transactions, however, corruption is more in the nature of a ‘fee,’ and is not difficult to enforce by the citizen, as the service is provided instantly on the receipt of the agreed to ‘fee.’ For other kinds of corruption moral hazard - or the possibility of default *after* receipt of illegal gratification - enters into the picture and enforcement becomes a major issue to be considered by the briber.
4. Corrupt earnings are usually not returned to the party from whom the amount was received on the ground that the amount happened to be ‘embarrassingly’ high.

## 2.0.2 Types of corruption

There can be many types of corruption. For example, in the ancient Indian treatise on economic administration, called *Arthashastra*, by Kautilya, forty ways of embezzlement have been outlined (Bardhan, 1996). For our purposes, we can classify corruption in terms of three basic types: bribes provided to receive a positive or a negative service, and bribes provided to outbid competition. I have tentatively classified corruption as follows:

**Type A bribe:** I call a type A bribe one in which the briber and the bribee face each other directly, and there is no third party involved in the transaction (i.e., there is no sub-agency problem).

### A.a) Bribes provided to receive a positive service (corruption without theft)

In this situation the bureaucrat can be modeled as a monopolist, who extracts the consumer surplus to the extent possible, in return for the service provided.

Examples of this form of corruption are:

- (a) When a briber receives a copy of his land revenue records from a corrupt land revenue clerk.
- (b) When a briber receives a train ticket reservation from a corrupt Ticket Collector.

In both cases, the requisite, prescribed, fee is received by the government. In addition, however, the bribee receives an extra amount, raising the real cost of the service to the briber. This form of corruption has been called corruption without theft by Shleifer and Vishny (1993), since while the citizen is being made to pay an undue amount, the government or the employer of the bureaucrat, has not been directly cheated.

While the effects of this form of corruption on efficiency might be relatively small, since the consumer surplus is being captured by the bribee, while the transaction, if efficient, still takes place, it has distributional consequences, wherein the poor (who cannot afford the bribes) are forced to part with their meager income in order to gain this service. Such corruption also has adverse social consequences in terms of promoting social unrest which can lead, ultimately, to terrorism (as has happened in India in a number of cases, including in the state where I work back home, in Assam).

### A.b) Bribes provided to receive a negative service (corruption with theft)

When the briber is saved from a real or imagined loss through the provision of a service by the bureaucrat, this can be called corruption arising from a negative

service. As Myrdal pointed out, corrupt officials may, instead of speeding up, actually cause administrative delays in order to attract more bribes.

Examples of this include:

- (a) When a corrupt income tax officer connives at the false statements made in an income tax return, which then helps the briber in reducing tax liability.
- (b) When a corrupt Police officer 'waives' the speeding ticket of a briber and thus prevents the loss of fine to the briber, in return for a bribe.
- (c) When an inspector of pollution puts down a lower figure of pollutants emitted by a factory, in return for a bribe.
- (d) When a drug testing laboratory lowers its standards in order to "pass" a particular drug which is profitable to the private firm.

This form of corruption has been called corruption with theft by Shleifer and Vishny (1993), since the bribe is being paid out of government revenues. Bardhan feels that this type of corruption is more insidious, difficult to detect, and therefore more persistent. This type of corruption also has adverse distributional effects, but these are more indirect, such as when the level of taxes in general is raised to compensate the loss of revenue arising from the action of corrupt officials. The major effect of such corruption appears to be in terms of efficiency loss, whereby negative externalities are imposed on the rest of the society by the participants in the corrupt transaction. Such externalities could also be fatal, for example, if poor quality drugs get approved for supply to a public health system.

#### **A.c) Bribes provided to outbid a competitor**

This is the kind of corruption studied in Mui (1986), where there is a bid between competing parties and the lowest or the most competent bidder is ousted by citing various, trivial, reasons, in order to favor a party who has paid a large bribe. A typical example where this plays a major role is in international procurement. It is here that many Western governments are debating about how to treat the 'expense' on this form of corruption.

This kind of corruption is usually applicable only to very large firms or parties, and does not often impact the common man. However, it generates *considerable inefficiency* as the best offer is rejected in favor of a relatively inferior offer, merely because of the bribe. When the criteria for decision making are not related to efficiency, expecting an efficient outcome is ruled out by default.

Bhagwati: 217). The new classical model allows for tax collection by government, but thereafter this tax is assumed to be wasted. In such a model there is no state (or hardly any role for it) and therefore no bureaucrat. Even if he were to exist, the bureaucrat would be invisible and altruistic, being entirely neutral - carrying out responsibilities assigned to him, costlessly, and without any incentive problems, for the good of the society. The classical sociological view of bureaucracy, as promoted by Max Weber (1947), is essentially such a view. Weber imagined bureaucrats to be selfless purveyors and enforcers of the policies of elected governments.

It does not take the vast experience of working in a highly corrupt LDC to realize that such a view is severely flawed. Unfortunately, this view was predominant in the developing nations when the socialistic influences were at their rise in the 1950s, and this favorable view of bureaucracy meant that centralization of decision making and planning was thought to be an excellent solution to the problem of development. As the events of the past fifty years have unfolded, we observe that such confidence in the bureaucracy was entirely misplaced. While one still has tremendously honest and hard-working officials in the bureaucracy in India, for example, even today, in the overall context, these officers have nothing to teach us about why corruption exists.

### 2.1.2 Paradigm 2: The bureaucrat as a self-aggrandizer

The above paradigm was challenged, in 1957, by Northcote Parkinson who showed the tendency for bureaucracies to expand, irrespective of need. This view led to the development of the school of *public choice*, wherein partial equilibrium models restricted attention to the bureaucrat's utility functions. The major economists who worked in this direction initially were Tullock (1965) and Downs (1967). Public choice theories make "specific assumptions about the objective functions of bureaucrats. ... In addition to size, budgets, discretion, prestige, and self-preservation, it has been suggested that security, the avoidance of risk or responsibility, secrecy, complexity, career promotion, leisure, internal patronage, and a bureaucrat's personal conception of the common or company good are objectives of bureaucrats" (Breton et al: 26).<sup>4</sup> Tullock concludes that "regardless of role, the bureaucrat responds to the rewards and punishments that he confronts" (Buchanan, cited in McLean: 760), which somehow, does not say much; in fact, brings us back to a kind of Pavlovian model of conditioning, which is certainly not true.

Later, William A. Niskanen (1971), in his *Bureaucracy and Representative Government*, argued that a bureaucrat's utility function comprises of power, money income, security, perquisites of office and patronage, and that the utility gained from all these is a monotonic function of budget size. This showed that bureaucrats might not always act in the public interest. Niskanen (1994) has now modified the theory of the budget maximizing bureaucrat to that of the *discretionary budget maximizing* bureaucrat, and has allowed for the influence of the political institutions and environment. This is an attempt to take the model out of its partial equilibrium framework. The public choice literature finally, was able to throw at us a relatively cynical view of the bureaucrat, in keeping with what the common man has always had.

While most of the public choice theorists have not concentrated on corruption as an outcome of this utility maximization process, it can well be argued that this approach leads to corruption, under certain situations. Given fixed preferences, and considering that bureaucrats are optimizing over their *personal benefits*, if the wages and perquisites

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<sup>4</sup> Obviously this jumble can become mathematically intractable; hence simplifying assumptions, as in Niskanen, are made. I am always skeptical about complex utility functions, however, since these functions need to be explained in terms of our natural evolution from primates.

decline either in absolute or in relative terms, then the bureaucrat would seek alternative sources of income to enable him to return to his original indifference curve. These alternative sources could include rent-seeking or corruption, carried out if the expected return *after* compensating him for the risk of dismissal from service on being caught, is positive. We can therefore summarize the findings of the public choice literature relating to corruption, in terms of the following proposition.

**Proposition 1:** Assuming an efficient role for government (i.e., absence of government failure) corruption could arise because the bureaucrat is not paid his marginal product.

Empirical studies seem to confirm that highly corrupt administrations are usually characterized by low salaries (Mauro, 1995). Appendix III discusses the case of Nigeria, where corruption is rampant due to extremely low wages. Appendix IV contains a small case study which describes the utility function of and its maximization by *some* senior bureaucrats of India, today. The case study shows that (a) personal financial goals *do* matter, and (b) when financial situations become adverse, there could be an *entire spectrum of responses* of the bureaucrat, ranging from seeking out all possible honest ways to increase personal finances, to, ultimately, corruption. Apart from using the opportunity of study leave to save a few dollars abroad, other honest response would include the following:

- a) High level of competition for foreign assignments, including assignments in international organizations, where the bureaucrat receives a wage in foreign currency.
- b) High level of competition for becoming the CEO of public sector corporations, where the level of perquisites is immense, such as frequent foreign travel, plenty of cars, guest houses in the capital city, etc. Such bureaucrats, in their own self-interest, then to maximize the size of their budget, and fight for the survival of the public sector corporation, despite knowing that the social loss due to its mismanagement is much higher than the personal gain that they receive. This illustrates the strong negative externalities that low wages of top bureaucrats can impose on an economy.

The first response - of studying abroad - might turn out to be efficient in that the returns to human capital for the nation from the learning of the bureaucrat might well outweigh the loss of services of the bureaucrat in his job in India for the period of study abroad. We also note that other 'honest' responses are in the nature of increased influence costs imposed on the system (Milgrom and Roberts, 1990), and clearly decrease efficiency.

In addition, of course, there are outright corrupt responses, of which there are a myriad types, some of which were discussed in Section 2.0.2. The 'creativity' of bureaucrats in inventing ways to be corrupt is extremely high, once they are determined about it. The response of corruption reduces efficiency by increasing transaction costs and

reducing the reliability of the institutions in the economy. We must recognize that in general, corruption is a surreptitious mechanism that uses the threat of an *increase* in transaction costs to attract rents, and hence, is inefficient, by definition. Additionally, corruption also costs the society heavily in terms of the moral sentiment, and in this way, by reducing the level of trust in the society, raises *monitoring costs*. This pushes the economy to a point well below its *technical frontier* (North, 1990).

Coming back to the Proposition, while there is no readily available way to determine the marginal product of a government bureaucrat, I am proposing that it should be possible to determine a shadow wage, based on the *average* wage received, outside government, of persons of similar ability. It would not be safe to subtract any amount from this wage on the ground that the bureaucrat has an altruistic interest in public service: if anything, there a reasonable sum should be added, in keeping with the efficiency wage hypothesis, so that the bureaucrat, if found to be corrupt, despite this high wage, will earn much less outside. This off-the equilibrium path combined threat of loss of reputation as well as higher wage, will keep the bureaucrat from being corrupt, at least in most cases.

Empirically, it appears that the wages of bureaucrats are substantially high in the West, compared to the private sector. For example, the Police Commissioner of Los Angeles seems to be paid hundreds of thousands of dollars a year, which is perhaps a similar wage to what he would expect to receive if were to work in the private sector. On the other hand, the Police Commissioner of New Delhi, who handles a similar population, receives \$6,000 per year, while a person of equal caliber in the private sector in India would receive at least five to ten times that amount. There are other possible reasons of course, for the relative absence of corruption in the West (Chief Williams was investigated regarding a hotel stay in Las Vegas). For example, the Police Commissioner of Los Angeles is appointed on a contract basis after a special recruitment process, while in India, there are two reasons why a police officer can become the Police Commissioner of New Delhi: (a) he has adequate seniority in terms of the number of years put into the Indian Police Service and (b) he is close to the political leaders of the day. None of the reasons are related to efficiency in terms of management of the New Delhi Police.

The problem is that this Proposition does not account for those who still obey some “higher” virtue, and does not quite take into account the institutional structure that perhaps leads to opportunism.

### **2.1.3 Paradigm 3: The neo-classical bureaucrat, affected by bad economic policies**

For neoclassical economists the state does plays a fundamental role in the economy, in terms of being a provider of public goods and an enforcer of contracts. Therefore there is a much more fertile literature in this case on rent-seeking and directly unproductive activities in the context of distorted economic policies . An excellent review of this literature is given Bardhan (1996). The issues relating to corruption are so many that most economic models, taken individually, are able to capture only a very small *portion* of the aspects involved.

Several papers consider the existence of multiple equilibria, whereby the same socioeconomic structure gives rise to different levels of corruption. The usual solution in such models is to prescribe salary increase for bureaucrats, so that a lower level of corruption is obtained. Further, high political turnover (or change) can increase corruption by increasing the discount that bureaucrats put on the future. Stable political regimes therefore can expect to have lower levels of corruption in such models. Cadot (1987) considers a bargaining game between bureaucrats and customers in a public office, where the supervisory authorities can also be corrupt. Various situations arise in the case of perfect information, asymmetric information and imperfect information on both sides. The results are similar to the ones mentioned above, viz., that a higher wage will increase the opportunity cost of the official, inducing him to take less bribe, as well as the expected effect of the discount rate the bureaucrat places on the future. The question of the role of punishment has been considered by Basu *et al* (1992). This penalty is an instrument to curb corruption. But the effects of various forms of punishment are different.

While we have indicated at most places above, that corruption is likely to be socially inefficient, there is a literature that claims to show that corruption could be efficiency-enhancing. “Economists have shown that in the second-best world when there are pre-existing policy-induced distortions, additional distortions in the form of black-marketing, smuggling, etc., may actually improve welfare even when some resources have to be spent in such activities. The argument for efficiency-improving corruption is a simple extension of this idea” (Bardhan, 1996). In this view, as pointed out by Boycko, Shleifer and Vishny (1995), “corruption is no different from any other side payment in the Coase Theorem.” But I am not quite convinced about these arguments, *especially* in a second best world, where the effects of corruption on entrepreneurship can be extremely adverse, and even divert investment into smuggling or mafias. These and other effects are not captured in simple economic models of the second best world, and we need to take any ‘praise’ of corruption with a considerable pinch of salt.

These theories of corruption being efficiency enhancing are sometimes supported by examples. For example, De Soto (1990) has tried to show why it might be much better for entrepreneurs to bribe their way through a system where the amount of paper work required under the law can take years to complete if all formalities are gone through properly. There is much merit in such views, but ultimately, this is an empirical question, difficult to analyze with simple models.

While a great many propositions can be derived from neo-classical economics, I am extracting a proposition that seems to me to capture the essential economic logic of this paradigm.

**Proposition 2:** The size of the bribe is directly related to the risk of being caught, and inversely to the frequency of similar transactions. In addition, the size of the bribe is inversely related to the expected opportunism of the bribee.

Since corruption is voluntary, one must note that gains (real or imaginary) must accrue to both parties to the transaction, else the act of corruption will not succeed. At this point, we understand to some extent the *Tullock paradox* (Bardhan, 1996) whereby it was first pointed out by Tullock that the size of the usual bribe seems to be extremely small compared to the rent collected by the briber. It appears that size of the bribe is related to the ‘frequency’ of a similar set of transactions, as mentioned above. A common example is the *small* bribe paid by trucks to various checkgates while transporting goods across the nation. Since there are so many trucks involved and since the same truck has to pay to so many people across the country, the typical size of the bribe is ten rupees (thirty US cents).

Among various critiques of neo-classical models is that rents should arise from bureaucratic discretion in *all* societies, including the West. But we do not find high levels of rent seeking behavior in the West. Perhaps the relatively higher wages received by bureaucrats in the West explains this discrepancy, but there is certainly the role played by culture and social norms, which is not captured in these simple models.

#### **2.1.4 Paradigm 4: The bureaucrat with changing values**

We need to explain the *both* the corruption as well as the continuing honesty of bureaucrats. A possible attempt can be made in the framework of changing metapreferences (Kuran, 1995). Using the dual personality model of Schelling (1984), we can consider a bureaucrat torn between conflicting objectives (“the contest of self-command”), such as maximization of national power and wealth *vs.* personal and family wealth and welfare, commitment to colleagues *vs.* personal glory, social and media acceptance *vs.* search for truth and nobility, etc. Consider a bureaucrat who entered service 30 years ago, and was strictly honest at that time. We wish to trace out the changing pressures on him, and his possible responses.

He first of all finds that his opportunities or incentives, in the form of declining wages as determined by the socialist government, or in the form of career opportunities which are no longer determined on merit but by political affiliation, have changed for the worse. He finds that the privileges and status which he was used to are more and more dependent on the whims of the political leader to whom he reports. He is often expected to write press releases or Ministers’ speeches, and otherwise defend policy or programs which he knows are intended to further the material self-interests of the political executive or other senior bureaucrats. He finds that those who are conniving at (or even worse, actually participating in) corruption and nepotism, are able to provide continuity of education for their children, while his children are forced to move from school to school as he is transferred from place to place. Further he finds that the culture in which he lives is now more *materialistic* (a much misused word, but which is used here to describe the increased commercialization of social relations in the society), causing unexpected demands on him from his family members.

In such a situation, if his values and commitments were originally very strong (at one end of the continuum), he would re-affirm his old values to himself, and tightening his belt or lowering his aspirations of material welfare, continue his earlier honest behavior. There would be a renewed *congruence* between his personal and public values. He would fall under the silent majority of strictly honest government officers in India who would *not* exploit any rents available to them under the so-called “bad” policies discovered by the neo-classical model.

If his personal values were not very strong to begin with (somewhere along the middle of the continuum), his behavior would be susceptible to strong change. He might first of all begin with connivance with the corrupt. At such a time, his personal values might conflict with his public behavior, and he might feel a lot of tension. But if his personal values are weak enough and his estimate of public morality low enough, he would cross the threshold and shift his values to the extreme end, rationalizing that he is but an “ordinary human being”, doing what “everyone else” is doing. Thereafter his values as well as behavior would also permanently change. Intermediate cases are also possible, such as reducing the quantity of work he puts in (crowding out of intrinsic motivation, *cf.* Frey, 1993), delaying decisions where he knows that political self-interest is involved, etc. We derive therefore, from this study of changing values of bureaucrats, a simple, self-evident proposition, which will explain to some extent the heterogeneity of behaviors despite adversely changing incentives.

**Proposition 3:** The level of corruption of a particular bureaucrat is a function of his own personal values or metapreferences. These values govern the choice among preferences.

Unfortunately, we note that this proposition seems to have little predictive power, and is in a way tautological. Empirical experimentation *could* however, be done on this proposition, in terms of psychological tests administered to bureaucrats at the time of their entry into government service. These tests might help us predict which bureaucrats are likely to shift permanently toward corruption as time goes by even if they were completely honest at the time of entry. Unfortunately, I know of no psychological test which tests the inner morality or value system of an individual.

### **2.1.5 The institutional causes of bureaucratic corruption**

So far we have not considered the insights of transaction cost economics, nor the institutional environment. In the world of new institutional economics, corruption would be seen as problem of opportunism in the *context* of a certain institutional framework or structure, including the culture of the nation. To motivate discussion, I ask the same question that Olson (1996) asked in the general case of development across man-made borders. Given that there exist two exactly similar kinds of people across man-made borders (easier to see this if we visualize the Germany of 1942 which was then split into two parts after the World War II), what makes the behavior of government officials in these two nations dramatically different over the course of a very short time (East Germany, it should come as no surprise, was an extremely corrupt socialistic regime,

along with many other such regimes). The answer must lie in institutions or man-made constraints set into place in these two societies.

Based on my understanding of the NIE literature, three possible Propositions are being placed here.

**Proposition 4:** The extended family method to control opportunism has broken down in LDCs, leaving few institutional mechanisms to control opportunism.

Greif (1994) showed that in the past, different societies evolved two types of mechanisms to control opportunism in international trading. The mechanism most commonly found in developing countries today is the extended family and reputational type (*cf.* Magribi traders). When this system breaks (as has happened as a consequence of rapid economic change in the past fifty years), and there is no alternative mechanism to control opportunism, the general level of morality in a society can *suddenly collapse*. In my view, this is what has happened in many developing countries today. In societies like India, people were simply expected to be honest, because their reputational capital was determined by this characteristic. However, as urbanization and mobility have increased, the value of reputational capital has declined immensely. Further, the concept of *privacy* has entered into the households in LDCs, enabling the ‘fruits’ of corruption to be kept secretly, without the knowledge of the rest of the members of the family. Thus it is possible for people to be corrupt today, and to keep even close relatives and friends in the dark about it. For LDCs, this breakdown of controls against opportunism has meant that corruption has rapidly spread into all niches and crannies of all institutions, further vitiating the atmosphere. In India judicial corruption has become endemic, distorting the enforcement of contracts and property rights.

On the other hand (*cf.* the Venetian traders), the West has developed the system of checks and balances on opportunism through strict enforcement of contracts. This system requires a very strong set of institutions, and tremendous attention to detail. Even today, the logic of agency theory and even modern economics has arisen only in the West, where efforts are being made to understand human behavior as privately utility maximizing, given bounded rationality and opportunism.

**Proposition 5:** In *most* cases where government institutions are corrupt, there should have been no role for government in the first place.

It appears that many cases of corruption are a consequence of *essential government failure*, where the word “essential” represents the fact that theoretically and practically, it is not possible for government to do these activities successfully. We know that government intervention is justified where it is *efficiency enhancing*, for which a usual pre-requisite is market failure. But the mere existence of market failure does not mean that government can do a better job than the market. Many LDCs and erstwhile socialistic countries, however, boldly allowed the government to enter into areas where it was ‘destined’ for failure. I will illustrate this by a few examples from India.

a) Public sector enterprises (PSEs): Most of these firms are grossly inefficient and rampant corruption is seen to take place, of the following types:

i. Ministers and colleagues of the CEO take bribes from various non-meritorious applicants to get them jobs in these PSEs. There is no control or check of such practices by a body of shareholders as would be the case in private firms, and therefore, corruption and inefficiency go together. The local information about the firm which enables shareholders to immediately buy and sell shares and thus penalize the bad firm, is totally missing in the case of public sector enterprises.

ii. Political parties in power frequently appoint as the CEO only those persons who are amenable to giving them some clandestine political donations when required. This system has led to cases where the post of CEO is often auctioned to the highest bidder, and the CEO is left free to expropriate whatever rents he can from the PSE, on the guarantee of constant government budgetary support of the PSE. It is indeed miraculous that PSEs which have usually a monopoly power in the nation and charge prices much higher than international prices for their finished product, still manage to go into perennial losses. This miracle is explained when one considers the inability of the shareholders (the ultimate principal, viz., the citizens) to intervene except through the monopoly of the elected representative.

Clearly, there should be no role for the government in most public sector enterprises. This will immediately bring down the levels of corruption in most LDCs.

b) Direct social welfare: While it may sound very altruistic, it is the sure recipe for the existence of corruption for a government to directly provide social services to backward groups in a society. I will give two common examples:

i. *Public distribution subsidies*: In India, the government has a system of procuring rice from poor farmers at the time it is produced, at lower than market price, and then providing this rice throughout the country during the year through a public distribution system where massive subsidies are provided to send back this rice to villages, and to ultimately sell the rice at extremely low prices. This is patently inefficient, since the role of the market is being taken over by government. In fact the government has strict laws forbidding the transfer of rice from one state to another, further blocking the functioning of the markets.

The motivation for this is twofold: (a) There have been cases in the past where markets failed and there was mass starvation and famine in certain parts of the nation. This system is supposed to prevent such famines. (b) Many political leaders find it extremely profitable (for their re-election) to promise highly subsidized rice to their constituents. The public distribution system is designed to help them to fulfill this promise.

Without going into the obvious details of why this kind of a system is guaranteed to be corrupt, it is clear that (a) there can be much more efficient systems devised to prevent famine and (b) even if it is a desirable concern to provide subsidized rice, the subsidization can be achieved by alternative methods such as food stamps which can then be traded in the market by peasants to maximize their utility suitably, based on their local knowledge of their place and circumstances. There is clearly no direct administrative role for government in this activity, which, by virtue of the huge differentials in prices due to subsidy, and the extreme difficulty of monitoring due to the vast distances involved, offers daily opportunities to the officials to extract rents. In fact it is a miracle that not everybody in the system is corrupt.

ii. *Rural development loans and grants:* Another common social service which leads to severe corruption in the bureaucracy is the administration of the rural development program, in which the following completely farcical activity is carried out, among others. In order to 'promote' the welfare of the poor in the villages, a subsidized loan (of which upto half the amount is a grant), is provided to purchase a goat or sheep or cattle from some person in the village and transfer it to an identified poor person. Moral hazard is so severe in this case that corruption was perhaps the only natural consequence of this program [moral hazard in identification of the person, the differential in prices causing rents to the bureaucrats with discretionary power, etc.].

On the other hand, this program is also against elementary economic principles. Consider what happens as a result of this program. Before the program came into existence, and in the presence of the incomplete rural markets, a particular cattle, say X, had been put to efficient use by a farmer, A. Now, by artificially inflating the price of this resource (since part of the subsidy is appropriated by the farmer A, who is selling his cattle to a 'captive bidder'), the resource goes to farmer B who was obviously not the most efficient user of this resource in the free market system (else, he would have somehow purchased this resource from A). The farmer B is now willing to purchase this resource because of the subsidy provided, including the low interest rate. The net result is that the cattle X has been transferred from a more efficient user to the less efficient user.

The second welfare theorem shows that it would have been distributionally efficient, without any loss of economic efficiency, to provide farmer B with a lumpsum amount and to allow him to then compete in the market for the best price for the resource that he or she can most efficiently manage, given his or her local circumstances.

Therefore, a basic institutional recommendation, to LDCs would be to immediately examine the existing programs of government on issues of efficiency and corruption. If government intervention is believed to be efficient in principle, then the next step would be

to ensure that the system of bureaucracy is designed in such a way that incentives for corruption are eliminated completely. Else, it can be assumed without any loss of generality, that there will be government failure of a nature worse than market failure.

**Proposition 6:** A strong institutional environment, in terms of setting into place sufficient institutional checks and balances on bureaucratic discretionary power, is lacking in societies with high levels of corruption.

The paper by Weingast (1995) on market-preserving federalism shows how important it is for the development of self-enforcing restraints on the discretionary powers of the state (and bureaucrats). In most LDCs, it seems that enough time has not elapsed to enable the development of such institutional checks and balances on discretionary bureaucratic power. This process could take hundreds of years, as seen from the experience of the development of institutions in Britain (Glorious Revolution), or the guilds in Germany, etc. In India, we have seen a relatively rapid evolution of stronger institutions over the past fifty years of independence. For example, today we find that the Election Commission and the Supreme Court are beginning to exercise their constitutional role in a free and independent manner. The Central Bureau of Investigation has also been prodded into action by the Supreme Court till finally, for the first time, serious charges of corruption have been filed against an ex-Prime Minister of India by this investigating agency. Among the strong institutions that act as part of the complex web of checks and balances in the West is the Press. Independence of various institutions, including the press and media, would raise the deterrence against corruption and help bring honesty back into the bureaucracy.

### 3.

#### What can be done? The Recommendations

The Propositions mentioned above, if found to hold empirically, can be used to deduce various strategies to minimize bureaucratic corruption. None of the strategies mentioned below are new in the literature. It is amazing, however, that people have not focused on institutional explanations of corruption and tried to reform institutions. Instead, most of the effort has been expended in attempting to bring about minor reform which, from what I have seen as a bureaucrat, can always be subverted. In particular, I do not believe that Codes of Conduct or other such documents should even be written down until the institutional framework is improved.

**Recommendation 1:** Withdraw from activities where government failure will take place.

Policy makers in government should seek *ab initio* justification for the existence of all government activities. The objective of the activity should be examined, and a clear comparative institutional analysis made, about which institutional arrangement will be appropriate for achieving the objectives. It is *crucial*, in this analysis, to focus on opportunism, which, if opportunities exist, can come into play, and distort the achievement of the objectives of the government intervention. From my personal experience, I feel that

Weberian views have pervaded our thinking for too long. While it is true that some senior bureaucrats might be motivated by honor, prestige, altruism, etc., for most of the bureaucracy, a government job is just a way to eke out a living, and there is no reason to believe that they would avoid tapping into rents if such opportunities came their way.

“Bureaucrats look for something to do, whether or not their intervention is likely (Milgrom and Roberts, 1990). This is the crucial bane of selective intervention, even if it were desirable. Therefore, knowing that even the most good-intentioned bureaucrat will make at least some inefficient interventions, will enable a decision in favor of government intervention to be made only if that intervention strongly dominates markets or private firms as an alternative. However, it is clear that shutting a government agency has its own costs, and therefore, like shutting the Pandora’s box once opened, this activity is not for the weak-willed.

Lin and Nugent (1995:2307) maintain that *institutional change* usually refers to a change in one institutional arrangement, not to a change in all arrangements in the structure. But in this case, we observe that there has to be a complete change in the thinking of policy makers *throughout* the system, in order for momentum to be generated for change of institutional arrangements of particular organizations. In addition, citizens at large will have to be taken into confidence, in order to enable the collective action problem to be overcome. Therefore, we are looking here at economy-wide change in ideology and thinking. Despite the immense magnitude of the problem of closing inefficient agencies, particularly for a soft state like India, it is clear that the entire nation is paying and will continue to pay a heavy price for ‘essential’ government failure. If nothing is done at this stage, then, ultimately, a financial or other crisis would occur and *force* the change, as happened in the case of the economic liberalization in India in 1991, which was forced down India’s throat by donor agencies.

**Recommendation 2:** Wherever government intervention is necessary, set into place economic or other *policy* which is simple and *transparent*, leaving little scope for rent seeking.

This is actually a corollary to the first recommendation, since it requires setting into place *good* government intervention. Among the examples of good intervention would be fixing a standard single rate of customs duty, as carried out in Chile. In India, it the act of classifying imports is completely discretionary, and manpower intensive, leading to immense scope for corruption.

**Recommendation 3:** Promote the establishment of strong norms, laws and mechanisms for placing controls on opportunistic tendencies in society.

This reform relates to the establishment of deterrents against opportunism, to substitute the break-down of the extended family norms. Varieties of warranties, consumer groups, measuring and verifying bodies (e.g., Consumer Reports), etc., have been

established in the West, to deter opportunistic private behavior. These kind of institutions have to be actively promoted and established in developing nations.

**Recommendation 4:** Establish and strengthen the institutional environment of checks and balances

To deter government leaders and bureaucrats from being corrupt, there is the need to build a *credible commitment* toward punishment of corrupt bureaucrats. Bureaucrats must realize that various alternative systems are in place which will punish them severely in case corrupt activities are caught. The judiciary is the first such institution which needs to be strengthened. But it is not the only one at all. There is the need to establish a completely free Ombudsman, and to allow bureaucrats from within the government to ‘whistle-blow’ against their corrupt colleagues. Empowering the citizens through Right to Information Acts will increase transparency in the bureaucracy, as also increasing awareness in schools about various places that people can file complaints against corrupt bureaucrats. The media the press need to be supported in their anti-corruption activities. Auditors and investigative agencies should also be given considerable independence.

It is to be kept in mind that we are looking at economy-wide changes, and it is difficult to promote one strategy, say, whistle blowing, when other systems like the judiciary and Ombudsman, are not strong enough.

**Recommendation 5:** Set up incentive contracts for bureaucrats to ensure high level of effort (with honesty). This could include setting a wage at least equal to the shadow marginal product of the bureaucrat.

As Kwon and Tang maintain (1997: 6), “... unless one can develop knowledge and experience about how principal-agent relationships vary with different contextual situations, one can hardly tell what incentive systems will motivate agency operators to work effectively”. This is the most challenging task of public sector reforms. Tenures are given liberally to bureaucrats in the Indian system, and it is very difficult to remove a tenured bureaucrat. This is not in keeping with efficiency. Senior positions should always be through selection by committees, and should include a test of skills of the bureaucrat, rather than by discretion of Ministers, which encourages politicization and corruption in bureaucracy.

But another basic issue is the wage. We repeatedly come across the recommendation in the literature to increase wages, and I tend to agree with it. The bureaucrat should receive a wage *at least* equal to his marginal product. In fact, as suggested elsewhere, this should only be the *base*. In addition, an efficiency wage should be paid to prevent the temptation of the bureaucrat to leave the government agency if better opportunities arise elsewhere.

As far as making funds available for this purpose, the following should help:

(a) If Recommendation 1 is carried out, i.e., there is a reduction in the size of government, this will automatically reduce enable the wage of those who remain behind to be raised.

(b) There is no alternative to increasing revenues. By setting into place a series of reforms intended to reduce the huge amount of subsidization of various welfare and non-welfare activities currently carried out by government, it should be possible to increase revenues and raise the wage rate of bureaucrats to reasonable levels.

**Recommendation 6:** Carry out internal “administrative reforms” designed to increase transparency and monitoring.

One has to start with changing laws which promote secrecy in bureaucracy, such as the Official Secrets Act. This Act has become a shield for corrupt officers, since documents which would otherwise clearly implicate them, are prevented from reaching the public on grounds of official secrecy. The citizens, and particularly the press, should have the right to look into any transaction carried out by bureaucrats.

The problem of the inefficiency of internal enforcement mechanisms is a serious one for economic performance. North (1990) emphasizes their importance as a crucial determinant of economic performance. One way to improve internal enforcement and monitoring would be to break down hierarchical relationships and build flatter organizations, giving rise to team work and mutual monitoring. But team work also gives rise to the collective action problems of shirking, free-riding, etc. Whichever way one sees it, there are complex issues involved in changing any institutional arrangement, and each case would have to be examined on its own merit. What we need to do is to train a substantial number of policy makers to become “institutional engineers” who will carefully examine the incentive structure within an organization and decide on the governance structure best suited to carry out a particular transaction.

#### 4.

### Conclusion

The analysis in this paper has been very tentative, and limited by time. The crucial point is that once we admit, or recognize, that governments will not go away merely by our assuming them away, that bureaucracies are important determinants of development, both by their acts of commission as well as by their acts of omission, that moral integrity in the bureaucracy is essential to ultimately reach the stage of neutral policy implementation that Weber envisaged, then we should be prepared to consider institutional arrangements which would help eliminate corruption. Given the fact that LDCs have not had enough time to develop the necessary institutions to create checks and balances on corruption, it is not surprising that corruption has been rampant and growing. What is not clear is why government continues to intervene in areas where moral hazard and

opportunism is almost guaranteed to lead to failure in achieving the objectives of the intervention.

Increasing the salaries of officers would be a step in the right direction. The option of whistle blowing, which is now available in many developed countries, could be institutionalized to enable corrupt bureaucrats to be exposed internally. We have also seen how economic policy and ideology plays an important role in creating the transparency that citizens need in order to take investment decisions.

At the end, looking back at the immensity of the problem, we need to realize that it is not going to be easy for LDCs to set into place the appropriate institutional structure needed to provide a clean government. Given the concept of *path dependence* and evolution of institutions, it might even be that LDCs will develop some other institutions which will solve the moral hazard problems. This has perhaps actually happened, as seen by the development of the 'hard' managerial state in East Asian nations.<sup>5</sup> The hard state is a major institutional innovation which quickly covers up the immense gap of technology and attitudinal change by providing a direction to the society and economy. Therefore there are no quick formulae for clean and effective governance, but the Propositions and Recommendations discussed here might throw some light on the problem.

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### Some recent illustrations of corruption in developed nations

#### Italy

HONG KONG, April 27 (Reuter) - Italian graftbusters are trying to trace an estimated US\$60 million believed hidden in Hong Kong by corrupt Italian politicians -- fearing it may be inaccessible after the British colony's handover to China, a newspaper reported on Sunday.

An earlier attempt by Rome to claim the cash led to accusations that the territory was protecting slush funds, the South China Morning Post said, quoting Alberto Bradanini, Italy's Consul-General in Hong Kong.

The newspaper said the slush fund allegedly is connected to a corruption scandal involving former Italian prime minister Bettino Craxi, who went into exile in Tunisia to avoid a prison sentence for bribery. Craxi has denied hiding money in Hong Kong, the daily said.

#### Argentina

BUENOS AIRES, April 26 (Reuter) - Argentina's Catholic Church said on Saturday that corruption and a lack of independence in the legal system threatened to "create a crisis of the country's social cohesion."

"The legal system requires a clear independence from the powers of the state and from the professional corporations and unions," the country's bishops said in a statement issued on the final day of a Church conference on Argentina's legal system, state news agency Telam reported.

### Role of international organizations in controlling corruption

#### 1. World Bank

By HARRY DUNPHY (26th of April, 1997)

WASHINGTON (AP) - In a campaign to clean up international business and make competition fair, the Clinton administration is pressing the World Bank and the International Monetary Fund to help crack down on bribery.

The United States wants the industrialized democracies to set examples by prohibiting businesses from claiming tax deductions for bribes paid to foreign officials - illegal here but not, for example, in Germany.

U.S. Treasury Secretary Robert Rubin said he will raise the issues at Sunday's meeting of G-7 finance ministers, and President Clinton has appealed in recent days to leaders of the Ukraine and African nations. G-7 is a grouping of major world economies.

The United States is among the few countries with laws against using bribery to further business deals abroad.

Many Third World nations have resisted following that lead to prevent Western values and practices from being imposed on them. Some American business people complain that as a result, the U.S. Foreign Corrupt Practices Act, passed in the late 1970s, puts them at a competitive disadvantage.

World Bank President James D. Wolfensohn said a "tidal wave of interest" in stopping corruption in developing countries has developed since he called it a "cancer" on the global economy last October.

"People don't like being poor, but they are prepared to put up with being poor if there is a future and if there is not inequity," Wolfensohn said Friday. "But if they see a lot of people creaming money off the top, that gets them mad." Wolfensohn has visited 50 poor countries in the past two years.

Rubin said the United States will urge Wolfensohn and his counterpart at the International Monetary Fund, Michel Camdessus, "to expand the scope of their anti-corruption activities."

"We urge the multilateral development banks to focus on establishing uniform rules" for World Bank and IMF projects, including a standard contract with a no-corruption pledge and "strong headquarters oversight."

Rubin also will urge members of the 29-nation Organization for Economic Cooperation and Development to eliminate the tax deductibility of bribing foreign officials and to make it a crime under their laws.

The question is expected come up at next month's meeting of OECD ministers in Paris. Some countries want an anti-corruption treaty, but the United States believes that would take years to negotiate and legislation in individual countries will be quicker.

Nancy Zucker Boswell, managing director of the American branch of transparency International, a private group that combats business corruption, said Rubin's statement ``will send a strong signal to all G-7 countries that it's critically important to move forward on this issue and stem the source of bribery.''

The World Bank and the IMF, having their spring meetings this weekend in Washington, make loans to developing countries to build bridges and roads or buy aircraft and agricultural equipment - often by contracting with foreign businesses.

Wolfensohn said the bank is helping Latvia and a dozen nations in Latin America, Asia and Africa develop anti-corruption programs.

He said the bank makes spot audits of projects it sponsors, and if corruption is found, projects are canceled and offenders ``blackballed.''

World Bank officials could not provide an example of a contract that was canceled for corruption.

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**CORRUPTION:  
A MAJOR BARRIER TO SOUND AND EQUITABLE DEVELOPMENT  
(October 7, 1996)**

(From the World Bank www site:

<http://www.worldbank.org/html/extdr/backgrd/ibrd/corrupt.htm>)

*...Let's not mince words: we need to deal with the cancer of corruption...In country after country, it is the people who are demanding action on this issue...Corruption is a major barrier to sound and equitable development... James D. Wolfensohn, Speech to the Board of Governors at the Annual Meetings of the World Bank and International Monetary Fund, October, 1996.*

Corruption hinders economic efficiency, diverts resources from the poor to the rich, increases the costs of running businesses, distorts public expenditures, and deters foreign investors. And it erodes the constituency for development programs and humanitarian relief. As official development assistance comes under mounting pressure, greater attention is being paid to how funds are being used.

While the World Bank cannot intervene in the political affairs of its member countries it has, since its establishment, sought to ensure that the funds it lends are used for their intended purposes, and that contracts for goods and services are awarded in a transparent and cost-effective way. But today's Bank is going further; it is offering its support to governments that wish to fight corruption and it is emphasizing that it will **not** tolerate corruption in the programs that it supports.

### **The Bank's Approach to Controlling Corruption**

Improving governance and controlling corruption is supported in four main areas of Bank activity: economic policy reform, institutional reform, fiduciary control, and multilateral partnerships.

#### *Economic Policy Reform*

Bank support of economic policy reform includes technical assistance, advice, and financial support to clients undertaking reforms in five areas that can lead to improved governance and a decrease in corrupt practices:

**Economic reform:** Reforming trade regimes, financial sectors and investment laws mitigates the effects of "rent-seeking" as administrative mechanisms -- such as export licenses, foreign exchange, and bank credit allocations -- are replaced with market mechanisms.

**Tax reform:** Simplifying and strengthening tax systems and strengthening collection capacity reduces corruption in customs and tax administration.

**Regulatory reform:** Eliminating price controls, simplifying government regulations, and strengthening the regulation of private and state-owned enterprises operating in non-competitive markets enhances transparency and adherence to the law.

**Privatization:** Because transferring state-owned assets to private ownership presents corruption risks, the Bank works especially closely with its clients undergoing transition to a market-based economy to help make the process open and transparent.

**Sector Policies:** Well designed environmental and social services policies decrease the opportunities for corruption. The Bank provides its clients with best practice advice based

on experience with other borrowers that have successfully improved their performance in these sectors.

### *Institutional Reform*

Strong public and private sector institutions are essential to good governance and to discouraging corruption. The Bank helps clients strengthen institutions through:

**Government financial management reform:** Increasingly the Bank is helping its clients modernize budgeting, financial management, accounting, and auditing systems.

**Civil service reform:** Emphasizing the reform of pay and employment conditions, training, and personnel management, the Bank has helped more than 40 client countries reform their civil service over the past decade.

**Public procurement:** Bank support for drafting new procurement laws and regulations, and training officials to implement them is leading to greater transparency and competition in client countries.

**Governance:** Bank support for legal, judicial, and regulatory reform helps control corruption. And programs such as EDI's training workshops for journalists help strengthen the ability of the press to scrutinize -- and report on -- all fields of public administration.

### *Fiduciary Control*

Bank support for good governance and decreased corruption is also achieved through its efforts to maintain the highest level of transparency in Bank loans and credits, and ethical standards among Bank staff.

**Guarding against corruption in Bank projects:** Based on the principles of economy, efficiency, and transparency, the Bank's long-established procedures for procurement, disbursement, reporting, and auditing, are second to none, and have been replicated by other international agencies and national governments around the world. Financial reporting under Bank loans has recently been strengthened to tighten the time frame for borrower completion of audits.

### *Procurement Guidelines*

The Bank's Board of Executive Directors recently approved important improvements to the Bank's loan documents and procurement guidelines.

### **The new guidelines provide that the Bank:**

may cancel a corresponding amount of a loan if it determines, with respect to any contract to be financed out of the proceeds of the loan, that corrupt or fraudulent practices were engaged in by representatives of the borrower or of a beneficiary of the loan during procurement or during the execution of the contract without the borrower having taken timely and appropriate action satisfactory to the Bank to remedy the situation;

will have the right to inspect accounts and records of suppliers and contractors relating to the performance of the contract, and to perform a complete audit by Bank-appointed auditors; and

may bar firms from Bank-financed contracts, either indefinitely or for a specified period of time if the Bank determines the firm engaged in corrupt or fraudulent practices in competing for, or in executing, a Bank-financed contract.

**Ethical standards among bank staff:** Long-standing and rigidly enforced staff rules on outside interests and disciplinary measures ensure the highest ethical standards are maintained by Bank staff.

**Changes in internal Bank procedures:** Public access to Bank project documents, the creation of the Independent Inspection Panel, and more participatory approaches to design, preparation, implementation, and appraisal of Bank projects is helping heighten attention to portfolio management and supervision, and to measuring performance.

### *Multilateral Partnerships*

Reducing corruption is also facilitated by coordinating activities with governments, other multilateral institutions, and partners in the private sector and civil society.

Because the negative effects of corruption reach across borders, they require the concerted attention of the international community. Important international organizations, including the OECD, the Council of Europe, and the OAS are also taking steps toward fighting corruption. Their efforts include the use of international instruments such as international conventions and formal recommendations to their members. Anti-corruption initiatives are also being undertaken by global business organizations and NGOs. To ensure that the broadest support is given to countries fighting corruption the Bank intends work in partnership, and to coordinate its efforts, with other bilateral and multilateral initiatives.

## 2. G-7

### **G-7 Talks Tough On Corruption Pushing Bribery Issue Higher As Key International Economic Policy Issue**

Washington D.C. and Berlin, April 30, 1997: The Group of 7 finance ministers, meeting in Washington this week, called on the international financial institutions and the Organization for Economic Cooperation and Development to accelerate work on the reduction of bribery. The G-7 communiqué stressed the “corrosive effects of bribery and corruption generally on the achievement of sustainable economic development, growth and stability.”

Dr. Peter Eigen, Chairman of Transparency International (TI), the non-governmental coalition to curb international corruption, headquartered in Berlin, said: “this is a landmark declaration by the G-7 in the global fight to curb corruption. It is likely to give major stimulus to official discussions on new anti-corruption policies and raise these discussions to a more urgent political level.”

The G-7 called on the multilateral development banks to establish uniform procurement models and “ensure strong oversight at headquarters of all facets of the procurement process.” TI, which now has national chapters in over 70 countries, is working closely with the World Bank to secure progress on the critical issue of transparency in international procurement.

The G-7 in paragraph 17 of its communiqué, called on the International Monetary Fund and the multilateral development banks “to strengthen and expand... their activities to help countries fight corruption.” Dr. Eigen said: “Over the last 12 months TI has had an expanding and deepening dialogue with the IMF and the World Bank on these issues. We are finding a refreshing and positive perspective from the leaders of these organizations and we believe the G-7 declaration will add support to their efforts in this crucial area.”

The communiqué called on the leading industrial countries, who are members of the OECD, “to reach agreement on measures that will permit effective and coordinated criminalization of foreign bribery and facilitate expeditious elimination of the tax deductibility of such bribes.” Dr. Eigen noted that “bribing is the 'supply side' of corruption. And much of the supply comes from international businesses in the G-7 countries.”

The TI Chairman added that: “The tax deductibility allowed by most OECD countries for bribes paid to foreign officials is a disgrace. It

encourages bribery and constitutes a double standard. It is not only morally indefensible and harmful to countries where the bribes are paid, but also has a pernicious influence on ethics within the bribing corporations. By urging the OECD countries, the multi-lateral development banks, and IMF to prohibit foreign bribery and eliminate its tax deductibility, the G-7 have placed corruption high on the international agenda - where it belongs," he said.

Transparency International is circulating the G-7 statement of April 27, 1997 to all its chapters around the world and urging them to monitor closely progress to implement it.

## Appendix III

### Same Salary, Three Lifestyles: Corruption's Toll on Nigeria

Antony Goldman, Special to *The Christian Science Monitor* (≈ April, 1997)

Consider the lifestyles of three actual Nigerians, each with a salary of \$75 a month: One, the director-general of a top government ministry, has a chauffeur and two children attending an exclusive boarding school in Britain. Another, a university lecturer, can afford such middle-class trappings as meat for dinner and electricity in the home. The third, a cook, scrabbles in a garbage bin for leftovers to take home to his family.

In an economy where wages bear little relation to living standards, only one of the three actually relies on salary alone to survive. The government official accepts bribes for expediting permits, while the professor sells grades to otherwise underachieving students. Nigeria has become a symbol of how corruption thrives when most salaries are inadequate to cover living costs.

The nation was recently dubbed the world's most corrupt country by the German nonprofit organization Transparency International, founded in 1993 to foster confidence in rules of law. Last year's top 10 included many of the world's most-populous nations: Pakistan, China, Venezuela, Russia, India, and Indonesia. Widespread bribery and graft in such nations has hindered economic growth and widened social inequality, experts say. And in Nigeria, corruption filters through many levels of the economy. A telecommunications engineer, for example, won't fix a line until the unfortunate customer forks over some money "for the cable." The system builds in corruption by rewarding individuals not through wages, which are often absurd, but through positions from which it is possible to dispense patronage, exerting influence in return for favors. This corrosion has been fueled by an oil industry that has produced 2 million barrels of oil a day for 20 years, money that might otherwise have made Africa's most populous country rich.

General Sani Abacha, who seized power in 1993 when the Army annulled elections judged free and fair by most observers, is the latest in a long line of military rulers who have promised to clean up Nigeria. In delivering a budget recently, he highlighted the problem: 18 projects financed by \$800 million in foreign loans had never even been started. Another 44 loans worth nearly \$5 billion stood unfinished. No effort would be spared, General Abacha said, in tracking down those who had disappeared with the loot. "All those involved will be brought before a tribunal. Nigerians must be assured that such acts, when uncovered, will be punished." It is no idle threat. Dozens of prominent businessmen, so-called "untouchables," are behind bars months after being detained in connection with an official probe into allegations of malpractice in the country's distressed banking sector. Military officers and senior policemen have all been brought before the law for misconduct. Not everyone is impressed. "It's all for show," says one Western diplomat in the commercial capital, Lagos. "It looks good, but the reality is that as much goes unaccounted for today as ever it did before. Transparency is a fiction." Western powers would like to see Nigeria follow other emerging markets and deregulate its economy, now

dominated by a huge public sector. But the government has turned its back on that advice. In his official briefing on the 1997 budget, Finance Minister Anthony Ani insisted Nigeria would move to privatize its inefficient public utilities at its own pace. "We are a sovereign nation," he said. "We will not be pushed around by anyone." Mr. Ani can resist pressure for reform from abroad because, unlike other aid-dependent African nations, he has access to \$11 billion a year in oil sales.

What most annoys the countries to whom Nigeria owes \$30 billion in debt is Abacha's stubborn refusal to reform a controversial exchange-rate policy that, one World Bank official says, "allows the rich to steal from the poor." While on the open market, the dollar sells for 80 naira, for official transactions the government pays just 22 naira for a dollar, a system widely condemned as building distortions into the economy as well as an open encouragement to corruption. The official exchange rate, for example, allows a limited number of individuals to travel abroad cheaply, using discounted dollars, or to speculate on the black market.

"The government says it believes in competition. But what can we do when their agencies only pay a quarter of what we do for imports?" complains Emanuel Onwuyamelu, a Lagos-based businessman. "This is a nation of traders, but they refuse to leave us to do business." The real problem with the dual exchange rate and the bloated public sector is that until they are abandoned, Nigeria will receive no relief from a debt burden that Abacha describes as "unsustainable." Nor will there be foreign investment in non-oil sectors of the economy, where unemployment is high, living standards are low, and infrastructure is crumbling. In these sectors, talk of expanding the economy by 5.5 percent a year seems remote. Abacha says he can tackle the problem without pandering to the Lagos business elite, which he mistrusts, or its friends abroad. He has announced new schemes to help the rural poor and looks to the Chinese and Southeast Asians for technical expertise.

With the transition to civilian rule scheduled for completion next year, critics say Abacha is moving too slowly. As the debate rages, a civil servant, apparently on the same salary as a man unable even to feed his family, will be jetting across continents first class.

**A thought experiment:  
The expectations and compulsions  
of a senior Indian civil servant.**

While on the subject of bureaucrats in India, I think that one of the best services that I can provide to the academic study of corruption will be to lay bare a case study which is, in my opinion, fairly representative of the *functioning of the mind* of many Indian bureaucrats today. The case study is my own. I am by now a senior Indian bureaucrat, with 15 years in the Indian Administrative Service. While there are many other motivations that drive my thinking apart from financial, there is no doubt that when I am honest with myself, this aspect does often dominate other thoughts.

Initially, at the time of joining the prestigious civil service of India, I was very naïve and enthusiastic about the contribution that I could make to Indian society by implementing the existing policies. I also thought that I should try to remove corruption by a direct attack on this malice. Accordingly, I have been a crusader against corruption throughout my career, taking action on the slightest hint, organizing ‘traps’ for corrupt officials, catching them red-handed and placing them in prison, and later on, in the role of State Enquiry Officer, being given the responsibility of causing disciplinary inquiries primarily against corrupt officials. But very soon I realized that even if hundreds of officials like me carry out such a crusade throughout their life, it is not going to make a serious dent on corruption in India, given the economic policies that we have been pursuing. I realized that the basic flaw in our system was *socialistic ideology* that led to centralization of decision making, along with its various compulsions toward inefficiency and corruption.

I now see how socialistic policies and corruption are intertwined. One of the primary reasons for corruption, as mentioned elsewhere in the paper, is the pathetic salary level of Indian bureaucrats, compared to the private sector. The bureaucrat’s relative income has been going down ever since our country adopted the socialistic pattern in 1950, and today, the starting salary of a fresh engineer or a manager in a multinational corporation in India is far higher than the maximum salary that a civil servant can draw at the end of his career of 35 years. Going by the relative income hypothesis of Easterlin (1996), it is easy to see that there is tremendous unhappiness in the Indian bureaucracy with this arrangement, where some of the best and the brightest candidates in the entire nation (who were selected through a very rigorous and highly competitive examination) are being over-run in terms of salary by upstarts and young relatives and friends who are nowhere comparable to them in terms of competence.

These low salaries have been promoted entirely by our socialistic policies. The socialistic system involved the interference of government in virtually everything, starting from production of consumer goods to various forms of welfare. Therefore, there was an unimaginable explosion in the number of government employees in the past fifty years in India. This explosion came along with a tremendous explosion in ‘development’

expenditures such as infrastructure building, etc., while at the same time, all agricultural incomes were exempted from income tax, land revenue became a net loss to the nation, and income tax evasion by the rich became a rule. Therefore it was the salaried government employee who was paying a large part of the income tax. Naturally, the average wage received by the bureaucracy dwindled into almost nothingness, so much so, that there have been times when the wage received by the lowest ranks in government has dipped precariously close to the national poverty line. At the end of it, the morale of the public servants as well as of the private entrepreneurs, has reached rock bottom, and we see how the socialist welfare state ended up by creating neither socialism nor welfare.

Today, when I find myself in the midst of such a system, I would like to report the results of a thought experiment carried out in my own mind. I asked myself the question, whether I was satisfied with the relative slide in income, in comparison to what people of my capacity were able to draw elsewhere in the economy. Obviously, the answer was, “No.” So, I asked myself, “What can I do to overcome the problem?” There were two answers: one, to become corrupt myself, and two, to leave the job and join the private sector. The first was an abhorrent solution to my problem since I happen to be an average Indian who has a well-groomed abhorrence toward corruption. Even the thought that I could be corrupt gives me a nauseating feeling. On the other hand, as mentioned above, I have seen a large number of my colleagues turning toward corruption in a big way to salvage their self-respect in a society where not being able to afford a car or a house or a good education for one’s children is being met with greater and greater contempt. Though the risks of corruption are high, the ‘rewards’ are proportionately higher, too, and many are beginning to find it worthwhile to indulge in corruption as a solution to their relative decline in financial status in the society.<sup>6</sup> If the relative balance had been maintained with the private sector, I doubt if so many bureaucrats from this highest civil service would have gone toward corruption since the risk of losing one’s reputation are so high when caught.

The second solution, of exiting the bureaucracy, has been foremost in my mind for many years now. But I have found that (a) the effort required to start out on my own in the private sector is going to be enormous, given my increasing age, and there is a huge uncertainty of success. Further, (b) I shall almost invariably have to become a bribe-giver if I join the private sector, since there is virtually no way that a private sector entrepreneur can otherwise overcome the many bureaucratic hurdles in socialistic India. Both these have meant that I have been forced to stay back in the civil service and watch my financial status decline every year. But it is obvious that most bureaucrats will not be able to sustain their basic honesty over the years as they find their status eroding to well below what is considered acceptable.

Now I come to an interesting “solution” accidentally discovered by some officers. Many of us discovered that we could improve our financial status without doing any

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<sup>6</sup> I know of at least a few officers of my own seniority who now make over \$100,000 above their salary on a routine basis every year (the average actual salary received by a bureaucrat like me is about \$3000 per year).

corruption, and while remaining in the civil service, by an alternative method: *of studying abroad*.

Five years ago, I was sent to Australia by the government of India for a year of studies in management. At the end of the stay, I found that I had saved some dollars from the meager scholarship paid to me. The value of these dollars was much more than my entire year's salary in India. In fact, the savings in one year of study abroad as a student, were greater than my *entire* saving in ten years of government service! Many other bureaucrats simultaneously discovered this situation. Therefore, we observe a vast change in the pattern of "study" of the Indian bureaucrat now. Whereas in the past 40 years after independence, only about one IAS officer went abroad each year to get a Ph.D., since the late 1980s, there has been a virtual exodus: about 5-6 officers leave the country each year now for this purpose (most of them are found in Los Angeles at USC, or in Boston in various universities there).

Although my financial status has not improved to the extent I had expected as a student in USA, I still think I am better off as a student here than as a senior civil servant in India. It would be too vast a generalization to state that those who are left behind in India are the corrupt ones, but there is very little incentive for a corrupt official to come abroad for studies and go through this grind, since he can make far greater amount of money while working within the system, and enjoy a far higher level of perquisites. But excluding the corrupt, there do remain in the system a very large number of honest civil servants who are somehow trudging along in the hope that their individual contributions to the nation will ultimately help them and their children.

This exodus to the USA for studies has not been in vain, and certainly not motivated entirely by the financial side. There has been a tremendous learning component in this exercise for most of these bureaucrats. The chief learning experience, I feel, has come from exposure to more efficient institutions. The academic input has been often less relevant for understanding policy than the sheer act of living in this nation. Our exposure to the use of modern technology such as the internet has also been tremendously enhanced.<sup>7</sup> Some of us have tried to sit back and analyze the policies that need to be introduced to reduce corruption in our society and to promote economic growth.<sup>8</sup> Hopefully, some of these bureaucrats will make some changes - small or big - when they go back, that will help transfer to our nation the much need institutions that are required to improve our governance and reduce corruption and other directly unproductive activities.

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<sup>7</sup> Some of us have taken to web design; e.g., I design and maintain the web page of the Economics department as well as of the University Computing Services (Operations and Facilities).

<sup>8</sup> A tentative compilation of my thoughts in this area is available at my web site: <http://www-scf.usc.edu/~ssabhlok>.