CORRUPTION AND THE PRIVATE SECTOR

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Again, the many are more incorruptible than the few; they are like the greater quantity of water which is less easily corrupted than a little. The individual is liable to be overcome by anger or by some other passion, and then his judgment is necessarily perverted; but it is hardly to be supposed that a great number of persons would all get into a passion and go wrong at the same moment.

From Aristotle's Politics, Book III Part X, 350 B.C.

The Issues

Let's imagine for a moment two people each running a different business. The first is a small shop owner who makes and sells pastries, cakes and other delectable treats to many satisfied customers, from local townsfolk to the many tourists that visit from spring to fall each year. He's been in business for five pretty good years, but he's starting to worry about the future. He's noticed the health inspector is making more visits, unannounced, and asking the usual questions that lead up to the inevitable, subtle, and unspoken cash transaction, followed by a smile and topped off with a *gratis* espresso and slice of his renowned chocolate torte. Other officials were on the move too for some reason. The tax inspector had already made twice as many visits this year than last. And, just the other day the director from the local business licensing office unexpectedly stopped by. After small talk, complimentary cakes and ice cream, he mentioned that, "oh by the way," our shop-owner-friend should stop by the licensing office soon to discuss some "irregularities" in the licensing papers he'd filed this year. This of course could mean only one thing more: yet another payment to keep his business "legal." His "unofficial payments" to government officials this year would certainly double at this rate.

Our second businessman manages a large holding company with several subsidiary interests in trade, telecommunications, print media, and light manufacturing exports. Right now he's on his way to a cocktail reception where he hopes he'll meet the Deputy Minister for Public Works and Communications. He's already had two meetings with the deputy to discuss the government's plan to privatize the largest TV broadcasting network in the country. The deputy knows of his company's interest in winning the bid, but our business manager is becoming less certain of their success. He recently learned their major competitor was lining up a foreign joint-venture partner with the promise of additional financing and access to new technologies that could sweeten their position and give them an unbeatable edge. Unfortunately his company hadn't been able to line up such partners. He was hoping that tonight the deputy would agree to have dinner with him next week. He'd for sure have to offer a substantial gift to win the deputy's favor, particularly in light of his competitor's growing advantage.

The involvement of a foreign investor did add another wrinkle that he might be able to work to his advantage, however. Several parliamentarians recently had introduced a draft bill to prohibit foreign investors from operating in certain "strategic sectors." Broadcasting was on that list, but he'd heard from his friends in parliament that certain private interests were lobbying heavily to get it removed. Tomorrow he'd call his cousin who works in the Prime Minister's office to find out which members of parliament were wavering on this issue, and then try to go meet with them. It could prove to be an expensive year for doing business, but he'd give it his best shot.

Many factors affect corruption between the public and private sector. [1] In the case of our baker, he must pay bribes out of necessity. If he didn't pay he'd faced

[1] Although not the subject of this paper, there are forms of business corruption, racketeering and extortion that exist outside the sphere of public sector involvement. Many small businesses, for example, are extorted for "security" or "protection payments" by mafia thugs. Mafia groups sometimes will pressure successful enterprises to buy from certain suppliers, or retail through certain outlets. In other cases that don't involve organized crime, loan officers may demand kickbacks in return for the business applicant's credit approval. Whatever the source, corruption takes capital away from productive investments that will help grow an enterprise and make it more competitive, which is a

several dangers. The paperwork might slow down to the point he has to spend more and more time chasing bureaucrats and less time running his business. Or, even worse, the corrupt officials could deny him a license and force him to shutdown. Taxes present him with another problem. If, as in many early stage open-market economies, his taxes are high and the tax code frequently changes, then it's probably cheaper (and quicker) to pay off the tax inspector than it is to put the time and money into following the letter of the tax laws, even though this is a short-run solution with dubious and unpredictable risks attached.

So, like a good business manager, our baker weighs his options, and chooses the most economical means of staying in business. But, what appears to be a quicker way to get the job done now (paying the bribe) overtime can become and expensive proposition with uncertain outcomes. The costs and risks of corruption are economically *inefficient* and thereby distort growth potential. The bribes he must pay are nothing but uneconomical transaction costs: they are rent payments that add nothing to his business. If he could instead invest those monies he could grow his business and create more jobs, produce more and better goods for his customers, generate higher incomes for himself and his employees, and generally contribute to a better standard of living for his community. Because so many businesses face the same problem the negative impacts on the local economy can be significant.

We might try to argue that the bribes are simply another form of taxing our baker, and if his bribery payments are less than what he'd pay in taxes, then he's in fact better off. Well, yes…and no: yes, the *costs may* be less but the *returns certainly* are less. In a developed economy tax payments go towards the public good: infrastructure that businesses need (water, electricity, roads), education that builds human skill and knowledge, health services for employees, a central banking system that stabilizes

principal argument presented here. Because this paper focuses on public sector corruption, these other areas aren't explored here.

financial markets, a police force that protects citizens, a judicial system that upholds the law, and the like. With an adequate and reliable tax system, governments can pay a living wage to bureaucrats and inspectors so they're under less pressure to engage in bribery and corruption.

But this brings us to yet more issues that shape the mindset of our baker. Public services may not be improving. In some former communist countries they may even be worse than before. He certainly isn't convinced that the government uses its budget wisely. So why should he pay his taxes? The streets are in shambles. Telephone service is erratic. Health costs are skyrocketing. He's been told that soon the cost of electricity will almost double. He has little police protection, if any: the police certainly aren't protecting him from the local mafia thugs that he *also* has to pay for "protection." So, in his cynical view bribery and corruption are a necessary evil, a fact of life and the reality of running a business. He sees no alternative. There's no one to complain to that will set things right.

The case of our large business manager is a bit different. He is trying to "buy" decision outcomes that will favor his enterprise and create a better growth opportunity *for him*. As we can see from the example, this significantly distorts the marketplace by eliminating competition that would produce greater value for consumers: when pressured out, the more efficient international investor will take his business and go somewhere else. In the short run, buying influence may produce growth opportunities for his business, but these are uneconomical and unsustainable in the medium to long term. Having paid once, he will likely have to pay again and again to secure his non-competitive position. Herein is a strong similarity to our baker: the money spent on bribes is money taken away from productive investment: capital productivity declines, markets distort, and the economy suffers.

A number of studies over the past decade seek to explain the dynamics or underlying causes of corruption as well as the economic impacts. Although researchers debate the methodological rigor and statistical validity of specific studies, evidence is emerging of a definite relationship between corruption and economic growth. The causal relationship may not be clear, but we know that economies with less corruption perform better. Most experts accept that there is a cyclical nature to corruption and poverty, where each feeds on and contributes to the other. However, until recently many scholars regarded corruption as a relatively low transaction cost compared to the benefits from increased employment and income in, for example, less-developed countries. Using mainly macroeconomic variables, these studies argued that bribery was an efficient means to secure productive capital investments that contribute to economic growth; in other words, the bribe simply helped to "grease the wheels" for the immediate transaction. This macro view was based mainly in Coasian Theory which states that if market transactions are costless, a rearrangement of rights will always take place if it leads to an increase in production value. [2] Another way of stating this is to say that if nothing obstructs efficient bargaining, then the parties to the negotiation will reach the most efficient agreement, commonly called a state of Pareto efficiency after the 19th Century mathematician and economist Vilfredo Pareto.[3] The problem with this model is that the Coasian world of costless bargaining, perfect information, and efficient markets is far different than the real world where affected parties are kept out of negotiations, information is restricted, and wealth accumulates to a few who control access to markets and to the levers of decision-making that establish un-economic rules of the marketplace.

New evidence, however, better illuminates the negative affects of corruption. The World Bank and other donors have supported research that looks at a broad range of institutional and legal variables affecting a) the competitive position of enterprises and in turn b) the comparative strengths of the economy. For example, Paolo Mauro argues that corruption has a negative

[2] Ronald Coase introduced this proposition, now known as the Coase Theorem, in his 1960 article "The Problem of Social Costs." Coase's ideas have since had a profound impact on economic and legal discussions.
[3] A "Pareto-efficient state" is where no one in the economy can be better off without someone else being worse off. In other words, this is when the economy is making optimum use of available resources for the greatest possible number of beneficiaries. Later the team of N. Kaldor and J.R. Hicks elaborated Pareto's work to formulate a test for comparing proposed changes (Economic Journal, 1939). Simply stated, the Kaldor-Hicks test compares the net benefits of two options: if the net benefit (aggregate benefits minus aggregate costs) of option A outweighs the net benefit of option B, then A is the better choice.

impact on the ratio of investments to GDP. [4] There is also a strong correlation between GDP and rankings on corruption indexes. In their work on economic growth and governance, Kaufmann and Kraay analyze the strong positive correlation between governance per capita incomes, for example. [5] Among the more interesting current debates is the question of "causality," i.e., does corruption result in low GDP or do low GDPs cause corruption? Many scholars have been unconvinced by the evidence, concluding that this is a "vicious cycle" of one affecting the other, and that the focus should be on "breaking this cycle" through economic growth and governance improvements. [6] The Kaufmann/Kraay study, however, suggests that there is more likely a flow of causality from good governance to increased incomes, rather than the reverse flow, which in fact may be somewhat negative. How then would we explain the phenomenon of China's economic growth without democratic reforms? Well, Kaufmann et al may explain this by looking at the negative reverse relationship between growth and governance. Recent studies of China have looked closely at the tenuous nature of their growth, which is being held together through unsustainable state intervention and dubious fiscal management, and an alarming level of corruption. In fact, it appears that areas of China that successfully institute good governance reforms are out-performing other areas still plagued by corruption. [7]

Our two earlier examples illustrate the motivation for and impacts of corruption between public officials and businesses. Many variables – social, economic, political, cultural – will shape the character of corruption in a specific context, but there are common conditions that set the stage for corruption to occur. In order to mitigate corruption, we must understand these conditions. In this paper we'll discuss: a) where corruption occurs, b) what creates the incentive for corruption, c) what creates the opportunity, and d) why institutional protections (laws, regulations, reporting and monitoring systems) are weak. We'll also explore the incentives and disincentives of government-business corruption and how it affects private sector growth and economic development in general. We'll elaborate a list of circumstances (or "vulnerabilities") in

[4] "Corruption and Growth," *Quarterly Journal of Economics*, CX/3 (August): 681 – 712.
[5] "Growth without Governance," Kaufmann, Daniel and Arat Kraay, The World Bank, July 2002.
[6] For a summary discussion of the economic impact debate, see "Research on Corruption: A Policy Oriented Survey" by Andvig and Fjeldstad, December 2000, Commissioned by NORAD.
[7] See the Financial Times five-part series on "China's Future," by James Kynge, October 28th – November 1st, 2002.

which corruption of this sort typically takes place. (See Table 3: Vulnerabilities – Where Does Corruption Take Place?) I'll conclude the paper by summarizing what is being done now to curb corruption in the public/private sphere of activity, and also by discussing strategies (working with business and with government) that USAID could consider or expand upon in its own work.

"Vulnerabilities" or Where Corruption Occurs

Official corruption has been with us since, well, at least since the time of Aristotle and most certainly before. Some level of corruption is still common in most of the world. (See Tables 1 and 2 for comparative regional data on corruption.) Most international companies have long accepted bribery as necessary for doing business in less developed economies where public officials had substantial control over contracts, licenses, and foreign investment decisions. Until recently, most Western countries even allowed bribery payments to foreign countries as legitimate business expenses (some still do). [8]

Table 1: Some Comparisons of Bribery Payments by Region and by Firm Size [9]

Category	Percentage of firms that responded they had to make "irregular payments" to get things done always, mostly or frequently.
By Region	
South Asia	65 %
Developing East Asia	62 %
Africa	52 %
MENA	36 %
CEE	33 %
CIS	29 %
LAC	28 %
OECD Countries	12 %
Developed East Asia	11 %

[8] The US government stopped allowing tax deductibility of foreign bribes in 1958.
[9] From "Voices of the Firms 2000: Investment Climate and Governance Findings of the World Business Environment Survey," Batra, Kaufmann and Stone. The World Bank Group, May 2002.

By Firm Size, All Regions	
Small	40 %
Medium	34 %
Large	31 %

Times are changing, however, and the anti-corruption movement is growing in the business world. This movement has some roots in the Foreign Corrupt Practices Act passed in the US in 1977 and similar laws passed in other countries with global business interests. Today there is a host of organizations promoting the benefits – social, political and economic – of ethical business practices. And, their credibility has been strengthened by recent studies showing not only the negative economic impacts of corruption, but also the positive effects on markets and economic growth that a stable investment climate and rule of law can have. Businesses are starting to listen and adopt "good governance" or "ethical business" programs for several reasons. Many global enterprises have prominent places in the market; they also know that a good public image and good public relations will help secure this position. And, aside from their sense of social responsibility, some enlightened business managers have a longer-term vision and know that corruption hinders social and economic development. By doing their part to foster growth of under-developed economies, they're creating new markets and wealthier consumers.

Table 2: Percentage of Revenues Paid in Unofficial Payments to Public Officials, by Region [10]		
Region	Percentage of Revenues Paid	Percentage of Firms Responding "0% Paid"
Africa	Not asked	Not asked

[10] Ibid, Batra et al.

MENA	Not asked	Not asked
CEE	5.5 %	0.9 %
South Asia	5.0 %	18.8 %
Developing East Asia	4.6 %	22.7
CIS	3.4 %	3.4 %
LAC	2.0 %	58.0 %
East Asia (not incl. China)	0.6 %	86.3 %
OECD Countries	0.6 %	83.0 %
Average	3.0 %	38.7 %

Let's look first at some basic concepts that will help us understand impacts of corruption. How does corruption harm private sector development? How does it harm the economy? If an under-paid government worker can make a little on the side to better feed his or her family why should we be concerned? The fundamental issue is about short-term gain to a few vs. long-term harm to many. As we saw from the two examples above, although the business (and the corrupt official) may gain in the short run, the bribe payment shifts money away from potentially productive investments in the business. These non-economic transaction costs keep the level of enterprise development low relative to those enterprises that are able to invest in growing their business.

To generate growth, businesses must use their capital resources productively. When capital is drawn away into non-economic transactions, this negatively affects enterprise growth as well as the marketplace in general. Corruption distorts growth incentives also by forcing out potentially better producers of goods or services. As we can see in the second example, the bribes to policy decision-makers give one firm an edge over the competition; it is, however, an uncertain edge that may be good only for the time being, for this one transaction, for the parties to the negotiation and *not* for the market. This "edge" too is not based on market factors; in fact they are non-economic advantages granted through rent payments to the state. That is, one firm wins the contract or pushes out the competition not because of the value they bring to the market, but because they can distort market-effects by controlling political decisions and their outcomes. The competition – who is prepared to bring new communication technologies and other sources of financing to the deal – loses the deal and their competitive advantage is kept out of the marketplace. Who loses? Workers who could have gotten a better wage working for a more competitive enterprise; consumers who could have gotten better quality goods or services at a better price; ultimately, the economy, which could have generated a better standard of living for all citizens.

This is a basic description of how corruption affects enterprise growth and economic development. But where do these corrupt transactions typically take place? Before we look at this range of "vulnerabilities" where corruption between business and government occurs, let's turn back to our two examples because they illustrate two broad categories of corruption that are useful to our understanding. Our baker faces the problem of *administrative corruption* or what is sometimes called "petty corruption," (although this is a term I don't advocate because it understates the impact of a single corrupt act which is typically repeated numerous times and collectively produces significant harm by keeping poor people poor and holding back those who could move ahead). He must pay bribes to public officials to keep his business running. These could be in the form of "processing fees" to get documents, or what we might call "blinders fees" to keep an inspector's head turned in the other direction. These payments don't "grease the wheels" of the plodding bureaucracy like some would think, they establish rules (albeit unpredictable) for the game that create *incentives* for public officials to fabricate more and more delays.

The second example illustrates another form of corruption called *state capture*. This is the payment of bribes to try and shape the policy and legal environment to the captor firm's advantage. A *capture economy* is one where such payments are common variables in the state's decision-making procedures. The negative impacts of state capture are not insignificant, even over a short period of time. A recent study by the World Bank showed that the overall growth rate of enterprises in a *capture economy* is about ten percentage points lower than a non-capture economy over a three-year period. [11]

The dynamics of state capture can involve active solicitation from the public sector side as well. In our example, the businessman is buying a decision from a policy maker. In reality, decision makers frequently abuse their position and offer up their influence to solicit support from business in the form of cash or gifts. It would be misleading to portray public officials as passive players that can be "engaged" or "captured" for the right price. Public officials also seek to sell their influence and power to the highest bidder. Public sector corruption also perpetuates a kind of illicit hierarchy where lower level jobs are sold off and these in turn create informal systems of kickbacks and patronage that perpetuate corrupt practices, inefficiencies, and barriers to meaningful public sector reform. In this way, the higher levels of corruption which we've characterized as state capture are linked down through the bureaucracy to administrative corruption that occurs at lower, seemingly "less harmful," levels. The point here is that public sector corruption creates a murky culture of abusive alliances where power and influence flow in many directions among players in government as well as business.

Table 3 describes the situations where corruption can most commonly occur in the relationships between public officials and private businesses. This comes from the

[11] "Seize the State, Seize the Day: State Capture, Corruption and Influence in Transition," World Bank Policy Research Working Paper 2444, Hellman, Jones and Kaufmann, September 2000.

work of Daniel Kaufmann, a Senior Expert at the World Bank. Notice that most of the situations described fall into the category of *state capture.*

Table 3: Vulnerabilities – Instances Where Corruption can Take Place. [12]
▪ Where a government agent is responsible for issuing of licenses, permits, customs clearance and border-crossing documents, banking licenses, etc. ▪ Where government regulators decide about price controls or taxes on commodities (for example: to keep prices high on locally produced commodities that have an inelastic demand; or to assign high duties on imported goods that compete with domestic producers). ▪ Where policies are set that could block new firms and investors from entering the marketplace, and thereby allow a monopoly position of another firm. ▪ In the awarding of contracts for publicly procured goods or services. ▪ In making policy decisions or enacting laws that would grant to certain classes of enterprises subsidies, soft credits, or tax exemptions. ▪ Where government inspectors monitor tax compliance or evasion. ▪ In the setting of and administration of foreign exchange control mechanisms. ▪ In allocating real estate/privatizing state properties. ▪ Where government agencies could "selectively" enforce socially desirable regulations (e.g. location of certain types of businesses, enforcement of equal employment regulations, etc.) ▪ Where monitoring mechanisms are weak and allow government officials to maintain obscure or secret budgetary accounts.

We can readily see that there is wide scope for corruption between business and government in an environment where rules and regulations are ambiguous, and where oversight is weak. It is a natural tendency for businesses to seek advantage over their

[12] "Anticorruption Strategies: Starting Afresh? Unconventional Lessons from Comparative Analysis," Kaufmann, Daniel in R. Stapenhurst and S. Kpundeh (editors), Curbing Corruption, The World Bank, 1999, p. 94. (Cited in "Corporate Governance: An Antidote to Corruption" by CIPE, 2002.

competitors, and it is not surprising that public officials would take advantage of weak institutional frameworks to peddle their influence for personal gain. Weak institutions, an uncertain rule of law, insecure property rights and the like encourage the kind of short term focus on day-to-day business survival that makes corruption appear more beneficial than it in fact is. The correlation between the rule of law and the “marketplace for corruption” is an inverse one. A strong rule of law would be characterized by:

- A rational set of laws governing the operations of private business, the protection of property rights, and the enforcement of contracts.
- Anti-monopoly policies and procedures to enforce them.
- A reasonable rate of taxation on private business.
- An efficient system of patents and protection for intellectual property.
- An efficient and stable set of regulations governing licensing, inspections and audits on business.
- An efficient judiciary (and ADR mechanisms) for sorting out contract disputes.
- Administrative procedures that guarantee public access to government decision makers and to their deliberations that shape policies and laws.
- Laws and administrative procedures that protect “whistle blowers” from reprisal.
- Laws and enforcement mechanisms that ensure accountability of private firms to their shareholders and capital markets.
- Disclosure laws that compel those in public office to disclose private financial interests.

In addition to public laws and governmental institutions, the private sector can also play a role in supporting the rule of law by promoting, for example: efficient capital market systems and institutions; practice of good corporate governance and business ethics (here is a role for associations for example), and; quality standards for goods and services in the marketplace. There is also an obvious role here for education and training institutions that target entrepreneurs and business managers.

Aside from the negative impacts of corruption on private enterprise development and economic growth (which we've argued earlier), why is a "strong rule of law" important to individual businesses? A major problem facing all businesses is risk. From the early stages of developing a business plan, to the point of running a successful operation, business managers are constantly dealing with risk. Risk is a natural force shaping the behavior of enterprises and the character of the marketplace in any economy. But, a strong rule of law helps to reduce risk or at least make it easier to estimate accurately by creating institutions and laws that are predictably – not idiosyncratically – enforced. Risks therefore are higher in an economy characterized by administrative corruption, rent-seeking officials, or a plethora of firms seeking to capture the state. If risk can be lowered through a rule of law that successfully mitigates corruption, investors are more likely to enter the market in greater numbers and dollars.

Up to this point we've highlighted the public sector side of corruption by focusing on the rule of law and how the absence of transparent, accountable public institutions and regulations creates the opportunity (and the incentive) for corrupt transactions. Within this view, we're naturally led to look towards "fixing the public sector" as a solution to the problem of corruption. No doubt the public sector has a major role to play, and indeed much of the literature to date is focused on the role of government, and on how ineffective public institutions and legal frameworks breed corruption. However, recent debates and studies are focusing more on how *corruption breeds inefficient and unaccountable governments*. (A popular cliché is "corruption is a two-way street.") This is a more complete picture because it highlights the role that business plays in perpetuating corruption, and leads us to explore strategies that involve changing the behavior of business, not just of government. In this regard there have been several conferences, papers, and workshops of late that explore the linkages between good *corporate governance* and corruption.

Corporate governance describes the relationship between the managers of a company and other stakeholders. How does this relate to corruption? Basically, if a company is accountable about its use of capital resources, then bribery payments should be disclosed. The threat of "exposure" is a disincentive to corruption. But, beyond simple accounting, ethical business practices are regarded more and more as important aspects of corporate governance. In 1999, 29 member countries of the OECD adopted the principles of corporate governance appearing in Table 4. In 2000, these principles were included among the 12 core "standards for global financial stability" which are recognized as important benchmarks by international financial institutions. According to the OECD,

> A good corporate governance regime helps to assure that corporations use their capital efficiently. Good corporate governance helps, too, to ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate, and that their boards are accountable to the company and the shareholders. This, in turn, helps to assure that corporations operate for the benefit of society as a whole. It helps to maintain the confidence of investors – both foreign and domestic – and to attract more "patient", long-term capital. ("OECD Principles of Corporate Governance," 1999, pg. 7)

Table 4: OECD Principles of Corporate Governance [13]
The Corporate Governance framework should: 1. Protect shareholders' rights. 2. Ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

[13] For the complete document, go to http://www.oecd.org/pdf/M00008000/M00008299.pdf.

3. Recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
4. Ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
5. Ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

We can see from this how lax corporate governance and the lack of corporate accountability facilitate corruption "vulnerabilities" between business and the public sector. If managers aren't answerable to shareholders and other stakeholders about how they use corporate funds and negotiate agreements, then there's less risk of getting caught. In fact, the incentives to be corrupt and the likelihood of succeeding at it become greater as oversight structures become weaker. Hellman et al discovered that in capture economies (characterized by a high degree of state capture corruption) captor firms grew four times as fast as other firms in the capture economy, and also had substantially greater levels of investment. But, let's not be misled by these growth rates. In spite of these gains to a few, the losses are greater to the private sector as a whole when compared with non-capture economies: the average growth rate of sales for all firms in high capture countries is only 11.1 percent, compared to 21.4 percent in low capture countries. [14] The long-term wealth of "gainer firms" in a capture economy is questionable too. Their "gains" are only relative in comparison to those firms they've been able to push out of the marketplace. The fact that they substitute corruption for productive investments and sound business practices undermines their long-term viability and global competitiveness.

Responses to Corruption in the Dealings Between Business and Government

Mitigating corruption that takes place between the public sector and business is a huge challenge. People in developing and transitioning economies have long accepted corruption as common practice. They don't like it when it directly affects them, but they see no alternative to getting business done. Effective anti-corruption programs also require resources, so although politicians denounce corruption, they may lack the funds to finance the institutional, legal, and human resource changes that are necessary to get positive results.

Faced with serious budget constraints, government leaders find it very difficult to accomplish two things necessary to mitigate corruption. The first is to shift the incentives so that public officials aren't tempted by bribes. This means increasing government salaries and benefits, and putting in place performance incentives with monetary rewards. The second area has to do with establishing a rule of law and the means to enforce it. This means implementing new laws, strengthening public agencies, building an effective and efficient judiciary, and creating reasonable yet effective oversight agencies that can identify and punish offenders, both from government as well as business. Although these measures are costly, the negative impacts on enterprise development, global competitiveness, and economic growth are worse.

We'll turn in a minute to some innovative work that's being done with the private sector, but let's first highlight what needs to be done to support anti-corruption efforts in the public sector. The list is large but necessary if governments want to pursue a serious anti-corruption program:

[14] Hellman, Jones and Kaufmann, page 18.

- Immediate adoption of laws that require public hearing periods for proposed laws and amendments, and implementation of public sector reforms that open the policy-process to broad civic participation.
- Setting of harsh criminal penalties for extortion by public officials.
- Adopting laws on political financing and asset declaration.
- Adopting laws and regulations on lobbying.
- Adopting laws and creating effective regulatory agencies that protect markets from monopolization and enforce anti-trust.
- Enacting "sunshine" laws that enable public access to government hearings, legislative debates, and require publicly-available minutes.
- Adopting "freedom of information" legislation that allows public access to all official documents, and mandatory disclosure of individual votes in parliament/legislature.
- Creation of a "corruption impact" agency to monitor and analyze potential vulnerabilities in government operations and new legislation.
- Requiring publication of court decisions and case schedules.
- Working with the media to inform and educate the public.

In addition to these legal and institutional reform efforts, governments must set a high priority on basic training and capacity building efforts for elected officials and all public agencies (including the judiciary) that interact with the private sector. The best way to raise awareness is through public education and open dialogue about corruption and how it affects the community and the economy.

Some recent innovations seem to hold particular promise in mitigating administrative corruption. One is "one-stop-shopping" for business licenses and other operating permits. Naturally, the greater number of official stamps or signatures that a business needs to operate, the greater the number of vulnerabilities or opportunities for bribery. Local governments are beginning to realize that they will attract more investment if they simplify these procedures and assign one office to interact with local businesses on all official matters. This approach has been piloted successfully in a number of transitioning economies of the former Soviet Bloc.

Another innovation builds on the theory that government ultimately is a service organization, and they should gauge their success on the basis of citizen (i.e. “customer”) satisfaction. [15] One simple monitoring tool for tracking customer satisfaction is a “point-of-service evaluation survey” or POSE. These are short surveys that are given to customers (for example, a truck driver passing through border-customs) that “score” the quality of government service provided to them. They can then be dropped into a collection box or returned by post (pre-stamped) anonymously. The advantage is that they are short, they provide ongoing feedback to senior public sector managers, and they can tell citizens who to contact if they have complaints about the services. The other advantage is that they promote positive attitudes about the proper role of government services. Such a system can be implemented anywhere that government is responsible for a transaction that affects an individual or a business. And, it could be tied to an awards system or certification of excellence program based on customer satisfaction. [16]

What can be done with the business community to encourage good corporate governance practices? At the international level there already are several conventions and “codes of conduct” in place that are designed to level the playing field in trade and foreign investment. Transparency International – a leading NGO in this field – has cited numerous examples of best practices in the private sector to mitigate corruption and promote ethical businesses practices in the corporate workplace. [17] There are also

[15] The World Bank, for example, is developing a series of “governance monitoring tools” that include a range of instruments and procedures to evaluate governmental service performance and measure improvements over time. These include surveys, scorecards, feedback forms, and hotlines.
[16] “Strategies to Combat State Capture and Administrative Corruption in Transition Economies,” Joel S. Hellman.
[17] See the TI Source Book 200 on “Confronting Corruption: The Elements of a National Integrity System,” Appendix of Emerging Best Practices.

many examples of businesses collaborating with civic groups to speak out on issues of corruption, promote public education, and advocate for market-led policy reforms and economic development. Many global companies have adopted their own standards of ethical conduct in an effort to “self-regulate.” A number of institutes, associations, and other NGOs offer services to large companies in how to design, implement, monitor, and provide training to staff on managing a corporate ethics program.

Can these “self-regulation” practices be successfully transferred to enterprises working primarily in domestic markets in underdeveloped or transitioning economies? How could they be motivated? I think it’s safe to say that global companies are motivated by their high profile and broad market base to maintain a good public image, and to adopt standards of conduct that will protect that image and those markets. This is particularly important in today’s “information age.” If a company is accused of corruption in one country, it’s only a matter of minutes before that news can be broadcast around the globe.

But what motivates companies operating in much smaller domestic markets to practice good corporate governance, let alone set up mechanisms to monitor and enforce a code of ethics? Here, the size and ownership structure of a company may be a factor. Smaller, privately owned companies deal mainly with the day-to-day problems of administrative corruption; they truly are at the mercy of the government. Their problems are affecting them and their employees, not a broader group of shareholders, board members, or venture capitalists. They are only accountable to themselves. Plus, they probably can’t afford the cost (or the risk) of liquidating their business and moving to another location. For them the best course of action would be to organize themselves and pressure the government to stop bribery and extortion. By teaming with other local interests – business associations, NGOs, and civic groups – micro, small and medium sized enterprises will speak with greater force and authority. And, by teaming with the media, they can educate the public about how corruption negatively affects consumers, discourages investors, and stifles employment and income growth in the community. In addition, businesses can propose that the government create a public-private partnership or task force to monitor anti-corruption efforts. Organization, political pressure, and public awareness are key strategies to fight administrative corruption at the local level.

Larger businesses that are traded on the local stock exchange, however, could have an impact on state capture and administrative corruption by adopting corporate governance principles, instituting a code of ethics, and engaging in open dialogue with their peers, the government, and the media about the problems of corruption. Their public commitment to stopping corruption could help shift expectations, redefine business norms or standards of practice, restore public confidence, and spur government to make legal and institutional reforms that promote competition.

But let's not be too enthusiastic or naïve. There is a problem inherent in this approach. Some (maybe even many) of these larger businesses have already been party to corruption, and very well may be in future. Why would they promote a practice that they don't subscribe to? Well, the same argument was certainly made a few decades ago about global companies. A few "enlightened" ones, however, found a connection between their corporate interests and the interests of the society at large in denouncing unethical business practices. Although there is no empirical evidence at hand, there should be a few leaders from this class of enterprises – those that are larger, publicly traded, and prominent in the local economy – willing to be our partners in promoting good corporate governance and ethical business practices. Local businesses with foreign interests may be good candidates; the foreign partner may be more familiar with the importance of good governance, and, in addition, may welcome this opportunity to improve their image in the local society.

Program Strategies

Corruption is a crosscutting issue affecting USAID's programs in economic growth and in democracy development. We can see from the discussion above that an effective anti-corruption effort must target stakeholders in both sectors – public as well as private. We can also see that the largest challenge is a fundamental one of changing attitudes, incentives and enforcement mechanisms to promote good behavior and punish corrupt actions or decisions. Much of the work that USAID is doing already has this aim. Among these programs, are the following:

- Promoting decentralization and fiscal accountability.
- Creating systems and institutions that promote public participation in policy dialogue and policy implementation.
- Creating more responsive and transparent public service mechanisms at the local level.
- Strengthening business associations as advocates for market reform.
- Promoting trade liberalization policies and competitiveness strategies.
- Improving accountability and efficiency of capital markets.
- Promoting and implementing transparent and efficient programs to procure state-services from the private sector.
- Helping businesses in a "cluster" or sub-sector to enhance their competitiveness in global markets.
- Opening up and improving legislative processes.
- Developing independent media that is educated about corruption and its affects on the economy.
- Creating public-private partnerships of businesses, civic groups, and local government to fight corruption and monitor results.
- Educating the public on the social and economic costs of corruption.
- Improving public communications capabilities of government officials.

- Strengthening the role and participation of independent “think tanks” to analyze political and economic issues.
- Legislating public disclosure of corporate interests held by elected officials.

Each of these objectives will affect corruption by helping reduce vulnerabilities between government and business. At the same time they are strengthening institutions and relationships among stakeholder groups that are necessary for successful enterprise growth and economic development. In addition, USAID should promote innovation in areas that directly address vulnerabilities. For example:

- Helping local governments institute “one-stop-shops” for enterprises to conduct official business and give business owners and citizens a place to provide customer feedback on services, etc.
- Helping business associations or think tanks conduct, analyze and publicize corruption surveys.
- Introducing a corruption curriculum (focused on the costs to enterprise growth and economic development) into public administration training programs and workshops.
- Instituting point-of-service-evaluations wherever businesses and government agencies interact.
- Supporting public education programs.
- Encouraging (and providing TA for) larger businesses to adopt governance standards and corporate codes of conduct.

Even considering the possible range of programmatic interventions, effectively reducing corruption and promoting real competition among enterprises in developing economies are enormous tasks. And, success will be determined mainly by the will and commitment of political and business leaders. For our part, we must convince them that corruption is holding back their entry into new markets and stifling economic growth which in turn will be good for business. We must constantly seek out leaders (in both public and private sector) that understand and advocate the "level playing field" argument, that is, that open markets will best serve social and economic objectives as well as private business interests over the long term.

The most promising new area for cost-effective impact may be the development and implementation of monitoring tools that expose corruption, mainly administrative corruption. But this alone isn't enough. Changing the higher-stakes, higher-return culture of state capture, may be more daunting, but it's nonetheless more important to achieving fundamental and sustainable change. In government, as in business, standards and expectations start at the top. For these reasons, USAID – along with other donors – must continue pushing for policy change and institutional reforms at all levels of government wherever possible, while at the same time researching, testing, and promoting best practices that mitigate, or at a minimum expose, corruption where vulnerabilities are highest.

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