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# CORRUPTION, FISCAL POLICY, AND FISCAL MANAGEMENT

FISCAL REFORM IN SUPPORT OF TRADE LIBERALIZATION

JUNE 2006

This publication was produced for review by the United States Agency for International Development. It was prepared by Georgia State University for DAI under DAI's contract with USAID no. PCE-I-00 00-00015-00.



# CORRUPTION, FISCAL POLICY, AND FISCAL MANAGEMENT

FISCAL REFORM IN SUPPORT OF TRADE LIBERALIZATION

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The authors' views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.



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# 1. INTRODUCTION

For many years the issue of corruption has, to some extent, been downplayed by governments, international organizations and policy experts. This happened because, first, corruption was considered a cultural and political issue; and second, because measuring corruption, much less eradicating it, was perceived as nearly impossible. Thus, elimination of corruption was not usually an economic objective of development agendas. Instead, it was taken as part of a country's nature, as exogenous perhaps as its geography. However, times have changed. Frustration with the lack of effectiveness of traditional approaches to development and the recognition that institutional development and good governance practices play a fundamental role in economic development have led to increased attention given to corruption. Many studies that assess corruption and discuss how to address it are already available, and the number is growing rapidly. Furthermore, there is no more uneasiness about exposing these issues, but rather there is a growing eagerness to discuss them openly at national and international levels.

The growing interest in corruption is the result of several factors besides development goals. First, the negative impact of corruption on poor countries is evident. International Financial Institutions (IFIs) cannot afford to ignore this problem anymore as most development aid and antipoverty strategies are predestined to fail if those resources are diverted by corrupt domestic administrations. Thus, IFIs have started to address corruption as a fundamental component of their development programs. Besides IFI's, several types of non-governmental and international organizations have also taken an active role in the fight against corruption.

One tangible result of the engagement of the aforementioned institutions was the collection and dissemination of objective data, opening possibilities for types of corruption research previously impossible. The availability of new data was coupled with the adoption of new measurement techniques, making possible the construction of broad datasets of cross-country measurements of corruption. The growing number of studies using these measurements, in turn, prompted IFI's and other institutions to extend their measurements from general indicators of corruption to several indicators of specific types of corruption. As stated by Kaufmann et al. (2003), data on corruption has helped to debunk old myths and to "de-sensationalize" the topic of corruption, making it an objective topic of dialogue. Among those myths challenged by the recently developed data is the belief that only developed countries can attain low levels of corruption. Corruption perception surveys show that some developing countries (e.g., Botswana) have reached levels of sound governance and corruption control comparable to those of some developed countries (Transparency International, 2005).

Finally, there is a growing recognition in the world of the fact that social issues related to poverty and corruption spill over national borders. Illnesses and diseases such as AIDS, for example, do not discriminate among countries or regions based on race, religion, geographic location, or per capita income. As a result, containment in countries that are more affected is necessary to prevent uncontrolled global spread. Similarly, poverty leads to social distortions and discontent, which in turn are translated into migration patterns of unemployed population towards industrialized countries. Political instability and weak rule of law also spread to the international community in several forms, such as organized crime, drug trafficking, and terrorism. The realization that corruption is a global phenomenon makes it clear that the fight against corruption is not an issue of development aid, but rather a matter of global survival.

This study seeks to assess the current state of knowledge and contribute to our understanding of how fiscal policies and management interact with corruption issues by integrating concrete and practical issues with conceptual analysis of their nature and consequences. The relationships between corruption and fiscal policy can be simple and direct but also subtle and complex. Moreover, these relationships can vary significantly from country to country. In some cases, the public sector gives

households and private firms an incentive to partake in corruption. For instance, poorly compensated public servants have powerful financial incentives to search for additional sources of income, including through bribes or extortion if necessary. Likewise, for two countries with similar ethical standards, there will be more corruption in the country where it is easier to conceal that a bribe was paid, for example, due to a much more complex tax structure. Poorly designed expenditure programs and budget processes may also give individuals or firms opportunities or incentives to bribe public officials or to perpetrate other frauds. Other corrupt practices are internal to the public sector itself. Corruption can result from acts by politicians or senior policy makers; tax administration and customs officials, or those entrusted with contracting or delivering government services.

The relationship between fiscal policy and corruption has been discussed extensively in the economic literature. However, the lessons learned in relation to fiscal policy and corruption seem to be separated according to their specific focus, analytical framework, and discipline of study.<sup>1</sup> This report presents an overarching discussion of corruption that not only points out the problems, but also potential solutions for a broad range of fiscal policy and fiscal reform issues.

This report is organized as follows: First, we present a theoretical framework of the economics of corruption (Section 2). Then, we provide general lessons regarding the design of anti-corruption strategies in developing and transitional countries (Section 3). In Section 4, we turn the general lessons into more concrete guidance to policymakers all around the world facing the demanding task of designing effective anti-corruption reform strategies. Then we provide some further discussion on sequencing and the implementation of anti-corruption policies (Section 5). Our conclusions follow (Section 6).

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<sup>1</sup> On the basis of over 4,000 publications on corruption, Transparency International (2001) reports that the distribution of subject areas is: Politics and Public Administration 74%, History 10%, Law and Judiciary 9%, Economics 4%, Ethnographic and Cultural 2%, and Business and Ethics 1%.

## 2. THE NATURE OF CORRUPTION

Corruption is present when public officials abuse their positions of public authority for private gain. Thus, corruption is, in the first place, a failure in ethics and moral standards of public officials. Therefore, requiring strict adherence to a Code of Conduct and integrating ethics sensitization in the training, evaluation, and promotion of public officials should be considered a first step in the fight against corruption. However, corruption is not just the result of an intrinsic lack of ethics and morals in the public sector or in society. Instead, corruption very often arises from conscious decisions by economically rational public officials that face a system of incentives and opportunities to engage in corrupt activities. Several factors affect this decision, some of which can be influenced by policymakers to foster an environment in which less corruption occurs. Therefore, the design of effective anti-corruption measures needs to take into account these rational responses to incentives and opportunities.

The corruption literature makes a distinction between two categories of factors contributing to corruption: first, elements that affect the motivation or incentives of agents to engage in corruption, and second, elements that create windows of opportunity for corrupt activities (Klitgaard, 1989; World Bank, 1999).<sup>2</sup>

Corruption incentives can be analyzed using a stylized model of a rational individual optimizing his/her decision to get involved in corrupt acts by equating the benefit from corruption to the associated cost.<sup>3</sup> The individual benefits from engaging in corruption can accrue in different forms, ranging from outright theft of public funds, to a bribe from evading taxpayers, to fraud in the tender process, or simple extortion of public service users. The individual associated costs of corruption may include job dismissal and other penalties, such as jail time or fines weighted by the probability of being caught perpetrating corrupt acts. In addition to the direct monetary costs associated with being detected, if dismissed or jailed, the public official must also consider differential between the public and private wages in case of dismissal (but not jail) and has to find employment in the private sector. A formal analysis of such a stylized model yields predictions that the level of corruption that a public officer is motivated to engage in will be higher when:

- Public sector wages are lower (i.e., an absolute wage effect);
- The difference between private and public wages is greater (i.e., a relative wage effect);
- The level of personal gain is higher (e.g., the higher the bribe offered);
- The probability of detection (P) is lower;
- The penalty (fine, etc.) is lower.

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<sup>2</sup> The terminology used in the literature varies across studies. For instance, policy responses associated with factors referred to in this study as motivations or incentives are classified in other studies as *preventive* strategies, whereas policy responses to factors described here as windows of opportunity are referred to in other studies as *enforcement* mechanisms.

<sup>3</sup> Further examples of theoretical analysis in this topic are Adiving and Moene (1990), Flatters and Macleod (1995), Acconcia, D'Amato and Martina (2003), Chand and Moene (1997), van Rijckeghem and Weder (1998).

The analysis above focuses exclusively on the motivation for corruption, and simply assumed unlimited possibility or availability of opportunities for personal gain for the potentially corrupt public official. This model can be further extended to include not only the motivation to engage in corruption, but also the opportunity for corruption. Klitgaard (1995) suggests that three key factors affect the opportunity for corruption, notably the financial discretion or control yielded to government officials, the monopoly power of public officials, and the accountability to which public officials are subjected.

The greater the level of financial discretion a public official is given, the greater his or her window of opportunity to extract personal gain through theft, bribes, or other corrupt acts. The size of the window is institutionally determined by the degree of monopoly control over the resources as well as the accountability and oversight to which the public official is subjected.

Given the positive relationship between the amount of potential personal gain and the degree of corruption, it is clear that anti-corruption policy should focus on decreasing the degree of monopoly power by public officials, while increasing their accountability. The government may also wish to reduce the financial discretion of public officials. Later in this paper we categorize opportunities for corruption by whether the opportunity manifests itself on the revenue or expenditure side of the budget, and according to the agent for corruption (i.e., political corruption or bureaucratic corruption).

Conceptually, it is possible to portray two policy scenarios to fight corruption. In the first scenario, the corruption containment strategy is based on a strong control of opportunities, while maintaining a weak structure of incentives. This type of anti-corruption approach is unlikely to be successful due to the pressure of a large number of individuals motivated to break the system of control. The second possible anti-corruption strategy may be based on a strong control of motivation (incentives) while downplaying control over opportunities. Once again, anti-corruption policies are likely to fail since those agents who would not have incentives otherwise feel tempted by the ease with which corrupt gains are made. While aggressive control of either one of these dimensions may reduce corruption in the short run, a sustainable and comprehensive strategy against corruption should address both incentives and opportunities for corruption.

Many instruments and mechanisms may be devised to affect incentives and opportunities for corruption and most of these reforms are costly. Increasing accountability usually requires, among other things, the implementation of monitoring systems, which imposes a cost to the government. Similarly, reducing the monopoly power and individual discretion of public employees in government decisions requires tightening legislative and regulatory frameworks and introduction of non-discretionary rules, which can result in a more bureaucratic approach to government administration. The total cost of the measures implemented to counteract corruption can be labeled as *corruption prevention costs*. Thus there is a general trade-off between the marginal cost of corruption to society and the marginal prevention cost.

Economics provides a rational guide for corruption control policies. Governments should spend increasing resources on corruption control as long as the marginal cost of controlling corruption is less than the marginal cost imposed on society by corruption. As a result, a sound governance strategy would seldom require corruption to be completely eliminated. That is why some level of corruption occurs even in the most developed, “uncorrupt” countries.

Quantifying corruption levels and the costs that corruption imposes on society is crucial in order to determine which corruption target levels are acceptable and how much to spend on corruption prevention. Corruption measures (such as corruption perception surveys) often not only provide a benchmark measurement of corruption that can be used to assess the effectiveness of anti-corruption policies and institutional reforms, but they can also identify key sources of corruption and thus the need for reform in these areas. Thus, analyzing the factors that affect incentives and opportunities for

corruption shows us where to target anti-corruption policy and how to best spend resources on corruption control. In practice, however, both the level of corruption and the economic costs of corruption are particularly difficult to measure.

The biggest challenge faced in the measurement of corruption is obviously the illicit nature of the activity. Neither the corrupt official, nor the accomplice (for instance, an evading taxpayer), nor the victim of corruption (e.g., the extorted user of government services) has an incentive to reveal the corruption, either for apparent self-serving reasons (such as detection of tax evasion) or for fear of retribution.

There are several approaches to measuring the extent of corruption. A first approach, employed in some studies, simply relies on anonymous questionnaires or surveys to elicit self-disclosure of corruption. Of course, this approach is prone to significant underreporting of corrupt acts. A second approach surveys not the incidence of corruption directly, but rather the *perception* of corruption within the business community. A third approach analyzes data on corruption prosecutions within a period of time. A fourth approach seeks to measure corruption through its correlation with other hard indicators such as non-compliant economic behavior (e.g., the level of tax evasion or the size of the shadow economy in a country), or by the difference between budgeted capital spending and field assessments of public infrastructure value. Overall, survey data appears to provide reasonably valid indicators of corruption levels. Although it is much needed, little progress has been made to date to complement survey data with the collection of “hard” objective data on corruption that are verifiable. As a result, for the near future, information on corruption will continue to come from survey data sources.

Measuring the costs of corruption is as important as identifying the extent of corruption. Conceptually, a consensus has been established in the literature that corruption is distorting and inefficient. This consensus rejects an earlier view that corruption does not represent a cost but rather it may increase efficiency by “greasing the wheels of the economy.” (Leff, 1964; Huntington, 1968; Bardhan, 1997). In fact, corruption decreases efficiency and raises the price of public services through several different channels. The bribe acts as a “corruption tax” on each unit of government services, which increases the overall cost of receiving public services and more broadly increases the cost of doing business, as public services and public infrastructure are important inputs in private production. In addition to its direct economic impact, corruption can represent significant non-monetary costs to the overall wellbeing of society.<sup>4</sup> In this sense, corruption has the potential to significantly weaken the rule of law, which is the backbone of a stable and effective market economy.

The empirical corruption literature presents a large number of empirical studies measuring the impact of corruption in a wide range of economic variables. In particular, econometric research suggests that corruption has a negative impact on per capita gross domestic product, efficiency, investment, tax revenues, productivity, health and education spending, and ultimately economic growth.

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<sup>4</sup> See Abed and Gupta (2002) for an extensive review of studies reflecting the consequences of corruption in a broad range of economic and non-economic issues including public service provision, poverty, and income distribution.

Our understanding of the nature of fiscal corruption has improved significantly over the last decade but it is still limited in several ways. Similarly, our understanding of the relative effectiveness of policy responses and anti-corruption strategies has also improved but is far from complete. In the next section we focus on what lessons so far can be extracted so far from the theoretical and empirical literature on corruption

### **3. A FEW GENERAL LESSONS**

The numerous recent studies that have begun to shed light on the multiple effects of corruption allow us to elaborate on several preliminary lessons regarding the design of anti-corruption strategies, keeping our particular focus on fiscal systems of developing and transitional countries:

#### **LESSON 1: FISCAL CORRUPTION IS A PROBLEM FACED TO DIFFERENT EXTENTS BY EVERY COUNTRY**

Corruption is a global phenomenon and it affects all countries without exception but in various degrees. Thus, a feasible goal would be not to free a country of corruption entirely, even if this were at all possible, but to introduce reforms and institutions that enable a country to fight and contain corruption where it arises. The realization that the effects of corruption do not stop at international borders and that the impact of corruption is felt not only by developing and transition countries but across the global economy has led the international community to address corruption reduction as a fundamental objective that goes beyond the notion of international aid, but rather as a matter of global survival.

#### **LESSON 2: REDUCING CORRUPTION IS NOT IMPOSSIBLE**

An important conclusion of this study is that corruption is not an untouchable or unsolvable problem. While it is true that there are no easy solutions in combating corruption, conceptual analysis and international experience suggest many practical instruments to fight different forms of corruption. In fact, some of the anti-corruption responses have been quite successful in curtailing even the most entrenched forms of corruption. The recognition that corruption is neither untouchable nor unsolvable economic governance problem signals a significant shift in attitudes towards this problem. As recently as the mid 1990s, the topic of corruption was taboo in a large sector of international policy circles. At that time, the prevailing notion was that corruption was primarily a domestic political problem and that the issue was outside the scope of international development efforts. Subsequent involvement of the International Monetary Fund in developing a Code of Good Practices on Transparency; and the World Bank, USAID and other bilateral donors' engagement in anti-corruption efforts, and in a variety of other governance issues, has signaled a change in attitudes towards corruption.

#### **LESSON 3: TO BE EFFECTIVE, IT IS IMPORTANT TO UNDERSTAND THE EXACT NATURE OF THE CORRUPTION CHALLENGE**

Corruption is a problem that can be studied, at least in part, in objective and systematic ways, which can facilitate the design of effective policy responses and remedies. From the perspective of this study, and much of the existing literature, corruption may not be so much the result of a predetermined absence of ethics and morals in the public sector or society at large, but rather the result of conscious and rational decisions by agents responding to incentives and opportunities offered by a particular institutional framework. Several factors affect these decisions, many of which can be conceptually modeled as a simultaneous system of incentives and opportunities to engage in corruption.

Corruption in the fiscal arena takes many forms, ranging from petty corruption by poorly paid public officials to grand corruption by wealthy, powerful, rent-seeking political operatives. Both forms of corruption are detrimental to economic growth and stability to different degrees but at the same time require different solutions. Anti-corruption policies should target the specific incentives and windows of opportunity that motivate and enable these different forms of corruption.

#### **LESSON 4: GOOD TARGETING IS IMPORTANT BECAUSE THERE ARE DISTINCTIVE PATTERNS OF CORRUPTION ACROSS COUNTRIES AND REGIONS**

As this study uncovered, there are distinctive patterns of corruption across countries and regions: regions often share similar corruption problems. This presents potential challenges of contagion across countries but also opportunities for learning how to fight corruption. This, however, also means that anti-corruption strategies cannot be adopted in a mechanical way. Appropriate anti-corruption design needs to recognize that corruption is a multifaceted phenomenon and that corruption in each country is likely to adopt different forms and nuances. Therefore, corruption strategies need to be adapted to the peculiarities of each country.

#### **LESSON 5: INSTITUTIONS MATTER AND INSTITUTIONAL REFORM IS KEY IN FIGHTING CORRUPTION**

This study has shown that the design of fiscal institutions is key for the presence (absence) of corruption. Other institutions of general governance, such as the rule of law and democratic representation are also key to containing corruption. Campaigns aiming to introduce or reinforce anti-corruption legislation and promote independence of judicial systems are needed to increase the number of reported cases of corruption that end up prosecuted and penalized. Some key institutional reforms should aim to relax extremely high standards of proof for the prosecution, to authorize and support the investigation of corruption, to eliminate secrecy of bank account information, to eliminate immunity of senior political figures against corruption charges, to grant prosecutorial powers to audit institutions or anti-corruption bureaus, and to promote the creation of bilateral and multilateral extradition agreements for corruption charges.

Other institutional reforms which may require longer periods of time to be effective in curbing corruption include the liberalization of markets, fiscal decentralization with functional and grass roots participation, the consolidation of democratic institutions and civil rights, and education in social ethics and moral standards.

#### **LESSON 6: SUCCESSFUL ANTI-CORRUPTION STRATEGIES REQUIRE A COMPREHENSIVE APPROACH AND SUSTAINED EFFORT**

There is a list of piecemeal anti-corruption policies that are well suited for quick implementation and which can attain outcomes in relatively short periods of time. Many of these have been proven quite effective, if not always long-lasting. A more permanent reduction of corruption is likely to require a sustained and comprehensive anti-corruption strategy. Comprehensiveness means the active participation of various stakeholders including the executive, the parliament and political opposition, citizen organizations, non-governmental organizations, the private sector, and often international organizations in the design and implementation of the anti-corruption strategy. Each and every one of these stakeholder groups plays a role that cannot be performed by the others. Each of these groups also has particular spheres of responsibility for which they should be held accountable by the other groups.

Comprehensiveness also means the breadth and depth of the scope of the anti-corruption strategy, from basic education programs to changes in laws and governance institutions, and so on. Anti-corruption strategies should aim simultaneously at the incentives and the opportunities for corruption. Anti-corruption policies targeting opportunities for corruption or the system of motivating factors alone are unlikely to be successful in curbing corruption. A double pronged approach should aim to reduce the opportunities for corruption by curative approaches based on enforcement and prosecution, while simultaneously using a preventive approach that attacks the roots of corruption by addressing

the system of incentives embedded in the public sector. Hong Kong and Singapore are good examples of how much can be done with well designed comprehensive strategies. Yet, both cases are small city-states with very specific histories, which could be considered as outliers not reflecting the challenges faced by a “typical” developing country.

To be successful, anti-corruption efforts also need to be sustained over time. The international experience reviewed in this study shows that one of the most common causes of failure in anti-corruption effort is the lack of continuity in effort once the strategy has been put into motion. In fact, sporadic efforts tend to be counterproductive as they undermine the credibility of future strategies. An important fact to keep in mind is that comprehensive anti-corruption initiatives are costly and their sustainability greatly depends on the availability of resources to fund them. Ideally, anti-corruption institutions should have long-term stable budgets that are independent of political influence.

### **LESSON 7: SUCCESSFUL ANTI-CORRUPTION STRATEGIES REQUIRE POLITICAL SUPPORT FROM THE HIGHEST LEVEL**

Comprehensiveness and sustainability of effort are generally not sufficient for success. Anti-corruption strategies need to be championed by the highest political offices in the country. This means the commitment of the office of the president and the entire government cabinet. Generating and keeping political will and momentum may be the most difficult of all these elements. The political class can get distracted (intentionally or not) after a while or may never be sufficiently motivated to provide support to the anti-corruption strategy.

Political will to fight corruption can be generated or reinforced by different stakeholders’ advocacy and pressure imposed on the others. Civil society organizations can be powerful advocates for an anti-corruption commitment at the policymaking level. In some cases, International Financial Institutions can exert pressure or even impose explicit financing conditions, on the implementation of anti-corruption reforms when political will is weak.



## 4. A PRACTICAL GUIDELINE TO THE FORMULATION OF AN ANTI-CORRUPTION STRATEGY

In this section we turn the general lessons into more concrete guidance to policymakers facing the demanding task of designing effective anti-corruption reform strategies. The aim is to provide a pragmatic guide and perhaps awaken the interest of policymakers fighting corruption to do further reading and study.

We believe that the first necessary step in an anti-corruption strategy design is to evaluate the extent of corruption within the existing institutions and organizations, identify the types of corrupt practices affecting these institutions, and to evaluate the weaknesses of the anti-corruption structure now in place, if there is any (see Lesson 3 above). This country-specific assessment and the careful consideration of national realities is the cornerstone for the development of an effective national anti-corruption program.

The second step is to spend time and resources in planning a comprehensive strategy (see Lesson 6 above). Even if it's not implemented as a package, the anti-corruption strategy must define all the anti-corruption elements and the inter-relationships between all of them. Then an anti-corruption implementation action plan should follow. This plan should contain the operational details of the strategy's implementation, such as the agents responsible for each specific task, the sequencing of proposed reforms, and the flow of resources to sustain the process. The anti-corruption action plan should also make explicit the mechanisms and processes of coordination to ensure the cohesiveness of the strategy.

The third step is to gain as broad as possible political support and commitment to the anti-corruption strategy (see Lesson 6 above). As we have argued, leadership and political commitment are key for the success of anti-corruption efforts. In order to maintain this political will it is important for the strategy to design formal channels of civil society's participation and programs to increase citizens' voice and general capability to demand greater accountability from their political leaders.

What are the concrete measures for an anti-corruption strategy? We are reminded again that the appropriate combination of anti-corruption measures must be considered in relation to the specific context of each country. However, starting from the more general institutional measures to the more concrete measures in fiscal policy and management, the following alternatives could be part of a national anti-corruption strategy:

### INSTITUTIONAL FRAMEWORK

#### 1. Watchdog Agencies

- **Anti-Corruption Bureau.** An independent anti-corruption body can be responsible for the enforcement of anti-corruption law and violations of public financial management laws and regulations, and also develop civil society and NGOs' oversight capacity and awareness through means such as educational programs and technical training.<sup>5</sup> For instance, a successful case is the Independent Commission against Corruption in Hong Kong (see Box 1). A good example is provided by Singapore's Corrupt Practices Investigation Bureau (CPIB), which reflects the strong

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<sup>5</sup> Anti-corruption bodies and other watchdog agencies should respond primarily to the parliament and must be independent from the executive branch in order to avoid conflict of interests. Mechanisms of internal monitoring (based on measures such as the consultation of external agents and civil society) must be built in order to evaluate the agencies' performance and ensure that they are not corrupted themselves.

commitment to fight corruption in that country. The CPIB counts on a Corruption Review Committee, an intelligence unit, and broad investigative powers including the rights to use polygraph testing in their investigations.<sup>6</sup>

- **Supreme Audit Institution (SAIs).** There must be external ex-post auditing of the use of all fiscal resources during the budget execution process in order to control corruption. The independence of the national audit office is of utmost importance.
- **Ombudsman.** A separate office of the ombudsman can be instrumental in receiving and investigating corruption allegations that may be outside the scope or feasibility of the Supreme Audit Institution.

## 2. Anti-Corruption Legislation

- **Financial disclosure laws.** Establishing a mandatory declaration of assets for public officials helps increase the probability of corruption detection. This legislation may shift the burden of proof from the prosecution to the defendant in illicit enrichment cases, as in Singapore and Hong Kong. However, in Hong Kong and Tanzania the special corruption rules might go too far by presuming a public official guilty of illicit enrichment until he/she is able to demonstrate the legal origin of his/her wealth.<sup>7</sup>
- **Codes of conduct-ethics.** A set of rules that define the standards of good behavior for public officials, ministers, and judges. A number of countries have had a Code of Conduct for many years, such as Japan (1948), United States (1977), Australia (1987), Ghana (1992), Singapore (1960, revised 1993), and Hong Kong (1971).
- **Whistle-blower protection legislation.** Protection from repercussions to those who denounce corrupt practices is vital in order to foster cooperation of public servants and ordinary citizens with watchdog agencies. This mechanism is used, for example, in the United States where any person is authorized to sue in the name of the government and receive up to 30 percent of the amount recovered as a result of the suit. Other countries with

### Box 1: Independent Commission Against Corruption in Hong Kong

During the 1960s and 1970s, corruption was a major social problem in Hong Kong. The severity of corruption was widespread in most public institutions and especially in the police. "Vivid examples included ambulance attendants demanding tea money before picking up a sick person and firemen soliciting water money before they would turn on the hoses to put out a fire. Even hospital amahs asked for "tips" before they gave patients a bedpan or a glass of water." (ICAC website History Gallery)

However, things have changed drastically during the last three decades. Hong Kong is now considered one of the least corrupt countries in the world. One single institution has played a crucial role in Hong Kong's success against corruption: the Independent Commission Against Corruption (ICAC). The ICAC was created in 1974 with the objectives of promoting education and the investigation and prevention of corruption in Hong Kong. The ICAC has currently more than 1300 staff members who are educated by means of a dedicated training school and learning resource center. The ICAC has powers of investigation and prosecution which are independent from the police. Indeed one of the first tasks of the ICAC was to clean up corruption in the police department.

The ICAC publishes a series of reports with the aim of informing the public of the ICAC activities: corruption reports, election-related corruption reports, and statistics regarding prosecutions. The Community Relations Department of the ICAC provides support to government departments, public bodies and private organizations in corruption prevention programs. This includes the arrangement of seminars on legislation covering corruption in Hong Kong, corporate system controls, ethical decision making at work, and managing staff integrity. Survey data shows a dramatic change in the public's perceptions of corruption from 1977 to the present and a widespread belief that the ICAC was and continues to be a key factor of this change.

*Source: ICAC website, World Bank (1997)*

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<sup>6</sup> Related legislation and further information of the CPIB is available at <http://www.cpi.gov.sg>.

<sup>7</sup> In Hong Kong, the Prevention of Bribery Act and in Tanzania the Prevention of Corruption Act.

whistleblower protection legislation include Australia, Great Britain, and New Zealand.<sup>8</sup>

- **Party financing laws.** Regulations of political campaign financing such as contribution limits, campaign spending ceilings, and public disclosure of party campaign finances are required to reduce opportunities of lobbying and political corruption.
- **Electoral laws.** Electoral systems in which individuals vote for individual candidates (rather than vote for party lists) are less prone to corruption by making politicians accountable to their constituencies rather than to party platforms. Assuring a transparent voting system empowers citizens to vote corrupt leaders out of office.

### 3. The Judiciary

- **Professionalization of the judiciary.** A judiciary system reform must ensure a transparent judicial appointment and promotion process and independence from political manipulation.
- **Adequate remuneration for judges and court staff.**
- **Modernization and restructuring of judicial procedures.** These include measures that may reduce opportunities for corruption, such as electronic recording of court files and standard mechanisms of case assignment among judges.
- **Systematic investigation of judicial corruption and reception of judicial corruption complaints.** The judiciary must be under the close oversight of watchdog agencies. Alternative mechanisms should be built in to make the judiciary also accountable to civil society and to collect and process allegations of judicial corruption.

### 4. Parliament Involvement

- **Parliamentarian capacity building programs.** The parliament must develop their institutional capacity to analyze budget proposals and budget execution reports and investigate evaluations and audit reports. To this end a Parliament Fiscal Analysis Unit can provide specialized technical support in many of these areas.
- **Strengthen the inter-relations between the Parliament, National Audit Institution and the anti-corruption bureau.** The parliament must build in systematic procedures for the discussion and response to reports from these institutions.<sup>9</sup>
- **Promote international associations and networks of legislators.** International experiences and best-practices of effective oversight of the budget and endorsement of anti-corruption legislation are valuable lessons for anti-corruption policymaking.

### 5. Nongovernmental Support

- **Promote the creation of anti-corruption coalitions outside government.** Citizens, NGOs, and the private sector can all be anti-corruption champions. Coalitions of these groups may engage in activities such as establishing of a Citizens Advocacy Office (CAO), conducting taxpayer surveys

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<sup>8</sup> See Groeneweg (2001) for a comparative analysis of whistleblower protection legislation in Australia, United States, and the United Kingdom.

<sup>9</sup> The parliament is the main body responsible for holding the executive branch accountable for the budget formulation, and thus decreasing opportunities for political corruption. This is achieved through review and discussion of audit work of the SAIs, reports from the Anti-corruption Bureau and following steps towards corrective actions.

and public service surveys to promote dialogue between civil society and the government about corruption issues; increasing public awareness of corruption in a country, and so on

- **International donors' participation.** Donors can explore possibilities for supporting civil society and other domestic champions of corruption.

## FISCAL SYSTEM AND MANAGEMENT

### 1. The Revenue Side

- **Tax administration reform.** Important anti-corruption measures within the tax administration include updating and modernizing tax agency procedures; restructuring the internal organization based on function (identification, assessment, billing, etc.) rather than by type of tax; limiting the discretionary power of tax officials; reducing number of clearances that are required from taxpayers to complete the compliance process (i.e., the number of forms, certifications, signatures, stamps, etc.), exploring the use of electronic filing and tax liability self-assessment.
- **Semi-autonomous revenue authority (SARAs).** When properly implemented, this enclave approach to tax administration reform may make possible the de-politicization of tax officials, increased wage levels for tax officials, and the strengthening of internal monitoring mechanisms.<sup>10</sup> SARAs have been introduced in countries as diverse as Malaysia, New Zealand, Singapore, Ghana, Kenya, Malawi, Rwanda, South Africa, Tanzania, Uganda, Zambia, Bolivia, Guatemala, Guyana, Mexico, Peru and Venezuela (Talercio, 2003; Bird, 2003).
- **Tax policy reform.** Reforms of the tax system can reduce opportunities for corruption by simplifying the tax system by reducing the number of discretionary tax incentives, exemptions, and deductions.

### 2. The Expenditure Side

- **Modern treasury systems.** Transparency of cash management and disbursement of resources for items authorized in the budget are required for the consistency between the budget formulation and the budget execution. The treasury must operate separately from the spending agencies. Discretionary power of treasury officials can be reduced by separating departments responsible for each budget execution stage (verification, payment authorization, etc.).
- **Financial management reform.** Having the basics right requires strengthening basic procedures of budget accounting, audit, and reporting. The public expenditure management system should take advantage of information technologies and integrated financial management systems.
- **Public spending tracking systems.** The identification of leaks in the budget implementation stage, through means such as public expenditure tracking systems and quantitative service delivery surveys can be useful in identifying problem areas.

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<sup>10</sup> Case experiences suggest that the enclave approach in the case of SARAs and Large Taxpayer Units (LTUs) relies heavily on the transparency and sustainability of a merit-based recruitment and the effectiveness of their internal monitoring units. Opportunities of patronage and capture of the merit based recruitment are higher when the head of these institutions is appointed by the executive branch. Higher wages will only supplement bribes if they are not coupled with higher internal monitoring within these units. Additional monitoring mechanisms, such as taxpayer surveys and independent complaint units, should allow citizens to assess SARA and LTU performance and also ensure that the internal monitoring units are not corrupted themselves.

- **Procurement system reform.** Establishing standardized procurement processes, ensuring maximum exposure and competition of foreign and national bidders, and satisfying international standards of procurement are key steps. Independent auditing of the procurement procedures should be conducted regularly and reviewed by parliament. E-procurement systems can be particularly useful if coupled with the necessary administrative capacity.
- **Comprehensive coverage of the budget.** The budgetary process should minimize the use of extra-budgetary and off-budget accounts in order to maximize transparency in the use of public resources.
- **Civil service reform.** The professionalization and de-politicization of public servants, the reduction of turnover rates, merit-based recruitment and promotion of bureaucracy are key measures to reduce probabilities of corruption and patronage.
- **Strategies that promote political representation and electoral accountability.** Broad political contestability decreases the opportunities of state capture. Relevant information regarding public spending, including parliament debates of the budget formulation, should be made available for scrutiny by ordinary citizens.

### 3. Intergovernmental Fiscal Structure

- **Decentralization of spending responsibilities and revenue sources.** Local governments' greater autonomy and increased accountability to citizens can be instrumental in reducing corruption.



## 5. SOME FURTHER REFLECTIONS ON SEQUENCING AND THE IMPLEMENTATION OF ANTI-CORRUPTION POLICIES

What is the appropriate timing or sequencing of these reforms? Clearly, not all anti-corruption steps and measures listed above can be applied simultaneously. There are some steps that need to be taken first to ensure the effectiveness of other subsequent steps. Some measures are actually alternative options to reach similar objectives, and others will not fit the institutional or constitutional context of specific countries.

Establishing an appropriate sequence for anti-corruption reforms is not an easy task. Yet, it is possible to suggest some stages in the process, which could be of practical use. Strengthening the rule of law and the judiciary must be a primary objective. Assuring the enforcement of existing laws must precede the enactment of new anti-corruption legislation. Similarly, strengthening the judicial system and ensuring its independence must precede creation of additional watchdog agencies.<sup>11</sup> Initiatives to strengthen the rule of law must send a strong message that future anti-corruption measures will be fully enforced.

A second stage could focus on promoting the enactment of new anti-corruption legislation supporting the existing institutional framework and building up the framework for future reforms. Several experiences reveal that new anti-corruption measures and institutions should be implemented only once a supporting legislative and regulatory framework is in place (e.g., Republic of Georgia).

Besides sequencing, it is equally important to take into account a number of implementation issues, which go beyond the technical dimensions of anti-corruption strategies. We may all agree that anti-corruption strategies need to be sustainable, comprehensive, adequately implemented, and appropriately designed. But this may not be of enough practical help. We need to worry about other issues such as how to adapt the implementation of a strategy to the particular characteristics of developing countries or indeed, how to generate a genuine desire to fight corruption at the highest levels of government.

International experience suggests that, even when the most sophisticated and sound anti-corruption strategies and institutional structures are technically in place, their success depends critically on the details of their implementation and the *de facto* mechanisms used in actual practice. Where these mechanisms have not been clearly identified, anti-corruption efforts may prove futile. For example, it is unlikely that the establishment of an Anti-corruption Monitoring Unit within the tax administration will reduce corruption levels if there are no additional monitoring mechanisms to ensure that this unit is not corrupted itself.<sup>12</sup> Similarly, it is hard to believe that an Anti-corruption Bureau or Supreme

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<sup>11</sup> The logic of the sequence suggested is clear and also supported by the experience in several Southeastern European countries where new anti-corruption legislation is rarely enforced, leading to cynical expectations regarding future reforms (Tisne and Smilov, 2004).

<sup>12</sup> The obvious question becomes who guards the guard? Practically, a chain of guards cannot continue indefinitely. It would seem necessary that the ultimate guardian have a genuine or personal interest in controlling corruption. Civil society (ordinary citizens) and the private sector seem to be perfectly suited for this role since they are negatively affected by corruption and often dispersed enough to be bribed. But this is not easily made operational. Hong Kong seems to offer a good example of how to delegate this role to civil society. Hong Kong's Anti-corruption Bureau has a special committee that receives complaints about their own officials and procedures from citizen groups. A special department of community relations encourages the participation of the private sector and citizen groups in these activities. To close the circle of accountability, complaints and other information would need to be reviewed by the parliament and exposed widely by the mass media.

Audit Institution will serve its purpose if their head and board are appointed by the executive branch. Often, these implementation “details” would seem to be overlooked. Thus, we need to ask not only whether a country does undertake a given anti-corruption strategy or measure, but also whether they do it correctly.

**Box 2: Curbing Corruption in Peru’s Tax Administration: The case of Semi-autonomous Revenue Agencies**

The government’s response to systemic corruption in tax administration in Peru was the creation of a Semi-autonomous Revenue Authority in 1991: the National Tax Administration Superintendency (SUNAT). “The reform had several key elements: granting SUNAT meaningful administrative and financial autonomy, implementing radical personnel reform, investing in infrastructure, and information technology, and generating public support.” (World Bank, 2001a, p.1).

The considerable degree of autonomy granted to SUNAT allowed flexibility and innovative management but also helped to protect the agency from political patronage, which was endemic in the previous administration. Additionally, a strong system of incentives to improve collection and reduce corruption was imposed at both the agency and at the personnel levels. At the agency level SUNAT’s budget was set as an automatic sharing deposit of 2 percent of collections; supposedly this generated an institutional motivation to increase collections. Personnel incentives to fight corruption were addressed by merit-based recruitment of the entire staff, and by a drastic increment in salaries from an average of \$50 to \$1000. Further provisions were taken to guarantee that salaries at SUNAT would remain competitive with those in the private sector.

As discussed in section II of this study, hard data on corruption is typically inexistent. Yet, the effectiveness of Peru’s SARA in curbing corruption can be assessed by citizens’ responses to a perception survey. The perceptions that SUNAT had contributed to curb corruption in the tax administration were exceptionally strong. Respondents that believed corruption was much less and substantially less than prior to the reform accounted for 85 percent of the total. Those percentages contrast with the weaker ones for the same kind of experiment in Mexico and Venezuela.

**To What Extent is there More Corruption in the Tax Agency than Before the reform?**

	<b>Much Less</b>	<b>Substantially Less</b>	<b>Slight Less</b>	<b>No Change</b>	<b>Slightly More</b>	<b>Substantially More</b>	<b>Much More</b>
Peru	52%	33%	10%	0%	0%	0%	4%
Mexico	4%	17%	34%	36%	6%	0%	2%
Venezuela	8%	18%	53%	18%	0%	0%	4%
Bolivia	2%	6%	18%	48%	16%	6%	4%

*Source: Talercio (2000)*

Despite the success of the SUNAT during its first years, it is widely believed that around early 1997, the SUNAT lost the strong commitment and the political support that it had when it was created. The decline of political commitment against corruption was also notable in the effectiveness of the judicial system and the police, leaving SUNAT’s anti-corruption efforts without the required institutional support to be fully effective. The lack of sustained political commitment purportedly reduced the efficiency of the SUNAT and generated once again internal corruption, infiltration of political interests and management manipulation. Revenues from tax collection delegated to the SUNAT (last column in Annex 4.A) experienced a moderate increment after the establishment of the SUNAT, yet revenues also decreased after 1997.

*Sources: Estela (2000), Talercio (2002, 2003), McCarten (2004), Mann (2004).*

In order to make headway towards reducing corruption, it is important to recognize the importance of the sustainability of the reform effort. The short-lived success of the semi-autonomous tax administration agency (SUNAT) in Peru is one example (Box 2). Failure in the sustainability of the reform effort has two main causes: (i) the absence of resources to maintain the program, and (ii) the lack of political will to foster the program's implementation or maintain the process with rigor. The lack of adequate resources may be addressed by ensuring a minimum operational budget over a multi-year period for anti-corruption agencies or programs rather than being subject to annual discussion. Of course, the assumption here is that the country can afford these programs or that foreign assistance is available. But it is the lack of political will to maintain the fight against corruption that is the most common cause of unsustainability and failure.



## 6. CONCLUSIONS

The growing interest and increasing number of studies of corruption have not produced any easy solution to this global problem. Analogous to most structural policy issues, the experience indicates that there are no unique solutions, but rather that fighting corruption requires the application of a wide range of strategies and the recognition of cultural and historical characteristics of a country. Yet, despite the complexity of anti-corruption policy design, anecdotal cases of success suggest that corruption is not part of a predetermined destiny or that corruption is necessarily ingrained in some cultures, but rather that corruption is an issue that can be addressed, and that fighting corruption is possible and worth doing.

There are countless types of corruption and many distinctions can be made based on the dynamics of the act (i.e., unilateral, multiparty), the agents involved (i.e. high level officials, low level officials, private agents), the size of the corrupt act (grand corruption or petty corruption), the budgetary functions affected (i.e., expenditures, revenues), the nature of the determinant involved (i.e., structure of incentives, institutional opportunities), and so on. This description and categorization of the different forms of corruption constitutes the first necessary step to identify policy issues and suggest remedies.

For convenience, we have organized our discussion around three main areas of fiscal policy and management: revenue collections, expenditure processes and quasi-fiscal operations. The discussion identifies the determinants of corruption within these areas by making the distinction between those affecting incentives and those affecting opportunities for corruption. For each of these areas, we have identified policy responses, from piecemeal to more general or programmatic, that have proven to be effective in combating corruption. Below we highlight the most prominent responses in each area.

First, there are policy responses that are effective in fighting corruption in all areas of fiscal management and policy. These include the introduction or strengthening of mechanisms to monitor officials, encouraging cooperation from other public employees through whistleblower protection plans, and the collection of anonymous reports. Laws for the mandatory disclosure of assets, effective prosecution and stringent penalties, and the reductions of wage differentials between the public and private sectors can also contribute to curbing corruption.

On the revenue side of the budget, it is important to focus on measures that reduce the number of tax evaders willing to exert pressure on tax officials and also reduce the potential gains from corruption and tax evasion. Among other things, these would include measures such as keeping tax burdens manageable and improving the fairness of the tax system

Basic oversight mechanisms such as computerized paper trails, institutionalized routine cross-checks, internal and external audits, or measures that decrease the discretionary power of tax revenue officials can eliminate many opportunities for corruption. Other common sense measures likely to decrease opportunities for corruption include the separation between officials responsible for the tax assessment, tax collection, and audits; rotation of staff; use of standardized and computerized systems of tax assessment and merchandise classification; use of presumptive tax regulations; and automatic mechanisms of tax audit selection, independent appeal courts; and establishment of an ombudsman office. Broader programmatic responses, such as the creation of “semi-autonomous revenue authorities” and LTUs have also been proven to be effective in reducing.

On the expenditure side of the budget, anti-corruption design can be more complex due to the larger scope and the greater variety of avenues for corruption. But here again there are quite simple, common sense, and effective ways to fight administrative or petty corruption, such as public service spending controls, integrated treasury systems, transparent procurement processes, and the application of international standards for internal and external audits. Public expenditure tracking surveys (PETS)

have been quite useful for identifying the potential scope of corruption and mobilizing policy responses.

Controlling political corruption in public expenditures can prove to be a more difficult and subtle task. Nevertheless, active involvement by the parliament and parliamentary anti-corruption commissions, supreme external audit institutions, civil society organizations, and the investigative media have proven effective in controlling this type of corruption. In addition, opportunities for political corruption can be reduced by strengthening political institutions that promote political representation and electoral accountability.

Large areas of the quasi-fiscal sector can face significant problems with corrupt practices. But here, too, there are practical steps that can be taken to reduce corruption incentives and opportunities. Corruption in the privatization of state assets can be reduced by decreasing the level of administrative discretion and bureaucratic clearances required in the process, by increasing the transparency of the process through the public and open disclosure of information, valuation procedures, and results of the privatization process.

Corruption and abuse of market regulation powers can be controlled by minimizing the number of market regulations, import controls, and so on. Corruption in the pricing of public utilities can be curtailed by promoting more independent regulatory agencies and by increasing the depth and scope of monitoring and auditing procedures. In the case of natural resource exploitation, the corruption stakes can be huge through the direct or indirect embezzlement of these revenues. Where democratic institutions are weak and parliamentary oversight and free media scrutiny are lacking, International Finance Institutions can be effective in exerting pressures on government leaders to disclose and enable external auditing of natural resource revenue accounts.

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