

**Corruption in
International Business**
The Challenge of Cultural and Legal Diversity

Edited by
Sharon Eicher

CORRUPTION IN INTERNATIONAL BUSINESS

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Corruption in
International Business
The Challenge of Cultural and Legal Diversity

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Preface

The goals of this work are both practical and pedagogical – to add something to business education – and research orientated – to add something to corruption work. The motivation for this book originated from two sources. The first was the shared interests by a group of public policy and political economy experts researching corruption in Central Asia and the Caucasus. The second was as chair of a department of business and economics and the developer of the program’s curriculum.

In 2005, the Central Eurasian Studies Society’s annual conference hosted two panels on corruption within Central Asian and Caucasus states. One of the contributors has written his own book. The other participants joined together to collectively develop perspectives from different fields about corruption.

The second motivation for this work is the experience of the editor of this work, a Ph.D. in economics who had studied and taught abroad and who closely observed international business dealings while living in the former Soviet Union. This individual went on to chair a business and economics program at a liberal arts college, where she began to lecture on business ethics among other topics. She realized that while academics do a fine job in preparing future business professionals to understand accounting principles, finance, management, and marketing, students are not as well prepared for the real, complicated world of international commerce. Studies of the extent of corruption in many foreign societies are not included in business programs, despite the fact that graduates enter this world after graduation. Employees receive little training in business schools or on the job to prepare them for differences in business practices, social skills, and other logistical issues in working abroad. Recalling employees who cannot fit in is costly.¹ Ethics scandals are even costlier.

It is a common practice to assume that business practices are mostly universal. Many of our business practices are cultural, and culture is composed of those assumptions that are so part of who we are and how we see the world that we are not even conscious of them. These cultural preconceptions can land us in a great deal of trouble, especially when encountering different norms regarding corruption.

We understand very well that corruption is not a new problem. The Code of Hammurabi, dating back to 1700 B.C.E., is often cited for a clause about corruption of public officials. We understand that corruption is not something that only occurs in less-developed countries. Kebschull (1992) states, ‘there is no golden age of incorruptible politics, in the United States, in Europe, or anywhere else in the

¹ Approximately 40 percent of employees assigned abroad are recalled after the company has invested two to five times the employee’s base salary to transfer his or her household (Schuster and Copeland 1996).

world.’ We are beginning to understand its public and private sector variations. Despite all that we do know, we are only today beginning to understand how to look at corruption as citizens of a global society. Understanding corruption and its manifestations around the world is invaluable knowledge to the professional in international business.

Business programs today are making a concerted effort to prepare graduates for the world where temptations lie and reputations can be ruined through poor decision-making. To do this, business ethics courses have become a core component of academic programs. However, business ethics content generally assumes a cultural status quo. We can mostly agree, for example, that misrepresentation on financial statements is a breach of ethics and how this should be handled. What about when we encounter ethical and moral dilemmas where we are not in agreement? When different cultural and value systems are at odds with one another? This is exactly the problem that international corruption poses.

The closest we come in preparing our graduates for navigating corrupt business climates is to educate students in ethics and international business. We hope that repetition on ethics themes will allow business professionals to understand that actions have consequences and that profits are not everything. Part of this preparation comes from studies of international business, which usually do not include any content on corruption. In other words, we do not properly prepare business professionals for that foreign posting or for entering negotiations on an international deal. People in these situations are forced to rely upon what has been learnt from ethics and other business classes, their common sense, and their own moral sensibilities to navigate corruption dilemmas.

A lengthy discussion between the editor and Raytheon corporate executives reinforced the concept that people are thrust into a world of complex and sometimes threatening situations involving corruption, without any preparation for this. Companies may educate their employees and managers about company policies towards bribes and gifts, but that is all. This is insufficient for an increasingly globalized workforce. Codes of conduct in small and large companies are increasingly common, and human resource managers spend countless hours training to prevent many possible violations of ethical and legal behavior. How well do they handle cross-cultural and international legal variations of these problems?

This work continues the work that other corruption researchers and writers have completed. We attempt to present a broader perspective about how corruption can be defined, the responsibilities of a representative of a publicly traded company to the shareholders, and the positive influence that corporations can have upon combating international corruption.

The goal of this work is to educate the business school student, before he or she plunges into international business operations, on how we talk about corruption, how we define it, how we view it, and how we combat it. We also aim to expose business professionals who are entering an international work environment that is different from that which they are accustomed to, to corruption that is an everyday occurrence in many countries.

Contributors

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Ethan S. Burger received his law degree from the Georgetown University Law Center (1989) after earning a Bachelor of Arts from Harvard University. He is a Scholar-in-Residence at American University's School of International Service, Adjunct Professor at the Georgetown University Law Center, and director of the International Legal Malpractice Advisors. Mr. Burger has practiced law for 15 years and visited states of the former Soviet Union more than 40 times to observe and facilitate in selective prosecutions and business disputes involving money laundering and businesses which knowingly or unknowingly facilitated governmental or organized crime. His appearances include presentations at the American Bar Association, International Law Institute, International Monetary Fund, Institute for State and Law (Moscow), Kennan Institute, Radio Free Europe/Radio Liberty, the Royal Institute of International Affairs, the Voice of America and the World Bank.

Sharon Eicher

Sharon Eicher is a Ph.D. in development economics (2002). Other degrees include a Bachelor of Arts in political science and Master's degrees in Islamic societies, Central Asian languages and cultures, and economics. Much of the conceptualization and research for this work occurred while she was teaching business and economics courses at KIMEP in Kazakhstan and at Bethel College in Kansas. She now teaches at Friends University in Wichita, Kansas, USA, as Associate Professor of Economics. Sharon has been studying and traveling to the former Soviet Union since 1989. She lived and worked in Kazakhstan for several years where she met with advocates for small business development, befriended many business professionals in the commercial center of Central Asia, Almaty, and developed her understanding of corruption.

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Mary S. Holland completed her law degree from Columbia Law School (1989) after completing a Bachelor of Arts' degree in Russian and Soviet studies and a Masters in international affairs. Ms Holland worked for the Lawyers Committee

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Donald Jacobsen is employed in the US Department of Justice. He will receive his Juris Doctorate in 2008 from the Georgetown University Law Center. Mr. Jacobsen has taught political science at the university level and served as a research assistant under a Carnegie Endowment grant studying Russian regional politics. A year spent living in Russia and more than ten visits have given him the opportunity to observe corruption in former Soviet countries firsthand. He has performed contract work for the World Bank and International Monetary Fund and has served on several committees of the United States Congress.

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Maks Kobonbaev was born in Kyrgyzstan and now works as a consultant for the World Bank Group in Public Sector Governance. He has worked on various development projects in Central Asia, such as the Comprehensive Development Framework Project under the World Bank, USAID Global Training for Development Project, and for the Japanese International Cooperation Agency and Goskominvest. He earned a Master's in public policy administration from the University of Missouri in Saint Louis and completed a Ph.D. (2008) comparing corruption in the Baltics with Central Asian states.

Talaibek Koichumanov

Talaibek Koichumanov has over 23 years of professional experience working in the Republic of Kyrgyzstan and CIS countries and more than eight years of experience in policy-making. He holds a Candidate of Science degree (the terminal degree in the former Soviet Union) in economics from Moscow State University, after which he became a 'Doctor of Science' (the highest academic honor within the former Soviet Union). He has authored nearly 70 publications and was awarded by the Economic Cooperation Organization (2002) for his work in economics. Dr Koichumanov was Minister of Economics and later Minister of Finance for the government of Kyrgyzstan in the 1990s. He worked as a local consultant on the UNDP's Project on Reforming of Public Administration and the World Bank's Capacity Building under the 2000–2002 CDF Program.

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Chapter 1

Introduction: What Corruption is and Why it Matters

Sharon Eicher

A New Consciousness

People everywhere are more concerned than they ever have been about corruption and business ethics. This represents social changes that are occurring everywhere, though to different degrees.

Partly this may be due to the pioneering efforts of the organization Transparency International, which has not only spearheaded the fight against corruption, but has made it possible to gauge and compare corruption across countries. Partly, it may be due to the plethora of scandals and company collapses that was experienced at the end of the 1990s and in the early 2000s. It may also be due to changes in the demographics of investors. Today the worker is also the capitalist, and the largest investors, institutional investors, are protecting the common person's pension savings, insurance funds, etc. It may also be due to globalization.

Globalization has expanded communication and the flow of information among ever widening circles of people, some of whose interests conflict with those of the private sector, and those adversely affected have organized themselves in a variety of ways to express their discontent. Globalization has forced like-minded western capitalists to interact with their counterparts in lower-income countries, where interpretations of trust, reciprocity, honesty, and social engagement may differ. Finally, globalization has created visible, open clashes among private actors, public officials, individuals, and organized groups at an unprecedented level and pace.

Public awareness has risen through the efforts of NGOs, international agencies, and scandals in the media. This awareness, combined with the changing definition of 'capitalist' and globalization, contributes to a new consciousness concerning corruption.

Today companies do not operate within national boundaries – where the rules are straightforward and understood – but in multiple countries, each with its own set of norms and rules. Corruption has entered the public sphere and dealing with corruption must become a foremost issue in training business professionals.

Defining Corruption

One difficulty in combating corruption is our struggle with defining it. ‘Virtually every published work on corruption, from the 1960s to the present, wrestles with the problem of defining it’ (Sandholtz and Koetzle, 1998). Without an internationally agreed-upon definition, operationalizing anti-corruption strategies is problematic.

In many cases ‘corrupt’ and ‘illicit’ are used interchangeably (Bardhan, 1997). This suggests to many that corrupt behavior violates a principle of legality. However, not all illegal behavior is corrupt,¹ and not all corrupt behavior is illegal. Rose-Ackerman (1975) describes the corruption payment constituting a bribe as ‘an illegal or unauthorized transfer of money or in-kind substitute’. *Illegal or unauthorized*. So, corruption payments may be legal but unethical, as they are not allowed under one’s rules of operation.

A common misconception, held in both western and developing countries, and even among many researchers on corruption, is to confuse what is corrupt with what is legal. Laws are defined by values, as are ethical norms, but the two are not equivalent.

Until recently, it was legal in many countries to use foreign-paid bribes as tax deductions. It was legal, but it was arguably unethical and corrupt. Paying a bribe was a crime only inasmuch if it violated a law in the country in question.

In countries that have ratified the OECD Convention to prohibit bribing foreign officials, it is no longer legal to use these as tax deductions. Now that it is not legal, is it less unethical and more corrupt? Plenty of corrupt behaviors, as with all ethical issues, are not illegal. Corruption in the public sector, involving public officials and employees, on the other hand, is illegal in most countries, though it may be highly tolerated. Consideration of the law and consideration of business ethics and corruption are necessarily two different, albeit closely related, matters.

Many firms have legal counsel to advise them and to set their anti-corruption policies. This will help companies to follow the laws of their home countries and their foreign bases of operations. It will not necessarily help them to avoid scandals, as many corrupt practices may be perfectly legal, such as offering incentives to a representative who is accepting bids in order to win a contract.

One of the ways that corruption may be differentiated is by discussing *public corruption* versus *private corruption*. Public corruption could occur when a member of the tax-paying public is given poor service or asked to pay a bribe by one who is engaged in public service: a judge, a policeman, a civil servant, etc. An example of private corruption could be when public company managers, whose job it is to look out for the interests of shareholders, engage in side deals or make decisions for the company in order to benefit them personally, rather than doing what is best for the firm and the shareholders.

¹ The quintessential example is that harboring Jews during the Holocaust was illegal, but ethical.

Corporate corruption generally takes two forms: engaging in bribe-making, usually as a supplier of bribes, and violations of ethical and professional standards with the intent to deceive or defraud investors. With respect to bribes, corporate corruption could consist of a representative of the firm receiving bribes in order to make a decision advantageous to the bribe-maker, or as a bribe-giver, either to another private party or to a representative of a domestic or foreign government.

In either public or private corruption, a dichotomy exists between what a person is charged to do and his or her actions. With public service, one is charged with serving the public and is compensated with a salary. Corruption occurs when one serves the public arbitrarily and with bonuses to one's salary. With private service, one is charged with serving the shareholders, or owners, of the firm for which one receives compensation. Corruption occurs when the worker's individual interests are served in a way that is not analogous to the interests of the company as a whole. (This problem only occurred in modern capitalism when ownership and management separated; Gitlow, 2005) Both forms of corruption involve misuse of one's position for personal gain – or in some cases company gain – at the expense of others, usually one's constituency.

All definitions of corruption include political corruption. 'Government for sale' is the phrase used to describe corruption where government property or services are privatized (see, for example, Schleifer and Vishny, 1993; De Soto, 2000). Corruption is defined by the World Bank (2005) similarly, as 'the extent to which public power is exercised for private gain, including petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.' The misuse of powers afforded by a government monopoly on services is the most restrictive definition of corruption.

The above definition defines the act by the actor, not by the action itself. All cases of corruption in the public sector include some combination of public officials, individuals, firms, or industries on one side and public officials on the other. That is, one cannot exclude private individuals or firms from even public corruption's definition. For this reason, broadening the definition of corruption and dealing with the action, rather than the actor, is the most sensible way to define corruption. Corruption research is moving in this direction, although many corruption indicators still explore only 'political corruption.'

Transparency International, a leader in fighting corruption,² has broadened its definition: 'Corruption is the abuse of entrusted power for private gain. It hurts everyone whose life, livelihood or happiness depends on the integrity of people in a position of authority' (transparency.org). This allows one to look at abuses of power rather than which type of actors are engaged in corrupt behavior.

2 Transparency International began publishing an annual Corruption Perceptions Index (CPI) in 1995 and now publishes a variety of indicators. This organization is often credited with putting the issue of corruption on the international policy agenda. It has 90 chapters around the world and ranks more than 150 countries by their perceived levels of corruption.

In this work, corruption is defined as any act where a trust between the principal, the one whose interests are supposed to be protected, is violated by the agent, the one who is supposed to be protecting the principal's interests. Rose-Ackerman (1975) describes how 'the person bribed must necessarily be acting as an agent for another individual or organization since the purpose of the bribe is to induce him to place his own interests ahead of the objectives of the organization for which he works.' This corresponds to Transparency International's definition, and it expands the definition of corruption into the broader realm of professional ethics. This principal-agent model is commonly used in the literature on corruption.

Corruption is a term that encompasses a wide variety of illicit behaviors. Some of these are illegal and others are not. All could at least be arguably unethical.

Corruption's Multiple Dimensions

Forms of corruption arise from a myriad of behaviors that are all lumped together and called 'corruption.' Confounding this problem are the subtle variations in how corruption is defined. Complicating how we view corruption is the possibility that some forms of corruption may allow us to accomplish goals in highly bureaucratic and inefficient environments better than we can if we are strictly honest and ethical. Corruption is a very complex issue, made no simpler by international production and commerce.

The discussion of 'corruption' groups together behavior that might arguably be considered unethical, which involves money, privileges, or favors in payment for a particular action, and through which someone is directly or indirectly harmed. A wide variety of unethical behaviors, such as bribery, fraud, kickbacks, and economic espionage, among other behaviors, are all grouped within this category.

One division within the acts that may be labeled as 'corrupt' is that which is done to benefit the firm in the short term and that which is done at the expense of the firm. Economic espionage and kickbacks, for example, are examples of unethical or corrupt behavior that may benefit the firm, although one might argue that the perpetrator committed the act more to enhance his or her career and reputation rather than to help the company. On the other hand, insider trading and securities fraud are examples of unethical or corrupt acts that harm the firm.

Transparency International also differentiates types of corruption by motive. Facilitation payments, or 'speed money,' is *according to rule* corruption; whereas a corrupt act committed in order to circumvent the law or regulations is *against the rule* corruption. Corruption behaviors that benefit a firm are also called *functional corruption*, whereas corruption behaviors that harm the firm are *dysfunctional corruption*. The basic idea is that some corrupt acts are part of management strategy to enhance profits and some are to enhance personal power and wealth.

This distinction is particularly relevant when discussing international business and corruption. Some acts, such as kickbacks and bribes, may allow the company

to operate more profitably, at least in the short run. The problem with working in a business climate where corruption is accepted is that engaging in such practices reinforces the corrupt culture. It requires that future business transactions offer similar 'perks.' It may violate the firm's code of conduct as well as the home country's legal norms. In such an environment, refusing to participate in the corrupt system may be disadvantageous in the short term because bureaucratic processes may move much slower and deals may be lost to another who is willing to 'be a player.'

Supranational organizations, such as the World Bank, and non-governmental organizations (NGOs), such as Transparency International, are mostly concerned with the kind of corporate corruption that may be beneficial to a firm in the short run, such as offering kickbacks and bribes to win contracts. Prohibitions against this type of corruption, are included as part of corporate social responsibility (CSR) programs. CSR policies adopt the perspective that managers must consider all stakeholders, the local community, local government, suppliers, as well as employees and shareholders. Through CSR policies that prohibit 'firm-beneficial' or functional corruption, companies constrain the supply side of corruption (who is offering a bribe, for example). These policies limit how money, favors, and gifts can be used to induce favorable business outcomes.

The difficulty in delineating between functional and dysfunctional corruption is that market economies and societies evolve. Gradually, many developing countries become better governed through rule of law. At some point, paying bribes to contractors and civil servants, insider trading, and other forms of corruption that are prevalent particularly in many developing countries, shift from being functional to dysfunctional. Bureaucratic systems become easier to navigate and systems become more transparent and more accountable. When this happens, the established procedures for public and private systems work well enough that corruption is not necessary. These actions no longer save a company money by facilitating bureaucracy and deal-making; they become burdensome additional costs for the company to bear. In other words, functional corruption is a part of a developmental stage of an economy.

Banfield (1975) differentiates *personal corruption* and *official corruption*. An agent is personally corrupt when he does not fulfill his obligations but serves his own private interests. She is officially corrupt when she acts illicitly in order to serve the principal's interests, such as by bribing someone to accept a contract's bid offer in order to gain an advantage for one's own firm. Using the previous terminology, official corruption might be functional and personal corruption might be dysfunctional.

The wording in the anticorruption convention sponsored by the Organization on Economic Cooperation and Development (OECD) differentiates between *active corruption* and *passive corruption*. Passive corruption is committed by a government official who receives a payment. Active corruption is committed by the one who pledges to give a bribe.

Another differentiation in defining corruption in the public sector is between *state capture corruption* and *administrative corruption*. State capture refers to the ability of an individual, firm, or industry to influence the content of law. Deflem (1995) discusses *bureaucratic corruption* which involves transfer of power and is similar to state capture. Bureaucratic corruption circumvents the regulations just as ordinary bribes do. Administrative corruption is the ability of an agent to affect how laws are implemented, i.e., this agent may receive special considerations when dealing with the state bureaucrats, regulators, etc. Public corruption which perverts government and misallocates power is viewed as the most egregious form of corruption by most people.

Complications from gift-giving practices

The concepts of rationality espoused by classical economics may be less important in conducting international business than relationships. In many cultures, people may require that a relationship be developed before business transactions occur. One way that this occurs is often through socializing and gift-giving that denote respect and appreciation or gratitude. It is often the case that in countries where commodity money (animals, furs, metals, etc.) were used recently, gift exchange is more common (Davies, 2002).

Cultural differences regarding such norms as gift giving make articulating international anti-corruption strategies difficult. 'Practices that one society condemns as corrupt are considered harmless or even appropriate in another cultural context' (Sandholtz and Koetzle, 1998).

Favors and gifts, which may seem like bribes to some, may be expected. A common, western example is that the service provider is expected to pick up the lunch bill for the potential client when initiating or reinforcing a business relationship. Is this a bribe? What differentiates this practice from expecting and accepting something larger and grander than a lunch bill? That which delineates a free lunch from receiving a grander favor or gift is largely cultural. Many societies do not differentiate between large and small gifts, while others do. What part of such practices is cultural, what part is acceptable, and what part constitutes an ethics violation? Unfortunately, there is no simple answer to this question, only guidelines.

Guidelines are created and reinforced by the individual's employer. In some cases, the guideline is to accept or offer nothing. For example, the author was explicitly prohibited from accepting a can of Coca Cola, a coffee cup, or writing implement from any student while teaching in the Kansas State University system. Rather than differentiate between 'appropriate gifts' and 'inappropriate gifts,' no gifts may be accepted. The protocol followed by employees of the *Economist* is appealing – one may accept any gift so long as it can be consumed in one day (*Economist*, 23 December 2006). A good bottle of Scotch is permissible, but two cases of champagne are not. Such a protocol allows for one to engage in local gift-

giving customs without allowing for excess to push the relationship into the realm of being corrupt.

Complications from lobbying practices and tipping

If corruption payments include a direct or indirect personal reward to the person providing the service from the person seeking the service, why do we not define lobbying and tipping as forms of corruption? The fact that one can legitimately pose such a question demonstrates how difficult it can be to define and understand what is and what is not corruption.

Because corruption is defined in vague terms and takes many forms, questions arise about accepted behavior, such as tipping for service and political contributions made by lobbyists. Eicher (2005) differentiates practices such as lobbying and tipping from outright corrupt acts through three criteria:

1. the payment is voluntary and not obligatory;
2. the size of the payment is negotiated; the seller does not set a 'monopoly price;' and
3. no social contract or trust has been broken (i.e., there is no principal-agent dilemma).

Corrupt acts normally violate all three conditions. In cases where a political figure requests a lobbyist to also satisfy all three conditions, public opinion holds this also to be corruption. Lobbying that does not require a payment and which does not persuade a political figure from violating the social trust that she has with her constituents does not satisfy these conditions and is 'legitimate.' Tipping clearly does not satisfy these conditions.

Some studies suggest that corruption and lobbying are substitutes, as seen in Harstad and Svensson (2006), for example, which is discussed in Chapter 2. As the society develops, lobbying replaces corruption.

Distinguishing between corruption and lobbying is certainly difficult. Both seek to persuade a decision-maker to act in the supplicant's interests; both often involve monetary gifts or other favors.³ Both depend upon personal relationships. One blatant difference between corruption and lobbying is that often the former is illegal, whereas the latter is legal.

3 Such monetary gifts may be direct and personally made or indirect, through political action committees and election campaign fundraising. While not all such donations are made with 'ulterior motives,' certainly many are.

Institutional Causes of Corruption

How do we get a corrupt society? The key source is weak institutions, whether one is examining public or private corruption. When these processes break down or are under-developed, agents can violate the society's institutional values with decreased threat of detection and punishment. In such an environment, corruption occurs. This is true of a developing country's politician extorting a bribe from a foreign company representative or of mismanagement of company funds in a developed country enabled by a lack of transparency to shareholders and regulatory agencies.

Institutions are weak when they are poorly developed or poorly enforced. When the institutions are weak, rules may be ambiguous. Consequently leaders are not held accountable for their actions. Bribery, nepotism and other undesirable behaviors result.

Institutions may be formal or informal. Formal institutions are those that with a tangible presence – buildings, organization, legal codes, etc., and have enforcement mechanisms in place. Laws, for example, are written codes of conduct for which a violator may be punished with incarceration or fines; laws are formal institutions. Traditions, customs, and attitudes, often based upon religious values, are often informal institutions. Both informal and formal institutions have methods for socialization, enforcement, and punishment.

These formal and informal institutions develop through historical experiences and factors that shape culture. It is not surprising then that Treisman finds several cultural experiences to be highly correlated with corruption, as discussed in Chapter 2. Among these are religious influence, democratic influences, and economic and trade development.

An excellent illustration of weakness in formal institutions occurred after the breakup of the former Soviet Union. The old order was almost instantly wiped out, and new laws, government agencies, codes of conduct, etc. had yet to be invented, while new economic, graft, and rent-seeking opportunities were created. Consequently, many politicians used their former positions of power to seize and divert national assets for their own private use. New entrepreneurs often worked through corrupt officials and around weak laws and policing systems.

In times of flux, social modes of control and organization are weakened. Huntington (1968) notes that transitional periods, from autocratic towards democratic, are accompanied by higher levels of corruption. It is at this time that corrupt practices are least detected and may produce the greatest profits.

Gitlow (2005) points to the concentration of power as the source for corruption in corporate America. This suggests that checks and balances are institutional means for controlling corruption and that a lack of them fosters corrupt tendencies. Sarbanes-Oxley, created in the wake of major corporate scandals, mostly enforces checks and balances upon officers, from separating functions of a position to improving transparency and accountability.

A vital issue to corruption is overall governance, whether one is looking at private or public corruption. Mr Wolfowitz, former president of the World Bank, defined governance as ‘the combination of transparent and accountable institutions, strong skills and competence, and a fundamental willingness to do the right thing’ (Wolf, 2007). Good governance institutions are necessary precursors for effective anti-corruption campaigns.

Institutions improve how well the society as a whole, and hence the business sector, operates. In such a system, rules for social conduct, political practices, and economic behavior are clearly articulated. Detection and enforcement mechanisms against violators are in place and they are effective. When everyone knows what the rules and punishments are, governance is transparent. Costs of each transaction can be clearly estimated. Procedures for achieving transactions and complying with regulations are understood. Middlemen or ‘fixers’ are not necessary. A level playing field exists between competing firms. This may not be advantageous to all parties, but it is optimal for the society as a whole.

The following can be a society’s strength or roots of corruption, depending upon their level of development and how they operate within the society:

- political networks and practices;
- economic incentives and rules governing the market;
- state legitimacy;
- effectiveness of governance;
- rule of law;
- social capital;
- cultural, moral and ethical orientation.

These factors enhance how well society functions if they are well governed and resilient. These same factors when poorly governed help to create an environment that is profitable to those who would engage in corrupt acts.

Political networks are mechanisms through which political and economic relationships are maintained. They create systems for behavior where each party helps the other. This may be legitimate behavior or, when rules of conduct are weak and violations are not penalized, this may exacerbate political and economic corruption. Strong rules that are clear and enforceable are needed to curb behavior that is fostered through political networks that cross a line of acceptable behavior.

Economic incentives clearly motivate people to violate norms. Greed and poor decision-making, coupled with a sense that no one would punish them, are now seen as being responsible for many of the excesses exhibited in the corporate scandals of the late 1990s. Each of the well-known cases involved large sums of money to tempt one into unethical behavior.

Rules and methods of accountability are required to limit how much economic incentives can tempt someone to discard norms and engage in corrupt behavior. In the case of private corruption, improved methods of accountability and transparency

curb this. In the case of public corruption, accountability is necessary, but equally needed are sufficient wages for public sector employees.

People who respect their officials as moral leaders are less likely to try to cheat, steal, embezzle, etc. When people perceive that their leaders are honorable and their government is acting to protect their interests, they are less likely to attempt to subvert social norms. Do people feel enfranchised – that they are part of government and that it is part of them? If so, people are more likely to respect its laws and regulations. State legitimacy and the effectiveness of government foster this feeling of enfranchisement and respect for authority.

Tied into notions of legitimacy and effectiveness of governance and government is rule of law.⁴ Civil societies are governed by discernible rules. *Ad hoc* rules and abuse of power operate where rule of law is absent. In the case of a company, the analogous factor is the ethics code of conduct. Many of the companies embroiled in scandals in the late 1990s had such codes, but employees did not know they existed. Such a company was not governed by the rule of law, but by *ad hoc* practices. In the case of countries where rule of law is weak – generally less developed countries – people have the power to operate capriciously.

Social capital, the embodiment of relationships that form community bonds and strengthen the society, is a double-edged sword. It takes place in social networks such as family, neighborhood, and community. These networks form linkages between people that allow a group to achieve goals and to regulate itself. Social capital may be an asset that allows the group to be more productive and to reduce conflict. It can also be a force that encourages disobeying external norms and rules when institutional enforcement mechanisms are weak, as illustrated through nepotism, biased bidding procedures, etc.

An example of strong social capital that fostered corrupt acts was the mafia. Mafia organizations were built upon notions of community, a brotherhood that protected its own. Jobs and protection were guaranteed to all of its members. While these aspects were beneficial, mafia organizations were notoriously connected to corrupt politicians, bribery, and illegal business operations. Such manifestations of social capital can worsen corruption.

Each society has its own moral and ethical orientation based upon its fundamental values. The underpinnings of each society's value system are the dominant religious and social values. For example, the paramount ethical value 'do no harm' is analogous to the Golden Rule, 'do unto others ...'. Value orientations vary from society to society, as each has its own influences of religion, culture, and historical events that shape it.

As countries have different moral and ethical systems, what is defined as corrupt varies from country to country. Some countries only view ethical violations

4 The rule of law provides a legal system with 'fair, transparent, and effective judicial institutions.' This is necessary to protect the rights of citizens from 'arbitrary use of state authority and lawless acts of both organizations and individuals.' Rule of law guarantees equal treatment before the law and human rights (USAID, 'Rule of Law').

as those involving public sector officials, and what is done in the private sector is just ‘market economics.’ Others view all behavior as subject to ethical codes of conduct.

In addition to how corruption is defined in the local economy, cultural factors play a large part in how frequently corrupt acts occur and how a society chooses to deal with its corrupt and unethical behavior. For example, the inclusion of women in the labor force reportedly reduces corruption – this would indicate a cultural influence. Factors such as a ‘Protestant work ethic’ may be involved, and indeed nine out of the top ten least corrupt countries in the 2006 Corruption Perceptions Index are predominantly Protestant countries.⁵

It is this uniqueness in societies’ moral systems that make ethics so interesting and so difficult. The vary nature of a unique value system makes the study of ethics relative. That is, no one ethical rule uniformly applies to all cultures. This is a notion that many ethicists are not comfortable with.

In practice in a global context, this means that one must operate in multiple ethical systems simultaneously – that of the home front, from where the individual is from and/or the company is based, and the foreign culture, where the individual is operating. Navigating across two ethical systems is treacherous. Illustrating this difficulty are those who are found guilty of the United States Foreign Corrupt Practices Act. These people often are following foreign customs involving corruption which violate their home country’s norms.

Corruption will be defined more explicitly in the chapter ‘Quantifying the Immeasurable’.

Why Corruption Matters

The discussion about corruption is all an academic exercise in ethics if no one is hurt by corrupt systems. Modern research strongly negates the notion that giving and taking bribes and favors is a ‘victimless crime,’ however. Some of the stylized facts concerning corruption are:

- Corruption reduces countries’ economic growth rates (Mauro, 1995).
- Corruption reduces private investment (Burki and Perry, 1998).
- Corruption limits economic development and well-being through depressed per capital income, increased child mortality, and illiteracy (Kaufmann et al., 1999).

5 The top ten best countries for lowest corruption are: Finland, Iceland, New Zealand, Denmark, Singapore, Sweden, Switzerland, Norway, Australia, the Netherlands. Transparency International, Transparency International Corruption Perceptions Index 2006, www.transparency.org (accessed June 19, 2007) Corruption ratings are discussed in more detail in Chapter 6.

- Corruption affects how countries formulate their economic policies (Bai and Wei, 2000).
- Corruption is correlated with economies that are dependent upon fuel exports, have less trade openness, and have more restrictive regulatory climates (Treisman, 2007).
- Corruption is lower in developed economies, historically liberal democracies, countries with a free press, countries with a high proportion of women in government, and economies that are historically open to trade (Treisman, 2007).

Public corruption hinders economic development and can also impact national security. The US Federal Bureau of Investigation ranks public corruption as its number four concern, preceded only by terrorism, espionage, and cyber crimes (O'Brien, 2005). When asked why corruption so concerned the FBI, the chief of the Public Corruption and Government Fraud program at FBI Headquarters, replies:

First, it strikes at the core of what our country's about. Our democracy depends on a healthy, efficient, and ethical government – whether it's in the courtroom or the halls of Congress. Second, public corruption can have a direct impact on national security. For example, in a recent case in Arizona, 26 current and former department of motor vehicles employees were indicted for taking cash bribes for fake driver's licenses, ID cards, and even a hazmat license. What if it's a terrorist trying to get one of those licenses? We've also seen bribes paid at our borders to let drugs come into the country. Again, what if a bribe lets a terrorist get through? (O'Brien, 2005)

Anti-corruption writers Heineman and Heimann (2006) condemn ideas that corruption may grease wheels of commerce and speed along governmental bureaucracy. 'Corruption distorts markets and competition, breeds cynicism among citizens, undermines the rule of law, damages government legitimacy, and corrodes the integrity of the private sector. It is also a major barrier to international development – systemic misappropriation by kleptocratic governments harms the poor.' Indeed, one of the newer criticisms of corruption is that it is the elites who benefit, worsening income inequality as well as hindering economic development.

In another statement by US government officials, Wayne and Jacobs state that the United States loses tens of billions of dollars in lost contracts (Federal News Service, 2001). Corruption creates a commercial loss for workers and owners of capital, as well as undermining good governance and democracy.

Clearly, it is not the case that corruption in the public sector only occurs in less-developed countries. However, it is true that countries that are better developed have stronger institutional bases for dealing with public sector corruption. In developed countries actively trying to control the supply end of international corruption, the policing body investigates such cases and arrests violators.

Because corruption is hidden, governments and NGOs can only surmise the economic costs of corruption. Some of the statistics that are published about its costs include:

- Over the past seven years, we have information or reports, rather, that USA citizens may have lost 100 contracts valued at \$30 billion (Federal News Service, 2001).
- The World Bank estimated that public officials around the world receive more than \$1 trillion in bribes each year (and that figure does not include embezzlement) (Heineman and Heimann, 2006).
- The Russian think-tank Indem estimated that more than \$300 billion in bribes is paid in Russia annually (Heineman and Heimann, 2006).

Another argument for protecting citizens against public sector corruption is to maintain public trust, i.e., the state legitimacy argument made above. 'People have a right to expect honest services from their public officials and our public corruption program is determined to prevent abuse of the public trust. Government is not for sale' (Swecker, 2006).

When civil servants and public officials deliver services or favors for a fee, this service has been privatized, which is contradictory to the nature of government and the public good. When bribes are traded for government controlled services, government is 'for sale.' This violates the trust implied in the social contract between those who are governed and those who govern.

One of the arguments against corruption has to do with fairness. Often cited is the desire for a 'level playing field' for all parties. This suggests that corruption is undemocratic and that a lack of democracy could retard productivity and growth. To the contrary, growth studies often show that an absence of democratic institutions does not inhibit growth. Corruption in the public sector may be undemocratic, but many countries exhibit high growth rates along with high corruption ratings (Campos, Pradhan, and Lien, 1999). However, growth does not necessarily mean improved opportunities for all. According to Lambsdorff (1999), 'corruption goes along with policy distortions, inequality of income, and lack of competition.' Corruption may be unfair and its presence may distort economic outcomes, but it is not necessarily bad for a country's GDP.

Another argument against corruption is that it distorts market outcomes. That is, it is 'inefficient.' When the costs of corruption are added into a firm's costs, it makes producing, importing, distributing, or marketing a product more expensive. Profits fall, affecting production decisions and value to shareholders. In a perfectly efficient capitalist market for a good or service, the cost of producing the last unit of a product equals the revenue it earns, so that exactly the right amount is produced. This squeezes out every last dollar that a producer can earn in a market and consumers receive the lowest possible prices for goods. This may be an abstract idea that works better in principles of economics textbooks than in real life, but the general principle holds: markets without distortions result in better outcomes

for consumers and better represent the positive outcomes associated with 'perfect competition.'

Costs rise due to public-sector corruption. Bribes must be paid. Uncertainty in regulation and bureaucratic costs exists. Delays are tacked onto production schedules. Producers and consumers lose. Ultimately, value to shareholders falls as firms produce less and costs rise. The only beneficiary in this scenario is the one who receives the 'rents' from corruption.

In the case of private corruption, such as embezzlement, engaging in side deals, unfair bids, etc., the costs rise, profits fall, and shareholders enjoy less return on their investment. When these costs are added to the costs of production, production decisions may be altered, thus causing market distortions (less efficient use of resources). Whether one is looking at a company from a theoretical economics perspective or from a practical business perspective, this outcome is sub-optimal.

Corruption is a factor in the widening of income inequality across the world and within countries. Forty percent of those countries in which corruption can be considered rampant are classified by the World Bank as low income countries (Transparency International, 2007a). Public corruption diverts resources away from citizens that could be used for improving health and education, which would increase incomes of poor people. Both public and private corruption enrich the corrupt elite. Both effects worsen income inequality.

Corruption also has sociological and psychological effects. Shame is attached to corruption scandals, whether they occur in the public or private sector, and confidence in leadership erodes. The degree of shame and how offenders are penalized varies across cultures. Indicative of this shame is that those who engage in corrupt acts never do so explicitly, and there is a rich vocabulary of euphemisms for engaging in either public or corporate unethical acts. These deeds are viewed so negatively that scandals may have a deep public effect. Citizens lose faith in their governments or consumers and shareholders lose confidence in firms. In the former case, democratically elected officials lose their power base should citizens become appalled with this behavior; in the latter case, managers are removed, firms may be fined or reorganized through the courts, and shareholders sell their shares. In either case, the reputation of the leaders is besmirched. Careers are lost and companies may be crushed.

Chapter 2

Government for Hire

Sharon Eicher

Introduction

This chapter covers political corruption or the misuse of government power for personal gain, with an emphasis upon those abuses relevant to living and working in a corrupt society. Corruption that occurs through the diversion of development aid and loans is not discussed here.¹

Public corruption is the area of corruption which has gathered the most interest by international agencies. The most conservative definitions of corruption include only corruption in the public sector. Oft-quoted Nye (1967) describes public corruption as:

Behavior which deviates from the formal duties of a public role because of private-regarding (personal, close family, private clique) pecuniary or status gains; or violates rules against the exercise of certain types of private-regarding influence. This includes such behavior as bribery (use of a reward to pervert the judgment of a person in a position of trust); nepotism (bestowal of patronage by reason of ascriptive relationship rather than merit); and misappropriation (illegal appropriation of public resources for private-regarding uses).

Similarly, 'The pattern of corruption may therefore be said to exist whenever a power holder who is charged with doing certain things, that is a responsible functionary or office holder is by monetary or other rewards, such as the expectation of a job in the future, induced to take actions which favor whoever provides the reward and thereby damage the group or organization to which the functionary belongs ...' (Friedrich, in Heidenheimer and Johnston, 1989). Such definitions focus upon the role of the public servant. Such a definition of corruption includes monetary forms of corruption, bribes and misappropriation of funds, and non-monetary forms of corruption, such as nepotism.

Public corruption is also the type of corruption that international agencies and NGOs seem most keen on controlling. Only recently has the discussion broadened from corruption in the public sector to corruption in both public and private sectors.

¹ Such far-reaching corruption, Herfkens (2001) labels as 'macro-economic corruption.' Such corruption has direct links to poverty reduction, or lack thereof.

Foremost American expert on corruption Rose-Ackerman (1975) does not limit corruption to only public corruption, although a stipulation is that the bribee must be in a position of power. The source of this power may be due to market imperfections or discretionary authority. Discretionary power is inherent in any political position where services are available only through a 'government monopoly,' for example, obtaining a driver's license may only be done through a government agency.

Private corruption involves activities such as improper financial reporting while a manager is buying or selling personal stock in the company, side deals with contractors, suppliers, or purchasers, embezzlement, etc. Public corruption includes illicit activities carried out by representatives of the police, judicial branch, elected officials, bureaucrats in the civil service, etc. This may include accepting bribes or merely accepting gifts or favors in exchange for publicly provided services or goods, such as accurate police reports, fair decisions in court, reasonable speed for processing government required documents, adequate and fair regulation, etc. This chapter examines aspects of public corruption, which local and foreign citizens and firms must deal with in everyday life and work relations.

Public corruption scandals are not limited to developing countries. Human beings are corruptible and many are quite greedy. The only other necessary ingredient is opportunity.

'Big' public corruption scandals make (or sell) news. These stories may be about officials, as was the case of Chinese former head of the Food and Drug Administration Zheng Xiaoyu, who was sentenced to death in July 2007. He was found guilty of accepting bribes for untested medicines in which at least ten people died. These 'big scandals' may be about political figures associated with public figures, as was the case of Jack Abramoff, who was linked to former House Majority Leader Tom DeLay, Ohio Republican Bob Ney, Californian Republican John Doolittle, and Montanan Republican Conrad Burns. The 'Republican superlobbyist' Abramoff pleaded guilty in January 2006 to several felony offenses, but it was his political associations that made his story headline news. On the other hand, petty tales of political corruption and corruption in the marketplace may be more onerous and more costly to the local population, but these make less interesting news stories.

Illustrating the popularity of some types of corruption over others is the frequency of hits from Internet search engines for corruption terms. We do not know how often private and public forms of corruption occur, but we can draw some inferences from reports appearing on the Internet, found through Internet searches.

We cannot infer from Internet searches that what appears more often occurs more often as reports are not weighted evenly. These hits indicate public interest as they tell us the frequency with which certain types of corruption are reported on the Internet. What is of greater interest is reported more frequently. This suggests that the greatest corruption concern is fraud, which includes both public and

Table 2.1 Frequency indicator for corrupt behaviors: Internet hits for corruption terms (search date: 22–23 August 2007)

Boolean terms searched	Hits on Google News	Hits on Yahoo search engine
fraud/corporate fraud	35 362 (43%)	169 000 000 (52%)
corruption	31 098 (38%)	121 000 000 (37%)
bribe/s	8 226 (10%)	13 900 000 (4%)
graft	3 212 (4%)	11 300 000 (3%)
kickback/s	2 379 (3%)	5 320 000 (2%)
embezzlement/s	1 609 (2%)	3 690 000 (1%)
misappropriation of funds	310 (0.4%)	961 000 (0.3%)

private corruption, bribes and graft (which usually, though not necessarily, refer to public corruption) are also frequent.

Before corruption was a popular topic of discussion and generated such Internet hits, ‘white collar crime,’ was a term used to describe similar behavior. This phrase was coined by Edwin Sutherland in his 1939 address to the American Sociological Society (Coleman, 1987). This was a general term to capture professional misconduct of an illicit nature. It ranged from stealing a stapler from work to grand larceny. This form of corruption could apply to public or private sector employees.

‘Government for Hire’

The phrase ‘government for hire’ has become a common one. The phrase suggests that private-sector market economics is the mechanism behind which one receives government services that should be provided free, or for a nominal fee.² Ideally, there are no ‘markets’ in receiving government services, and certainly no auction markets, although these services may require fees. When fees are required, they are legally set fees to cover the cost of providing a service or they may be to allocate a scarce resource, such as with hunting and fishing licenses. The fee scale is published and collected fees contribute to government revenues. These fees have no strings attached.

When government services become privatized though corruption, the fees charged are not published, because they are illicit. These payments are hidden

² Some references to the phrase ‘government for hire’ refer to a very different concept of outsourcing and privatizing a government service.

and are often not made directly. These fees do not offset operating expenses and do not add to government revenues. Rather, they add to the income of the public employee, politician, judge, or political party member. These fees are payments in exchange for some kind of special, prohibited privilege.

Causes of Public Corruption

Corruption is a function of potential payoff, the risk of being caught and punished, and the moral or psychological costs upon the individual. Rose-Ackerman (1978) described the cause of public corruption as simply perceiving the potential benefits of corruption as exceeding the potential costs, an economics argument. The relationship between relative payoff and moral cost can be summarized with the word 'greed.' Also related to the moral cost, or lack thereof, are some of the political motivations for public corruption.

It's economics

Greed is instrumental in causing public-sector corruption, but the greatest source is inadequate pay. Bureaucrats are often paid the lowest salaries available. Judges are paid just as poorly.

Corruption has been improved by raising salaries and changing the culture of corruption. Illustrating this was the case of Singapore. The prime minister, Lee Kuan Yew, argued that salaries of government employees had to rise to control corruption or graft and corruption would continue (Rosario, 2006). The government responded and raised salaries, and Singapore became a model country with low levels of corruption. Less impoverished employees have less incentive to try to earn income through illicit means.

More is involved than just poor pay. Vladimir Putin issued a decree raising the salaries of government ministers and thousands of lower-level state employees in 2004. Russia's Corruption Perceptions Index worsened.³ In Russia, it seems that the president's interest in corruption is better correlated with improving this score than public-sector salaries. Alternatively, it is also possible that salaries still remained too low.

While Putin raised minister's salaries to \$3000 per month, federal employees' salary increases were \$100–500 per month (Bransten, 2004). Corruption earnings could easily exceed pay hikes. Laurence Cockroft, chairman of Transparency International's British chapter, states that the information available to ministers has the potential money-generating power of millions of dollars; quadrupling salaries cannot compete with such potential corruption rents.

3 Russia's Corruption Perception Index was 2.1 in 2000; it was 2.8 in 2004 and fell to 2.5 in 2006. (Higher numbers mean less corruption is perceived.) Russia had a score of '1' in the EIU's 2007 corruption data – the lowest possible score.

China also tried raising salaries in 2004 with similar results. It may also be relevant that in both of these cases, both BRIC countries, the private sector and markets are developing rapidly. Returns to corrupt behavior are likely to be higher in rapidly growing economies, where economic growth outpaces institutional development.

However, pay is a large contributor to the problem. In transitional countries, the minimum civil servant's monthly salary can be as low as \$20 in Tajikistan or \$800 in oil-rich Kazakhstan (Bransten, 2004). In both countries, the cost of living exceeds the monthly salary.

It's politics

Countries' anti-corruption programs are often sincere expressions of a desire to improve rule of law and to raise honesty and integrity levels in the society, such as with the example of Singapore. Oftentimes, however, anti-corruption campaigns are functions of internal politics and 'scandals' are merely exercises for forcing unpopular political figures out of the political arena.

Illustrating this was the case of the ouster of the son-in-law of President Nazarbayev of Kazakhstan, Rakhmat Aliyev (Chivers, 2007). Aliyev, who had served as ambassador to Austria, developed political aspirations. He criticized his father-in-law Nazarbayev for enabling the president to remain in office indefinitely. Aliyev was dismissed from his position, and he was accused of kidnapping two bank presidents and demanding that they sign over to him their family interests in their banks – a case of corruption plus assault and kidnapping. Aliyev may, or may not, be guilty. What is significant is that accusations were raised only after he began to compete politically with President Nazarbayev.

Another political dimension to the corruption control problem is how deeply rooted it is in public culture. To curb public corruption politicians, judges, policemen, bureaucrats, and political party workers must be held accountable. In most situations, public corruption operates on the basis of a pyramid scheme. Those at the bottom pay a portion of their ill-gotten gains to their superiors. Accountability is enforced by the superiors. So long as they are benefiting from the corrupt system, leaders are unlikely to forsake these benefits and to punish subordinates who are dishonest. In fact, the opposite is often true. Honest bureaucrats may be demoted or not promoted, because they fail to contribute to their superiors' incomes (Eicher, 2005).

Officials may be accused of corruption and forced from their positions for political reasons unrelated to corrupt activity. Corruptible public officials who demand bribes may be preferred for promotion over those who fail to collect corruption payments in the public sector's bribery pyramid scheme. Politics plays an important part in corruption practices and anti-corruption purges.

Where and How Public Corruption Occurs

Public corruption is occurring whenever an elected or appointed official or public-sector employee is serving his or her own needs, or the needs of relatives or friends, at the expense of the public interest. This is behavior 'which deviates from the formal duties' (Nye, 1967) of one's professional position, out of self-interest rather than from incompetence or ignorance.

Heads of state, national representatives, and ministers and secretaries of ministries and federal departments are implicated in corruption scandals, but corruption is a daily event, rather than an isolated event which occasionally makes the headlines. In highly corrupt countries, public corruption is encountered every day, from being stopped for a mythical traffic violation to paying underpaid school teachers to pass one's child. Examples of daily corruption experiences in many countries are described below.

Police

Law enforcement officials are paid on the lower end of civil servants' salary range. When someone is stopped for a traffic violation, public intoxication, larceny, and perhaps even murder, how these cases proceed depends upon how corrupt the officer is and how large the bribe is.

Military service

In countries with mandatory conscription, it is not uncommon that one receives a special dispensation from service if the right officers or officials receive a bribe. One may bribe to receive a waiver or a medical excuse to avoid service which other countrymen must complete.

Public education

Educational systems may also be corrupted as teachers receive low salaries. This applies to university systems as well. Exams and class attendance are waived if the instructor receives an adequate bribe. Bribes may be extorted from parents in order for a good student to receive a well-deserved passing grade. In some systems, even university graduate degrees allegedly can be purchased.

Public health

Many developing countries offer free health services, but waits are long and quality of service may be poor. Doctors are more receptive, and service may dramatically improve with the correctly placed bribe.

Procurement and tenders for public projects

This is a corruption area that has the potential for large benefits to public officials and to companies. Tenders should be evaluated on the basis of cost, plans, and past performance of the firm. Tenders that are accompanied with bribes may be preferred over tenders that better address the project's needs. Tenders won through bribes may not be the most cost-effective and from the most competitive firms.

Concessions for extraction rights

Many countries restrict extraction of valuable natural resources, such as oil and gas, to those firms which acquire concessions to drill, mine, and tap natural resources from the government. Such concessions create monopoly access to firms and are quite valuable. Hence, many firms are tempted to win such concessions through corruption payments to decision-makers. Such payments are costly to both firms and citizens of a country who are denied legitimate inflows of revenue used to fund public programs (corruption payments will necessarily reduce the maximum bid that a company will make to gain these concessions).

Applying for employment

Nepotism is a common problem in many countries that experience corruption. Employees may be selected for their personal relationships, rather than upon their merits. This offers an unfair advantage to those who are better socially networked. Employment opportunities may also be linked to an applicant's ability to pay a bribe. This offers an unfair advantage to less worthy, but more affluent applicants.

Licenses and permits

Companies and residents alike require licenses and permits that are issued by bureaucratic offices. Registering a firm or renewing a license may be nearly impossible without several bribes.⁴ Residence and construction permits may also require bribes.

Paying taxes

One does not need to pay a bribe for the privilege of paying taxes, but tax inspectors in various countries reduce one's tax bill after receiving a bribe. In some countries

4 De Soto (2000) conducted an experiment in Peru to see how long it took to receive all necessary business licenses for a new start-up. A team spent 6 hours a day and, in 289 days, they received their documents. De Soto shows that there are often 50–200 procedures required to register a new business.

tax inspectors visit small business owners on site to collect various taxes. Such a system is easily abused.

Regulation

This is most burdensome on small business owners. Health, labor, environmental, safety and fire inspections may be done on site. Inspectors may 'find' many violations if not compensated. Violations suddenly disappear following receipt of a bribe.

For most foreign businesses, procurement and tender preferences related to bribes may be the dimension of public corruption that affects them the most. However, foreign company employees have to operate and perhaps live in this climate, thus personally encountering other forms of corruption as well. A heavily corrupt bureaucracy can be a great nuisance, as it seems that one encounters it in every aspect of life.

The above types of administrative corruption are often referred to as *petty* corruption. 'And while it does not reshape national policy or work on a macro-scale, there is in fact, for the majority of its victims, nothing petty about it. We are talking about government benefits such as social security, insurance, the amount of taxes to be paid, affecting legal outcomes or paying officials to "look the other way"' (Herfkens, 2001). Such corruption denies citizens rights or assistance they are guaranteed by the government, but which they are unable to receive. Those without means to work the corrupt system may be denied medical services, educational opportunities, or may be harassed daily. Petty corruption worsens the country's business climate and makes normal day-to-day transactions more difficult.

The OECD rates regions of the world for how corrupt public sectors in these areas are. This kind of generalized view is useful only inasmuch as countries within regions of the world share cultural similarities which contribute to some types of corruption. The OECD results are represented below with index numbers of 1 to 4, 1 being least corrupt and 4 being most corrupt. Of the four public sectors (the utility sector, public taxation, public procurement, and the judiciary), public procurement was almost always the most corrupt and utilities were usually the least corrupt.

Two anomalies from the general trends are that the judiciaries in South Asia and tax authorities in sub-Saharan Africa are relatively less corrupt sectors than other regions.

Administrative corruption increases costs to every citizen and firm that has to deal with any government agency. Bureaucratic costs are composed of time, effort, and the explicit costs from corruption payments. The actual payments for 'petty corruption' is often small, but the time and effort expended may be substantial, although often payments are designed to decrease one's effort and time expenditures.

Table 2.2 Integrity in public services by region

Region	Utilities	Taxation	Procurement	Judiciary
OECD	1	2	4	3
East Asia (Newly Industrializing)	1	2	4	3
East Asia (Developed Countries)	1	2	4	3
South Asia	2	3	4	1
Sub-Saharan Africa	3	1	4	3
Former Soviet Union	1	2	3	4
Eastern Europe	1	2	4	3
Latin American	1	2	4	3

Source: OECD, Integrity in public procurement: Good practice from A to Z.

Such costs are annoying, because they are unreliable. Fees and procedures are variable and may not deliver desired results.⁵ New ‘fees’ may appear. Administrative corruption is enabled by the lack of transparency and accountability that poor governance affords public employees and officials. The rules can change; which agency is the responsible agency that one needs to work with may not be public information; the chain of command may be unclear. Hence, citizens and firms may have little choice but to hire staff to wade through the bureaucracy or to expend a great deal of personal time. Such annoyances and the costs of personnel, as well as the financial costs raise the cost of doing business.

The Notion of State Capture

Corruption to the degree of state capture suggests that officials are so highly corruptible that they permit private interests to influence policies and legal reform. (This is also an argument for comparing lobbyists and bribe makers.) If state capture exists, well-connected and affluent private parties can set policy and laws to suit their personal and business interests. Some oligarchs in former Communist countries, for example, have been accused of holding this kind of power.

⁵ Several sources note that if bribed officials do not deliver the promised services, contract, etc., there is no effective means of recourse or means to lodge a complaint, as it is generally illegal to be party in bribing a public official or government representative.

Nice (1986) tested theories about whether corruption altered policy outcomes. He tested if political corruption especially harmed the poor and benefited the wealthy, by decreasing benefits from unemployment, welfare programs, and education. When state social and economic traits were included in the model, Nice was unable to show any policy impact from corruption. These results suggested that state capture was not much of a risk, at least not in a developed country. Meier and Holbrook (1992) pointed out that the use of audits to deter corruption may have convinced officials that their corrupt acts were more likely to be discovered and this deterred corruption. Given the decreased level of accountability, the odds of state capture would be greater in developing countries than what Nice observed in developed countries.

Herfkens (2001) describes various types of corruption including state capture. Her analysis below focuses upon how this harms businesses seeking access to markets:

This phenomenon refers to the capacity of firms to shape and affect the formation of the basic rules of the game through private payments to public officials and politicians. Influence tends to be inherited by incumbent firms with formal ties to the state... This is certainly true within the transitional societies. But it is also true, though for different reasons, in countries and regions where military rule has created its own business elite, where certain ethnic, religious or linguistic groups have long ruled and created exclusive business circles. And it exists in non-communist countries where one-party rule has been a historic and all-pervasive legacy. Concentrations of wealth accumulate to the detriment of other businesses that cannot compete. And to the detriment of the rest of society which is shut-out of the market. New empirical data on capture economies underscores how business can not only corrupt, but also impede the economic growth of the entire society.

Where social and political networks are long established, opportunities for state capture are more available. These networks effectively limit access to their members. This is one of the few negative sides to a society's wealth of social capital.

State capture is enabled best through the concentration of power, either political or economic. While it benefits existing firms, it is detrimental to competing firms trying to enter a market.

Lobbying

One may ask how state capture, where social and economic powers directly influence the content and implementation of laws, is different from a system where elected officials accept money from political action funds and lobby groups. Corruption of public officials and lobbying both seek to influence the execution of duties carried out by government representatives and civil service employees.

One difference between lobbying and corruption is legality. Lobbying is allowed in most systems, whereas public corruption is legal in fewer and fewer countries. Ethically, the differences between the two may be a matter of degree. Lobbyists influence. State corruption to the extent of 'state capture' needs no influence; it owns the system.

Harstad and Svensson (2006) present a model where corruption payments and lobbying are substitutes in a growing economy where firms are subject to government regulation. They show that small firms (firms with small levels of capital) tend to bribe. The size of the corruption payments increase as capital levels increase, which decreases incentives to invest more or until bribe-takers price themselves out of their market. The former contributes to creating poverty traps with persistent corruption. Their model suggests that an industry's size is a good predictor of when lobbying will replace corruption.

Legal Status

White-collar crime is defined as a violation of the law committed by one holding a position of respect and authority in the community who uses his or her legitimate occupation to commit such as action (Coleman, 1987). This closely parallels the type of wording used to make public corruption illegal.

The law contains many ambiguities with respect to private corruption. However, public corruption is usually clearly defined as illegal, whether or not this is enforced. Countries that did not previously have anti-corruption legislation regarding their civil service and judiciary are now creating such laws. The OECD and UN anti-corruption legal campaigns have done much to encourage countries to enact such legislation.

Citizens of countries that have signed the OECD Convention (discussed in other chapters) are all required to abide by laws that prohibit the bribing of any public official, party representative, etc. This convention encourages legislation similar to the U.S. Foreign Corrupt Practices Act which has imposed such restrictions on American business professionals since the 1970s.

What Can We Say about Corruption and the Type of Government?

Sandholtz and Koetzle (1998) define public corruption as a violation of trust, equality, and openness that is basically undemocratic:

Democratic norms embody these ideals; in a democracy, all acts of government derive their legitimacy, in principle, from the will of the citizenry (or a majority of it). Public office is therefore a fiduciary trust exercised not for the personal benefit of the officeholder but on behalf of the people. Corruption perverts two central norms of democracy: equality (corruption entails special access and influence) and openness.

Sandholtz and Koetzle (1998) test the hypothesis that democratic institutions help control corruption. They find that when these variables are used as independent variables in a statistical regression to explain corruption, each has a significant, negative coefficient. This suggests that democratic institutions (economic freedom, political and civil rights, and years of democratic rule) decrease corruption. This reinforces the need for improving governance and democratic practices in order to control corruption.

Another indicator of democratic society is competition between parties and the ability to execute checks and balances. One check upon corruption occurs through auditing financial records. Meier and Holbrook (1992) examined the number of public officials convicted in each US state between 1977 and 1987, from US Department of Justice data. They demonstrated that a society's urban population, size of government employment, and officials' gambling arrests were statistically significant at increasing corruption. A state's percentage of college-educated citizens, political party competition, and access to computers (which enables audits and better communication) were statistically significant at reducing corruption levels.

Lederman, Loayza and Soares (2001) study the determinants of corruption with panel data. They demonstrate that political institutions affect corruption through accountability and how public goods are provided. 'Political mechanisms that increase political accountability, either by encouraging punishment of corrupt individuals or by reducing the informational problem related to government activities, tend to reduce the incidence of corruption. Also, institutions generating a competitive environment in the provision of public services tend to reduce the extraction of rents, therefore reducing corruption.' Certain democratic institutions, such as parliamentary systems, political stability, and a free press correspond with decreased corruption levels. Openness and rule of law are less associated with corruption once other variables are included.

Treisman (2000) examined cultural and historical factors which explain public corruption well:

- protestant traditions;
- histories of British rule;
- economic development;
- federal political structure;
- exposure to democracy (though degree of democracy was not significant);
- and
- high levels of imports (weakly significant).

Treisman theorizes that Protestant sects were less hierarchical and arose in systems where state and religious hierarchies were not intertwined, in comparison to many other world religions. Past association with the British Empire greatly decreased corruption, which seems partly due to the Anglican influence. Ethno-linguistic distinctions were not good at predicting corruption. Countries which

were never colonized were not less likely to be corrupt today. When looking at fuel, metal, and mineral exports, corruption in the early 1980s could be explained much more successfully than corruption in the late 1990s. Not only was having a federal political system relevant in explaining corruption, but so were cultural factors, such as Protestant tradition and history of British rule.

Economic development is another factor contributing to the government's development and governance. Developed, higher-income countries can afford well-run administrative systems with clear rules and less opportunity for officials to deviate from proscribed norms. More depends upon how taxation and regulation are administered than whether they exist, i.e., people are not using corrupt means to avoid taxes when these systems were administered well. With good governance, fewer firms 'go underground' (Johnson, Kaufmann and Zoido-Lobaton, 1998a, 1998b) or are forced to participate in corruption payments.

Public corruption is enabled through limited access to government allocated resources as well as poor governance. Lack of transparency and lack of accountability make complicated bureaucracies more complicated and reduce options available to citizens and firms who try not to engage in corruption payments. Such lack of transparency and accountability reaches the highest levels of government in some cases and without information and democratic checks and balances, citizens cannot effect change in their countries.

More democratic systems allow for change. The public can elect better state officers and remove corrupt and inefficient incumbents from office. Governance improvements require commitment from leadership which is not going to happen if an undemocratic system has a corrupt person in charge, and his or her cronies are running the rest of the government. This is true of developed and developing countries, democracies and authoritarian states.

A well-regulated and transparent institutional environment creates opportunities for better economic results and improved financial stability. Therefore, institutions such as the IMF, World Bank, OECD, UN, and Transparency International have been striving to improve transparency in governmental systems. The IMF and World Bank have created 12 areas in which countries can boost their institutional environments in order to improve governance and decrease corruption. These are in the areas of public policy, financial regulation, and market integrity.⁶

6 These are Data Transparency (*Special Data Dissemination Standard* and the *General Data Dissemination System*); Fiscal Transparency (*Code of Good Practices in Fiscal Transparency*); Monetary Transparency (*Code of Good Practices on Transparency in Monetary and Financial Policies*); Banking Supervision (*Core Principles for Effective Banking Supervision*); Securities (*Objectives for Securities Regulation*); Insurance (*Insurance Supervisory Principles*); Payments Systems (*Insurance Supervisory Principles and Recommendations for Securities Settlement Systems*); Money Laundering (Financial Action Task Force's *40+9 Recommendations*); Corporate Governance (*Principles of Corporate Governance*); Accounting (*International Accounting Standards*); Auditing (*International Standards on Auditing*); and Insolvency and Creditor Rights (*Principles for*

Lack of transparency is the main obstacle to monitoring bureaucrats and publicly elected or appointed officials. When we examine the private organization of companies in the energy sector, EITI, we see that their efforts are to raise public awareness of oil, gas, and mineral revenues going to the state, in order to make it more difficult to divert public funds. When we examine the work of public officials in Uganda (Reinikka and Svensson, 2007) we see that publication in the press of budget allotments improves the flow of public funding to its intended target, in this case to schools, by making officials more accountable.

Publicity cannot solve all the problems of corruption and diversion of funds in the provision of local services. And improving schooling requires more than to improve governance in general and governance of social services in particular. However, one conclusion we draw from the Uganda experiment is that since traditional approaches to improve governance have produced weak results in most developing countries, experimentation and evaluation of new tools to enhance accountability should be an integral part in the research agenda on improving social services and reducing public corruption.

Since corruption is hidden and disguised, shedding light upon it may be the best way to eradicate it, whether it occurs in the public or private sector.

Conclusion

Government for hire is the idea that services that ought to be equally accessible to all are privatized. Benefits of government services and access are then restricted to those with the ability to influence, generally through gifts, favors, and money. Such a system is only possible through the limited access that governments create. Governmental controls are beneficial in theory, but the limited availability of scarce, necessary resources combined with poor oversight and cultural norms that are favorable towards corruption, result in an abuse of power that is difficult to resolve.

We generally see merit in trying to control monopoly powers. Consequences of a monopoly industry are that technological innovation slows due to lack of competition, quality of services can degrade, and consumers may be victims of price-gauging. Government goods and services are monopolistically supplied. These are viewed more favorably than privately supplied services and goods only because the public can hold government excess in check – theoretically – and government officials are motivated by the desire to serve public needs and improve welfare, not by profits – theoretically. The problem is that when public and political agents are not held in check, i.e., if democratic institutions are weak, or when government officials are motivated by incentives other than altruism and

serving the public, government monopolies are no better than private monopolies in terms of their possible negative consequences.

Furthermore, as government services and goods are monopolistically supplied, there are information asymmetries between the ‘consumer’ of the service, the private individual or firm, and the supplier, the government agency allocated these monopoly rights. ‘In this context, corruption arises spontaneously as a consequence of the existence of rents and monitoring failures. The possibility of rent extraction and the precise nature of the informational problem depend on the political institutions, which determine the incentives facing individuals dealing with and within the state’ (Lederman et al., 2001).

Coleman described the requirements of motive and opportunity to stimulate white-collar crime. Unchecked public officials have monetary motives and opportunities offered through monopoly powers to supply a good or service in demand. After all, who else may supply a driver’s license or building permit than a local government official?

If accountability is important, then nothing is more essential for holding elected officials accountable than democratic elections. Nothing is more essential for holding appointed officials accountable than transparency and disclosure of their budgets and administrative procedures.⁷ Equally important is the existence of a higher authority to monitor public and political agents. There must be a credible threat of removal and penalty before policies to eradicate public corruption can be effective. If the holder of the highest office in the land is himself or herself associated with corruption favors and payments, as is the case in several countries, it seems unlikely that an authority exists to properly monitor public corruption.

7 Such ideas have been discussed by authors such as Bailey and Valenzuela (1997); Djankov et al. (2001b); Laffont and Meleu (2001); Linz (1990); Linz and Stepan (1996); Persson, Roland and Tabelini (1997); Rose-Ackerman (1999) and others.

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Chapter 3

When Shareholders Lose (or Win) through Corruption

Sharon Eicher

Introduction

Whether shareholders gain or lose through corruption depends upon whether or not corruption payments affect the revenue and costs of public companies. If business could not function without corruption payments – if one subscribes to the ‘corruption is grease that oils the wheels of commerce’ concept – then corruption payments are necessary costs, and are no different than wages and material costs. If one views corruption as unnecessary for business to occur, then corruption adds to normal production, distribution, and marketing costs. This decreases company profits and returns to shareholders through lower dividends and lower stock prices.

Setting the tone for the public’s view of private corruption were the many cases of criminal mismanagement that occurred in many large corporations which became publicly known at the beginning of the millennium. The beginning of 2004 was an especially busy season in the United States for its federal anti-fraud and securities divisions. The following cases illustrate the variety of senior-level corporate corruption and the concentration of high-profile cases occurring just within 2004.

On March of 2004 Martha Stewart was released from federal prison. She had served five months for her conviction for conspiracy, obstruction, and lying to US federal investigators regarding insider trading which allowed her to avoid losing \$50 000 from ImClone stock by selling the stock on the basis of ‘insider information,’ rather than waiting for this information to become public or reporting this sale to the SEC. ‘Her “guilty” verdict and prison sentence served as a dramatic morality tale for the public and corporate leaders by demonstrating that fame, wealth, and power could not provide immunity from the prosecution and punishment of corporate deviance’ (Orcutt, 2007).

Bernie Ebbers, then the CEO of WorldCom, was said to run ‘one of the most successful companies in the telecommunications business’ (Time, cyber elite) – or at least he did before being convicted of fraud. His company had improperly booked \$3.8 billion in expenses and was facing \$41 billion in debt (Beltran, 2002).

Two weeks after Stewart’s release, Bernard Ebbers was sentenced for securities fraud, conspiracy, and filing false reports. Ebbers’ bankruptcy of WorldCom, a

global telecommunications company, cost investors \$11 billion.¹ He received a 25-year sentence in 2005.

Dennis Kozlowski, former CEO of Tyco International, had a mistrial in 2004 and was retried and sentenced in 2006 on 22 counts and for up to 25 years (Orcutt, 2007). This case is discussed further later on in this chapter.

Richard Scrushy, former CEO of HealthSouth, was indicted in 2003 for misreporting HealthSouth's profits from 1996 until 2002 (Crawford, 2005). He was also charged under the Sarbanes-Oxley Act.² He ultimately was indicted and tried in federal court in 2005 for conspiracy; mail, wire and securities fraud; false statements; false certifications and money-laundering. Five of his CFOs testified against him in a \$2.7 billion accounting fraud case (Crawford, 2005). Scrushy was acquitted in 2005. While this case was indicted in 2003 and tried in 2005, it was one of the corporate corruption cases frequently discussed in the media in 2004.

Kenneth Lay was indicted for his role in the Enron collapse in 2004, primarily for manipulating Enron's publicly reported financial results. Before Enron's downfall it was the seventh largest corporation in the United States. A revealing piece of evidence in the Enron trials were a series of audio tapes of Enron's energy traders joking about their illegal efforts to maintain critical shortages of electric power and drive up energy prices in Western states. This case took on a political tone because of Lay's affiliation with members of the Bush administration.

The case was awaiting sentencing in 2006, when Lay died from a heart attack. It is not even possible to estimate the total lost due to Enron's mismanagement and collapse, as many companies were embroiled in the scandal, and many of Enron's losses were diverted into separate shell companies, resembling a pyramid scheme (BBC, 2004b).

Each of these cases represented corrupt acts by senior managers of companies. Each, bar Stewart's, represented cases where these actions directly harmed shareholders. The plethora of scandals occurring in the beginning of the 2000s helped to inform the public about the frequency of corruption within corporations and how this corruption occurred. While these cases made headline news and cost investors and the public billions of dollars, they were probably miniscule when compared to the aggregated 'petty corruption' that has occurred in private and public organizations and when compared to all corporate corruption, including that which has not been punished.

These cases also demonstrate that while much of this chapter concerns corruption involving foreign countries and representatives of multinational firms working overseas, corruption occurs in developed countries. As Coleman points

1 According to the FBI's statistics for conventional crimes in 1999, this amount exceeded all costs of robbery, burglary, and larceny-theft combined to US citizens (Orcutt, 2007).

2 He was charged under the provision of the Act that requires CEOs and CFOs in public companies to ensure the accuracy of all financial reports.

out, to become corrupt one requires motive and opportunity. Both are available in Western countries as well as in developing countries.

Doing Business is ‘Different’ Abroad

Much of learning to work overseas is to learn to overcome one’s preconceived ideas. We all are victims of our biases. These biases are not so much prejudices as much as assumptions that we make, often incorrectly, about how people in other countries accomplish the same tasks that we do in our home environments.

In Western countries, laws often set the guidelines for what is and what is not acceptable business practice. In non-Western countries, rule of law is often less developed. When rule of law is weaker, individuals tend to direct social interactions and to be more arbitrary in decision making, rather than laws and norms being uniformly applied to everyone.

As stated in Chapter 1, corruption is not a recent problem, a problem of developing countries, or a problem solely of the misuse of power by politicians and civil servants. Historical references indicate that corruption has long existed, that it occurs in developing countries as well as well-developed ones, and that the same type of self-oriented, rent-seeking behavior occurs in the private sector as in the public sector. The differences lie mainly in how society deals with its corruption. Well-developed countries seek to contain corruption through laws, business practices, and education. Developing countries are learning how to do this at an institutional level.

Even when anti-corruption laws exist, especially in non-Western countries, they may not be effective. Laws are often window-dressing; they exist on paper, but there is no budget or staff allocated for enforcement. In these cases, it is often up to non-governmental organizations (NGOs) and the media to police actions. However, since both are weaker in more autocratic societies, which are frequently less-developed, resource-exporting countries, NGOs and the media may be limited in what they can do. Another reason that anti-corruption campaigns may be less effective in non-Western countries is that corruption in developing countries tends to be defined restrictively.³ These conditions place a heavier burden upon representatives of firms who are working abroad to follow a set of ethical standards that are stricter than local ones.

It is often up to the companies engaged in transnational commerce to police themselves, according to the preferences of management and shareholders. This requires multinational firms’ management to think through corruption practices abroad and to create internal systems for working in another normative environment if one of the management goals is good corporate social responsibility.

3 Corruption is more likely to be defined by its minimalist definition – that involving public officials and bribery. Corruption within the private sector is often completely misunderstood as being ‘normal business practices.’

Complexities in Discussing Corruption and the Private Sector

Today's discussions of corruption illustrate that it is a multidimensional problem. Corruption may be private and intra-firm, where private-sector agents engage in unethical behavior that violates an implicit trust. Corruption may be private and inter-firm, where corruption payments or favors are made as a requirement for a deal. Corruption may be public, between private agents and representatives of the government. Representatives of firms may be suppliers in corruption – they pay the bribes, etc., or they may be recipients – they are defrauding their shareholders, suppliers, employees, or customers. Even in cases where firms are suppliers of corruption payments, they may be perpetrators by encouraging bribe-taking or they may be victims of extortion strategies that require payments in order to conduct business.

Another dimension to corruption is that it may be 'functional,' or optimal, because some companies and governments are so poorly governed that without corruption payments, normal business transactions cannot take place. One example of this could be in post-Soviet countries immediately after the breakup of the USSR, before the newly independent countries had established new institutions. Some debate whether any corruption can truly be 'functional.'⁴

Corruption, Fiduciary Responsibility, and Shareholders

Employees and managers of firms are charged with producing quality products, containing costs, improving efficiency, and generally with preserving the value of the firm so that shareholders' assets are maintained. Poor management decisions may result in one or more of these factors not occurring. Private-sector corruption and weak ethical standards may also hinder these. When employees and managers of companies seek to maximize their personal welfare rather than the company's, they have failed in their duties to the owners of the company – the shareholders. One form of corruption affecting shareholders is intra-firm, private corruption. Because the manager's obligation is to the shareholder and this corruption decreases profits, it is easy to see that such behavior is unethical.

Efficiency and competition in a corrupt environment

One argument for controlling corruption is that cost distortions that occur are significant. There are explicit cost distortions when bribes are paid, and bribes increase as profits of the company increase. There are also implicit costs – contracts may be lost to inferior competitors who pay corruption payments. Another implicit

4 This author's perspective is that private-sector corruption is much more likely to be beneficial in the short term than in the long term. In the long term, corruption stymies the development of good governance, both governmental and corporate.

cost is the time and energy of managers which should be devoted to running the company and is directed instead toward handling corruption issues. This requires firms to allocate more resources, making them less efficient; costs increase and profits fall. Implicit costs are difficult to quantify. Generally when corruption costs are specifically cited, these include only direct costs, such as bribes. Reinikka and Svensson (2002) and J. Svensson (2003) find bribes paid in Uganda, for example, to be 8–10 percent of total costs. Dal Bo and Rossi (2007) observe explicit costs in corruption settings, as more labor is used to produce any given level of output when corruption plays a role.

Who must pay bribes? In the study of 176 Swedish consulting firms by Reinikka and Svensson (2002), 143 (81 percent) reported that bribes had to be paid for them to operate their businesses. The more time that a firm had to spend on dealing with regulations and taxes, the more likely it was that this firm had to pay bribes (Reinikka and Svensson, 2002).

Functionality of corruption

It is extremely difficult to define fiduciary responsibility and management's obligation to shareholders when speaking of inter-firm and public corruption. When speaking of public corruption or even corruption between firms in some cases,⁵ one may argue that some forms of corruption are 'necessary evils,' that they are 'functional' as opposed to 'dysfunctional.' That is, they are advantageous to the firm's profits and to shareholder welfare. It is this type of conflict that makes ethics so difficult ... and so interesting. The real questions which no one is answering in the corruption literature are: is it possible that in some cases, engaging in corrupt acts enhances a company's value and shareholder assets? And if so, should one engage in a corrupt act or maintain the moral high ground?

Because we as individuals have different moral outlooks, our responses to opportunities that seem to be 'functional' corruption differ. One individual may take the view 'Do nothing where the ends have to justify the means. Do what is right.' Another individual may see this dilemma as 'My job is to take care of my company. If it is not illegal and it is pragmatic, I will do it!' One can appreciate how both individuals may take such contradictory positions and still be behaving according to a comprehensible code of ethics.

The operative question may be: does this action, which may be considered to be corrupt and unethical by some conscientious individuals, benefit the company in the long term, or does it only yield a short-term gain?⁶ There are many lessons

5 This is referring to situations where bribes and kickbacks or other favors may be required (extorted) as a cost of doing business. This demand could feasibly come from a government official as well as from an employee of a private company.

6 While 'legal' does not translate into 'ethical,' legality may certainly be useful in making such decisions. Decisions are more complicated when something may be legal, but not necessarily ethical.

in life where we see individuals making what seemed like reasonable actions at the time only to suffer personally or to have their companies and shareholders suffer in the long run. Even actions that benefit the firm, i.e., ‘functional corruption,’ may not be beneficial in the long term when all repercussions are considered.

Principal agent model

How public corruption costs both firms and citizens and how private corruption that is disadvantageous to shareholders (i.e. it is dysfunctional) is demonstrated through the principal agent model. This theory seeks to explain how contracts between agents, such as an employee-manager and an owner,⁷ can fail to protect the interests of the principal. Much of the research regarding this model asks: ‘How does the principal (the employer or owner) ensure that the agent (the employee or contractor) is serving the principal’s needs and not his or her own interests?’

With private corruption, the principal is the body of shareholders and the agent is the employee or manager of a firm. A problem exists when the employees or management are engaged in behavior that enhances their personal welfare while either directly or indirectly harming the shareholders by not enhancing the value of the firm. We call such behaviors corporate malfeasance or lack of fiduciary responsibility. This simply means that those who are hired to protect shareholders’ interests are not doing so. This manifests itself through such acts as earnings manipulation, backdating, inaccuracy in reporting, and blatantly criminal acts such as fraud.

With public corruption, the principal is any legal entity or citizen. Those who are charged with serving the public in exchange for a salary (judges, politicians, civil servants) are the agents. A problem exists when these public servants are serving themselves, rather than the citizens or firms that pay the taxes supporting their employment. This situation manifests itself through demands for corruption payments or favors to fix problems or even to provide basic government-supplied services, such as health, education, and bureaucratic services.

In both scenarios of the principal-agent problem, private and public, the problem arises because of a disharmony of goals between the principal and the agent and the high cost for the principal of monitoring the agent. In any case where the agent is supposedly working for the principal, the principal’s interests are not served well by the agent, and monitoring and controlling the agent is difficult, there is a principal-agent problem that is interesting and worthy of research. Due to the nature of the relationship between the principal and the agent, this is a popular method for analyzing corruption.

Whether or not paying bribes and kickbacks were illustrations of a principal agent problem would depend upon whether or not most shareholders in a firm

7 There are many permutations to this relationship. Principal-agent relationships could just as well be modeling incomplete information in insurance industries, screening contracts, lacking disclosure to shareholders of company finances, etc.

personally objected to this behavior; that is, if the management promoted policies that reflected the owners' own values, this would not be a principal agent problem. As Gitlow (2005) observes, private-sector, dysfunctional corruption was not a problem in emergent modern capitalism, because in a simpler economy the owner was the manager. Similarly, the issue of whether or not to engage in corrupt practices when it may benefit the company, i.e., 'functional' corruption, became a complex problem only after ownership and management separated.

Sentiments of entitlement

Gitlow stated that the concentration of power in the late twentieth century in the chief executive officer created 'the imperial executive.' This allowed a CEO in many cases to behave with impunity by dominating the entire senior management and Board of Directors. The fallout from this included many types of corruption being unveiled: corporate, governmental, functional and dysfunctional. Improvements in management practices and governance in the post-Enron environment sought to rectify this power imbalance. Campaigns from public officials, from Tony Blair, former prime minister of Great Britain, to Paul Wolfowitz, former head of the World Bank, pushed anti-corruption movements into the public forum.⁸

In all of the ethics and corruption scandals that have been publicized, glaring lapses in judgment seemed evident. In some cases this was greed overtaking good sense; in other cases it was bad decisions being followed by worse decisions, rather than admitting fault and facing disfavor.

In many unveiled corruption arrangements, self-blame seems missing when the press reports on a scandal. One must ask, 'does this person not see how badly he (or she) behaved?' This is explained by Gitlow with the argument that company officers had a sense of entitlement.⁹

The key is their [the company's officers'] conviction that they are creating wealth for shareholders, and for the community, as they build corporate empires and stock values soar. The belief is fed like a gas fueled fire by the 'irrational exuberance' of a market bubble. Accounting adjustments that help the process seem validated by stockholder behavior that bids the market value of corporate securities up into the economic

8 Ironically, these proponents of anti-corruption became embroiled in their own scandals. Besides the BAE affair, there were allegations that four of Britain's richest individuals made large loans to the Labour Party, and these loans were kept secret while Mr Blair recommended peerages for these individuals (BBC, 2007a). This sounds much like a behind-closed-doors corruption tradeoff. Mr Wolfowitz was forced to resign as the president of the World Bank after an ethics panel found him guilty of breaking World Bank rules, when he negotiated a tax-free increase in pay for his girlfriend (Times Online, 2007).

9 In cases where corruption involved a public servant behaving inappropriately, entitlement is also often involved. It is common for these occupations to be poorly paid. Accepting private payments for services rendered may seem justifiable when one has a family to feed and the normal salary is too low to accomplish this.

stratosphere. Given such a context, it seems easy for the CEO to convince himself that the creation of vast wealth, even if it is only on paper at the moment, entitles a goodly share to go to the creator. (Gitlow 2005: 16)

So long as stock prices are stabilized, this type of officer feels entitled to a large salary and perk, even if the stock price is based upon an illusion rather than true value.

Certainly the desire to stabilize stock prices is a strong motivator for much of private corruption. Finance is driven by risk avoidance, and risk is defined by fluctuating, unpredictable standard deviations in the rate of return. Some changes to how things are reported in the company's books can stabilize a stock's price to become a less volatile, less risky, asset.¹⁰ This creates an incentive to even out cost and earning reports, i.e., earnings estimation and smoothing. Estimation is inevitable whenever there is a timing problem between outflows and inflows. Issues such as not writing off unpaid account receivables or depreciated inventory may become ethical issues if too much time has passed, but they are not corruption. This raises the dilemma of acting in a disingenuous manner and deceiving shareholders, and perhaps protecting a stock's value, or accurately reporting and delivering a loss to shareholders.

Advancements in Monitoring Corruption through Accounting

Chapter 9 of this book covers international agencies changing corruption around the world, however, some discussion about detection is also warranted here. Whether the case is public corruption or private corruption, accounting norms and audits are the best tools of detection. Many countries and many companies have policies requiring officials, and often their family members as well, to declare all sources of income. The problem is non-compliance. If one simply audits the officials' consumption, for example, it is clear when spending exceeds legal income. Another reason that accounting is so important is that today accounting methods differ across countries and firms. When everyone adopts the same standards, finances are much more transparent.

The international institution for setting higher accounting standards is the International Accounting Standards Board. One way that it does this is by establishing international financial reporting standards, or IFRS. Another way that the institution is normalizing international accounting standards is by creating a language for electronic communication of business and financial data, 'XBRL' or the eXtensible Business Reporting Language. This is a development in financial institutions that will help to eliminate corruption through improved transparency,

¹⁰ The irony is that even when companies practice unethical earnings smoothing and this becomes public and the stock price falls as a result, the loss in shareholder value may be less than when earnings are allowed to randomly fluctuate.

as well as make it easier to financially evaluate the operations of a company, which under the old system of independent national accounting standards agencies would have been difficult to do.

There is evidence to suggest that patterns of non-transparent accounting hurt markets. Bhattacharya, Daouk and Welker (2003) combine earnings aggressiveness, loss avoidance, and earnings smoothing into a measure per country. After controlling for other influences, they find that higher ratings for these factors ('earnings opacity') resulted in higher equity costs and fewer stock trades for a country. This means that shareholders enjoy less liquidity in their stock shares as well as decreased returns from equity investment. Poor securities management at a national and institutional level harms the efficiency and development of the financial market, which indirectly harms all parties.

The Profit or Loss of a Bribe

Everyone has a choice as to whether or not to pay a bribe. However, the costs of *not* paying a bribe can be high. Necessary documents may not be processed; tenders can be lost; job offers are made to someone else; another student gets a place at a university instead of you. Simple economic profit equations are useful when determining if one is better, or worse off, for paying a bribe.

The gain to a bribe recipient is a function of the size of the bribe, probability of punishment, the kind of punishment that may be incurred, and the 'moral cost' (Rose-Ackerman 1975). The gain to a private-sector bribe-maker is a function of variables – revenue earned if the bribe enables one to conduct business, the cost of production, and all the factors involved with the recipient. When the value of a bribe exceeds some minimum penalty and moral cost, bribery will occur.¹¹

Clearly, every firm must have sales greater than costs to participate in corruption. If losses were incurred, corruption payments would not be feasible. Competitive markets include many buyers, many sellers, and homogeneous products. Bribes should be more common for heterogeneous products where it is difficult to compare prices (Svensson, 2003). Hence, we expect that the stronger market competition is, the more difficult it is to win business through bribery and to conceal bribe-making.

As competition increases and profit margins fall, corruption payments must decrease. This is shown in a simple profit equation:

$$\Pi_{i,j} = p_{i,j} \times q_{i,j} - TC(q_{i,j}) - X_{i,j} - \varpi_{i,j} > 0$$

Such that profits of firm i , supplying service j is $\Pi_{i,j}$; revenue from sales, price times quantity for firm i , supplying service j is $p_{i,j} \times q_{i,j}$; total costs of producing

¹¹ This is not to say that all individuals are corruptible. For those for whom the 'moral cost' would be high, the value of a bribe will never exceed this minimum value.

quantity (q) of service j by firm i is $TC(q_{i,j})$; corruption payment by firm i , related to supplying service j is $X_{i,j}$; and moral cost ($\varpi_{i,j}$) must be positive. Firms earn the greatest profits when they are monopolies and the least when there is competition. When barriers to entry exist, such as bureaucratic obstacles, firms earn profits more like monopoly profits than competitive profits.

The association between a company's profits and corruption payments is direct. An increase in profits of one standard deviation incurred \$113 additional bribe dollars per employee (Svensson, 2003). Since profit-earning firms are able to engage in corrupt practices and unprofitable ones are not, it is more likely that corruption payments occur when bureaucratic obstacles exist. (Other causes of monopoly powers may be from market imperfections or discretionary authority.)

This, in and of itself, is an argument for strengthening markets and allowing open competition. It is also an argument for improving business climates and making it easier for firms and entrepreneurs to operate. Using the simple profit equation as our model, we anticipate that the more closed and bureaucratic an economy is, the more likely it is that accounting profits earned in that country will be sufficient to allow for corruption payments. This is, however, a model, not an absolute for each and every country. On a country-by-country level, conditions may vary.

How do these interpretations of corruption, competition, and openness compare with actual corruption perceptions ratings? The 20 worst ranked countries for corruption (by perception) are ranked the 150–179th places in the 2007 corruption perceptions ratings (Transparency International, 2008) – this includes 31 countries, since 12 are ranked in the 150th place. Of these 31 worst countries, only 7 are formerly communist, and from these, all but Belorussia are of Central Asia. The remaining 24 countries, with the worst 20 ranked positions for corruption in 2007, are simply underdeveloped but these are not closed economies. Cuba and China, which are relatively more government controlled, in contrast, are ranked in the 61st and 72nd places, respectively. This suggests that there are other factors besides openness and free market economics that impact profitability and corruption.

This is not to say that competition in the market will not decrease corruption, but that profits may have more to do with an economy's high growth rate and its tolerance for unethical standards, than its market competitiveness. All other things equal, certainly more competitive market environments will allow for lower profits, and hence less from which to draw corruption payments, than less competitive markets.

Part of this model is also moral costs. The above profit model also suggests an argument for strengthening ethical training and corporate responsibility programs. With the growth and development of value systems, moral costs increase. These costs may occur through the shame experienced by culprits when their deeds come to light. They may also occur through the decline in the public's view of a firm and its products or services when this company's representatives are implicated in a controversy.

Shareholders pay corruption payment costs ($X_{i,j}$) – regardless of the payment’s ability to help a company earn greater revenue. Shareholders’ returns are based on dividend and capital gains from stocks. Profits increase these, but costs lower them. Corruption payments are costs, along with normal production and operating costs. These costs are not insignificant. The average corruption payment found in Uganda by J Svensson (2003) was \$8300. This amount is about 10 percent of total costs.

Due to corruption payments, dividends decrease or retained earnings needed for investment to produce future profits decrease. Lower profit margins impact stock values, so shareholders’ capital gains are less. When representatives of firms are implicated in corruption scandals, shareholders may be embarrassed to own this stock, the scandal may cause legal or governmental intervention which is costly, and stock prices fall as the company’s reputation is dragged through the mud. This makes up part of the moral cost ($\varpi_{i,j}$) that shareholders bear when companies engage in corrupt and illicit practices and are sanctioned for it.

The ‘Principals’ are Demanding More

It is not surprising that those whose interests are theoretically being tended to may be making some radical revisions to the ‘principal-agent contract’, given the degree of corporate and public corruption that has been reported in the media in recent years. The principals, whether they are electing constituents or voting shareholders, have been let down.

As described in the indictment against Causey, Skilling, and Lay in the Enron indictment (US v. Causey, 2004), deception can be quite costly to investors:

Executives provided guidance to the investing public regarding anticipated revenue, earnings for upcoming reporting periods, and other information regarding Enron’s business activity. Such guidance was communicated in presentations and conference calls to securities analysts and in other public statements by ... executives. Relying in part on the company’s guidance, securities analysts disseminated to the public their own estimates of the company’s expected performance. These earnings estimates, or analysts’ expectations, were closely followed by investors. Typically, if a company announced earnings that failed to meet or exceed analysts’ expectations, the price of the company’s stock declined.

The business environment has changed and there is a new climate in the corporate world, particularly within the United States. Corporate corruption that involves deception is not tolerated. Such behavior offends moral sensibilities as much as it hurts financially.

The changing public view of corporate governance in developed countries is greatly impacting how many firms are managed. Investors and governments are demanding greater transparency and accountability. ‘Shareholder activists’ are

playing a greater role in management. They are mostly seen attacking executive compensation packages, but this change indicates a new role for shareholders, who may soon move towards policing their company's corporate governance and corruption policies.

It is extremely problematic to filter out all of the information, except a scandal, that affects a stock price. Besides the profitability of the company, there are many industrial, macroeconomic, and other factors that affect a stock's price. It is therefore not possible to say, 'event X itself caused this increase or decrease in a stock's price.' However, we can sample scandals of corruption and see what happens to the stock price. In other words, how might a scandal affect shareholders? The reader can use his or her inference to decide how to interpret the different types of scandals and their effects in these short cases. Many more cases are discussed in the chapter 'Private-Sector Incentives for Fighting International Corruption,' by Burger and Holland.

Isolated case of intra-firm corruption – BMW, 2005

In 1918, BMW AG was formed as a publicly traded company. The company had difficulties for several decades as a result of World War II and Germany's occupation. Two plants (Munich and Allach) were dismantled by the Americans and another (Eisenach) was governed by the Soviets. The company did not regain its assets until the mid 1950s. In the late 1960s, it bought three plants and BMW was reborn. BMW acquired control of the car brands, BMW, MINI, and Rolls-Royce, which it has produced and marketed internationally with little scandal or corruption to mar its image.

However, in 2005, A BMW employee was charged with accepting 82 800 euros (\$100 000) in bribes from a supplier in return for directing business towards the supplier. (Deutsch World, 2005a) This example of corruption was for personal gain to the employees involved in the scandal, i.e., it was dysfunctional corruption. It was, however, an isolated event, and BMW is a company with a reputation that does not normally include corruption scandals.

This was a scandal limited in scope – involving few employees. Certainly, this was an embarrassment to BMW, but it had minor impact on shareholders. The report of the arrest in August 2005 was accompanied by trading about three times greater than other days in that two-month period, but stock price overall was unaffected.

Case of multiple corruption acts within a corporation – Infineon, 2005

A worldwide computer components company, Infineon, was created when Siemens AG spun it off as an independent company in 1999. The Munich-based company became the second largest chipmaker in Europe after Intel (Foremski, 2005), and enjoys about 18 percent of the world's chip market (Oligopoly Watch, 2006).

Infineon manufactures power semiconductors (it is particularly strong in automotive semiconductors); communications hardware; and high-security chipcards (Infineon website). It is a global company with subsidiaries in the USA and in the Asia-Pacific region.

Corrupt behavior seems linked to other forms of less-than-ethical behavior. Manufacturers of DRAM memory chips were found guilty of violating US antitrust law in 2002.¹² The four largest companies in this oligopoly were Samsung, Infineon, Hynix, and Micron. The leader in this industry, Intel, has been sued by the European Commission, which accused the company of anti-competitive behavior to marginalize competitors. If Intel loses this suit, it is liable for up to \$3 billion in fines (Laurent, 2007). Though not a corruption case, per se, overly aggressive competition suggests a corporate culture where poor ethical standards may be more tolerated. This sets the tone for a corruption case in Infineon that occurred a few years later.

Andreas von Zitewitz, head of the memory division of Infineon, was implicated in corruption, breach of trust and tax fraud. Reportedly, he received 259 000 euros (\$312 000) from Udo Schneider of BF Consulting of Switzerland, in return for business favors¹³ (Deutsch World, 2005b). Head of the microchip division, Harald Eggers, reportedly received 50 000 euros. Managers of Infineon admitted knowing about the case since 2004 (Deutsch World, 2005c); the company conducted an internal investigation which turned up nothing.

Infineon's stock prices peaked in 2005 shortly before this scandal hit, suggesting that rumors were probably circulating about the scandal and the stock prices were beginning to feel the impact of this. Stock fell on the day of the scandal's report ('Shares closed down 1.2 percent at 8.31 euros on the blue-chip DAX index yesterday'; Deutsch World, 2005c). They continued a downward trend until September, representing a negative shock to the company's market value of 12.15 percent.

This was not the last scandal for Infineon. Another scandal arose in July 2005 when an internal audit discovered flagrant overspending on the company's new headquarters outside of Munich. The former chairman of the board of directors, Ulrich Schumacher, was blamed for allowing 'overly generous architects' bills' (Anonymous, in *Business Report*, 2005). Schumacher was removed in 2001.

This appears to be a case where ethical leadership was weak in a rapidly growing, relatively young company. The company had earlier been found guilty

12 In the antitrust case, each of the companies pleaded guilty and one or more executives received jail time. Only Micron, which participated in the investigation, was not found guilty as a corporation and was not fined. Infineon pleaded guilty and four executives were given short jail sentences and fines. The company was fined \$160 million. Hynix and Samsung were fined \$185 and \$300 million, respectively (Oligopoly Watch, 2006). Samsung, Infineon, and Hynix also agreed in 2006 to pay \$100 million in an antitrust case led by computer consulting groups (Oligopoly Watch, 2006).

13 Such as motor sport sponsorship contracts.

of unfair trading practices and violations of US antitrust law. Individuals in upper management of the company were suspected of behaving inappropriately, but too little effort was made to ascertain the facts. When the case became public, the corruption scandal shook investor confidence in Infineon and stock prices fell dramatically as a result.

The cases involving DRAM and Intel suggest that uncompetitive behavior is an industry problem, rather than just a problem in Infineon. Although price fixing resulted in large fines, it is quite possible that revenue earned outweighed fines. The case involving Zitewitz and Eggers may not have directly hurt shareholders. They received bribes from BF Consulting, so the owners of BF Consulting paid the explicit price of corruption. However, declining share value and falling profits from lost sales due to the scandal hurt Infineon shareholders. The last matter of overspending and directing work towards a favored company may be a case of poor management decisions rather than corruption. This cost to shareholders, as the company squandered capital resources, decreased equity for the company and thereby harmed shareholders.

Infineon's website discusses its commitment to good corporate governance and to corporate social responsibility. Today, Infineon has adopted 'almost all' of the German Corporate Governance Code's regulations and observes US legal norms (Infineon, 2007) and has created an administrative position for managing CSR issues.

Case of multiple corruption acts within and between corporations – Tyco International and CIT, 2001–2002

Tyco International was born in 1960 as a research laboratory for experimental work for the government. In 1962 it incorporated and in 1964 it became a public company and began expanding. Tyco moved from research into manufacturing (Tyco website).

This Bermuda-based company announced a stock deal to purchase the CIT Group, a commercial finance company, in 2001. This deal was brokered in part by Tyco director Frank Walsh. Walsh received \$10 million from the CIT Group deal and another \$10 million went to a charity he directed (USAToday.com, 2005). Tyco filed a complaint with the Securities and Exchange Commission in January 2002.

Tyco CEO Dennis Kozlowski announced plans to split Tyco into four companies. This plan was abandoned in April and management decided to monetize CIT through a public offering in July 2002.

Kozlowski and CFO Mark Swartz sold more than \$100 million of their Tyco stock without reporting this according to *New York Times* reports (USAToday.com, 2005), and Kozlowski fell under investigation by the Manhattan District Attorney (DA) for tax evasion of \$1 million. Kozlowski resigned in June 2003. John Fort, a former Tyco CEO, served as interim CEO until Edward Breen was appointed the

new chairman of the board and CEO of Tyco. The board of directors launched its own investigation.

The scandal expanded when the DA accused both Kozlowski and Swartz of enterprise corruption for stealing \$170 million from Tyco and obtaining \$430 million by fraud in selling company shares (USAToday.com, 2005). Tyco counsel Mark Belnick was charged by the DA for falsifying records to hide more than \$14 million in illicit loans.

In December, 2001, Tyco shares had closed at a high of \$59.76. In the month of January 2002, Tyco stock fell 39 percent; by the second week of June, the stock had fallen to under \$10 per share. Tyco stock continued to improve, but remained low relative to previous levels. Only after a 1:4 stock split in July 2007, did its stock price regain a value of about \$50 per share.

‘In its final quarter as part of Tyco, CIT posted a whopping \$1.99 billion loss, with almost all of that due to a *goodwill impairment charge* [emphasis added] the company had to take as part of the \$4.6 billion initial public offering that freed CIT from Tyco’s grips’ (Goldstein, 2002). CIT shares had been priced at \$23 per share for the July 1 IPO; by late July, they were trading 17 percent below that.

Kozlowski had a mistrial in 2004 and was retried and sentenced in 2006 of 22 counts and up to 25 years (Orcutt, 2007). This scandal cost Tyco shareholders who lost directly through the loss due to malfeasance by top managers as well as from decreases in share prices. This scandal cost owners of CIT, who spent at least \$20 million on Walsh to broker the Tyco–CIT deal and whose company lost goodwill. The scandal caused the taxpayers of New York City to investigate and prosecute guilty parties. The Tyco–CIT deal may have been a profitable one and could have gone through without unethical intervention; however, it did not, so corruption costs were borne by three separate groups.

These three cases represent three extreme examples of corporate corruption. They vary in scale and scope, from relatively small-scale personal rewards to tens of millions and from isolated employee incidents to cases involving senior management. The loss to shareholders increases according to the severity of the case.

Conclusion

Different societies have different norms. This includes corporate cultures as well. Sometimes corruption arises because people are placed in confusing worlds where the rules are suddenly different from what they are used to, but often, corruption is evident even within developed countries where the rules are similar.

Corruption within public companies is a cost borne by shareholders. There are efficiency losses as managers’ attention and efforts are misdirected from production to dealing with corrupt representatives of government. There are efficiency losses as management of companies investigates internal corruption cases. These cost companies, which translates into decreased profits, dividends, and share prices.

There are efficiency losses from the poor morale of a company besieged by bad press during a corruption scandal. The actual bribes make up an estimated 10 percent of total costs, not to mention kickbacks, cost of side-deals, etc. However, the indirect costs in terms of company goodwill, morale, and investor confidence may be far, far greater costs to public companies.

There remains the argument that corruption in a market with weak market discipline and an overly bureaucratic government may make money for the company. Anyone who has experience in countries where corruption is the norm, rather than the exception, cannot brush this argument aside. Revered Samuel Huntington felt similarly.¹⁴ Many companies are trying to work around corruption, however. No longer is it accepted that this is a standard way of doing business. The business world is changing. Hopefully, to use the principal-agent paradigm, the agents will do a better job of looking out for the interests of the principals, and shareholders will enjoy the results.

¹⁴ 'The only thing worse than a society with a rigid, overcentralized, dishonest bureaucracy is one with a rigid, overcentralized, honest bureaucracy.'

Chapter 4

The Good and Evil Faces of Foreign Investment

Sharon Eicher

Introduction

There is nothing new about foreign investment. A pre-modern example of foreign direct investment is Chingis Han (or Genghiz Khan, 1162–1227) controlling a vast political, military, and economic dynasty through his sons while remaining at his home. We do not read of his buying up local businesses, but we know he controlled assets in other countries.

Closer to the modern era, 1880–1914, but still predating when people usually think of globalization being in its full swing, Eichengreen (1991) estimates that international capital flows were perhaps three times their 1980s levels. The only thing new about trans-boundary ownership of companies is how intertwined production methods are today and the effect this has had upon our modern economies.

Direct investment historically has led other forms of investment in markets. ‘The hiatus in private flows was ended [circa 1959] – first by the resumption of foreign direct investment, and second, through lending through the banking system’ (Eichengreen, 1991). The bond market was closed to developing country borrowers. Most countries did not have developed portfolio markets and those that existed became better integrated globally after the advent of computing. Furthermore, stock markets had other barriers – institutional differences across countries as well as information and logistical costs make these less accessible to foreigners. Since 1989, capital flows have surged through channels of foreign direct investment (FDI), bond markets, and equity markets.

Some differences between historical FDI and modern FDI are the regulations that governments systematically place upon firms, labor and environmental laws, taxation, capital controls, etc. Wei (1999) shows that tax rates, corruption, and capital restrictions independently decrease FDI into a country.

Today FDI is defined as having a controlling interest (equal to or greater than 10 percent¹) of managerial control in an enterprise not in one’s domestic economy.

1 The difference between portfolio investment and foreign direct investment is whether or not a controlling ownership interest is held. Ten percent has been chosen as the magic number to represent sufficient ownership to have an impact upon management decisions.

We observed a dramatic rise in nominal FDI in the latter half of the twentieth century. With the extreme globalization that has occurred around the world, FDI seems less noteworthy today. Where FDI used to be unusual and occurred in a limited number of countries, it is now quite common everywhere in the world. It is completely normal to have supply and production units across several countries, a headquarters in another, and customer support in yet another country.

Companies that wish to acquire production assets in a foreign market have the choice to do so through greenfield (creating new project) direct investment, brownfield (buying existing assets) direct investment, portfolio investment, joint ventures, or licensing to local companies. If a company's home country has norms that penalize firms registered in their domain for engaging in corrupt practices, an incentive may exist to prefer direct investment over portfolio investment or joint ventures. This is because of managerial control and culpability. In a joint venture, a firm may not know what its partner is doing but is still liable if its domestic laws are broken. In the presence of binding domestic legal norms that prevent corruption, child labor, etc., it may be better to distance oneself from those making managerial decisions. In this case, the company would want a middle-man to run interference, such as a sales agent. Alternatively, the company would want to own the foreign production unit in its entirety and to control all managerial decision making. In this case, foreign owners can prohibit activities that violate their domestic legal norms.

Hines (1995) suggests that American companies, bound by the Foreign Corrupt Practices Act, will opt for direct investment over joint ventures. Other authors have suggested that ownership is preferred over joint operations when managerial control is important, probably for the same reasons.

Why Does Capital Move and What Does That Imply?

The most basic inputs to production are land, labor, and capital. Recent economics works have added factors such as human capital, social capital, and technological inputs. 'Capital,' as used in economics, refers to fixed or physical capital – machines, equipment, vehicles, etc. 'Financial capital,' i.e., money, can be easily stored and transferred to other parties or locations in order to buy goods and services and the inputs of land, labor, and (physical) capital.

Land is immobile. Except for draining swamps as was done in the Netherlands or filling in the ocean with garbage, as was done in lower Manhattan, we cannot make more of it.

Labor is mobile. Despite the concerns in Europe and North America over labor migration, workers are generally resistant to moving. We can produce more labor through population growth, but this is not necessarily a good strategy. The best that we can do is to augment labor through education and training.

Financial capital is highly mobile. Fixed capital is transportable, although it may be costly to do so. Financial capital can be used to acquire both additional

fixed and human capital through the investment process, so it is indirectly self-replicating, meaning that endogenous growth in an economy occurs when we make these investments. Financial capital markets are risky, however.

Learning from the Great Depression taught us how monetary policy in the economy is directly tied to economic growth, but it may not have been until the 1980s that people began to appreciate the risks to financial capital markets. It was then that the Latin American debt crisis arose and then the American savings and loan (S&L) institutions crashed. The former was due to poor banking decisions and the latter from under-regulation and overly risky investment practices by S&L managers.

The Latin American debt crisis and the East Asian currency crisis of the late 1990s demonstrated the linkage effects of exchange rates. We then began to appreciate 'contagion effects.' These experiences have led to the prioritizing of financial markets for maintaining a healthy global economy. This work has modified economic knowledge and pedagogy.

Financial liberalization opened doors for investment in countries that had previously been closed to foreign investors. Property laws changed. New stock markets were created. This allowed for both foreign portfolio and direct investment.

At the same time, computing allowed for money to be relocated electronically. A paper check that used to take one month to clear between London and New York City could be transferred electronically using SWIFT² in one day.

Although financial capital is more fungible than it has ever been and although globalization and FDI flows are often discussed with respect to how they impact developing countries, domestic savings are unlikely to leave their country of origin. Feldstein and Horioka observed this in 1980 and capital flows continue in this pattern. Among the developed countries, the UK, the Netherlands, and the USA are the preferred destinations for FDI. These countries attract FDI because of their relatively large economic size and because they are seen as safe investments against political risk, exchange risk, corruption loss, etc. Brazil leads the developing countries for FDI inflows, by attracting investment from 75 percent of the top hundred transnational corporations (Financial Times Ltd., 2005). Mexico, Hong Kong, Singapore and South Africa are other popular destinations for FDI.

We look to FDI as a factor that greatly impacts economic development, since capital is so easily transferred and countries lacking sufficient investment capital can offer returns greater than those in the investors' home countries. Unlike financial capital, land cannot be moved or created. Skilled labor can be

2 SWIFT is an industry-owned cooperative that creates an interface between more than 8100 financial institutions in 208 countries and territories. Its members are banks, brokers and investment houses. 'Over the past ten years, SWIFT message prices have been reduced over 80 percent, and system availability approaches 5×9 reliability – 99.999% of uptime' (SWIFT website, <http://www.swift.com>).

moved and created, but most workers are hesitant to relocate for employment and most developing countries do not offer educational systems on par with those in developed countries.³ Physical capital is transportable, but shipping costs are prohibitive. The easiest resource to move across borders is electronic money. This is then converted and used to acquire the inputs of foreign labor and fixed capital.

We expect that investment capital would chase high returns which are often most readily available in less-developed countries. However, most FDI stays within developed countries. Even much lower levels of FDI inflows into a developing country may have a great impact, because investment capital is less available and credit markets are not developed enough to serve domestic investment needs. FDI is still quite important to emerging economies.

Does FDI Cause Corruption?

One of the explanations for corruption, particularly in developing countries, is that too much money enters countries too rapidly, while institutions are still weak and under-developed. In such an environment, embezzlement, misappropriation of funding, graft and kickbacks become the norm. Companies are blamed for (a) being the source of rapid change in an economy that is unprepared to deal with its changing economic conditions and (b) for being the supplier of capital inflows and corruption payments. Many companies, it seems, are complicit in fostering corruption, in search of expediency and short-term profits, rather than long-term market development. On the other hand, one must ask an ethical question: is it the job of firms in the private sector to change the indigenous society? It does not seem fair to blame corporations for inherent social problems inside a country, although private firms are certainly part of the corruption cycle.

Certainly corruption costs companies enough that they, and their shareholders, would surely appreciate keeping in profits. An increase in the average corruption level from that of Singapore to that of Mexico is equivalent to raising the tax rate by 29.3 percentage points (Wei, 1999). That is equivalent to earning 70.7 cents on the official post-tax dollar (or euro).

‘The need for international investors to pay bribery and deal with extortion by corrupt bureaucrats tends to increase with the frequency and the extent of their interactions with local bureaucrats’ (Wei, 2000). Repeated interactions will require repeated corruption payments, and the sunk costs incurred from a greenfield or brownfield investment places the foreign investor in a weaker position from which to attempt to negotiate corruption payments. Wei therefore views corruption as more detrimental to foreign investors than to other types of investors – international banks and portfolio investors. Furthermore, international creditors are more likely

3 Educational systems in many developing countries are also known for being highly corrupt. This results in higher ‘taxes’ (fees for giving good grades) for parents with children attending school or university.

to be bailed out if there is a financial crisis due partly to corruption, which is a privilege never offered to a private company that loses its assets in a foreign investment.

This points again to the need for business professionals who are working abroad to be sensitive to and respond accordingly to local and home-country norms. An example of how this does *not* occur is seen in Svensson's work on Swedish consulting firms. Most of the firms in the study bribe in the hope of winning foreign tenders, yet Sweden has an extremely good corruption rating. The home country norms are quite different from the norms demonstrated by Swedes when they work abroad. Swedish consultants *could* be exporting the fine ethical values of Sweden; instead they do what is needed to win a contract. This is not to suggest that Westerners should practice cultural imperialism and make the world in their image. (However, no authority claims that corruption is good for the society or economy.) The question is, are professionals willing to potentially lose a contract today in order to help shape a better business climate tomorrow?

An Empirical Question: How are Corruption and Foreign Investment Related?

There are several basic questions about corruption and FDI. The first is whether firms as private agents are responsible for enacting social change in another country. This is an ethical question which perhaps each company must resolve within its own management. One empirical, ethics-free question is whether firms are less likely to invest in countries with poor business climates and poor governance. Corruption goes hand in hand with both of these conditions. A second empirical question is whether FDI, both inflow of capital and the special access that is created by it for elites in the society, worsen corruption and income inequality.

How does FDI affect corruption and vice versa?

Corruption might restrict direct investment by raising risks of negative publicity due to exposure in the media, higher costs of production due to payoff expenses, and risks due to uncertainty once a payoff relationship is established. Foreign investors may decide that these risks are too great in a corrupt society.

Another argument is that FDI can reduce corruption through several venues. Foreign owners bring in foreign management practices. In most cases, these practices are more efficient and more based upon meritocracy than nepotism, which is more egalitarian as well as more efficient. When direct investment increases resources in the economy and stimulates economic growth, average income increases. When incomes rise, there is less incentive to behave unethically, because gains through ethical means have increased.

Correlations and signs in regressions can be used to indicate either relationship. If corruption restricts FDI then these two should have a negative correlation. The

effects of corruption on FDI from a statistical regression should be negative and significant. If FDI worsens corruption conditions then these two should have a positive correlation (more FDI implies more corruption) and the sign in a statistical regression of FDI on corruption should be positive and significant.

Simple correlations A graph of corruption and FDI statistics for various countries illustrates a slowly increasing but positive relationship. When including FDI outflows, simple graphing of data available from the International Financial Statistics for ‘direct investment in economy’ (FDI) and from Transparency International’s CPI indicator still suggests a positive relationship (see Figure 4.1).⁴

However, these correlations are not as strong as they appear graphically. Using a dataset of IMF International Financial Statistics (IFS) for ‘Foreign Investment into an Economy’ and Transparency International’s Corruption Perception Index (CPI), one finds positive but weak correlations. The correlation between FDI and CPI is 0.284 when outliers are included; the correlation after outliers are removed is 0.378.

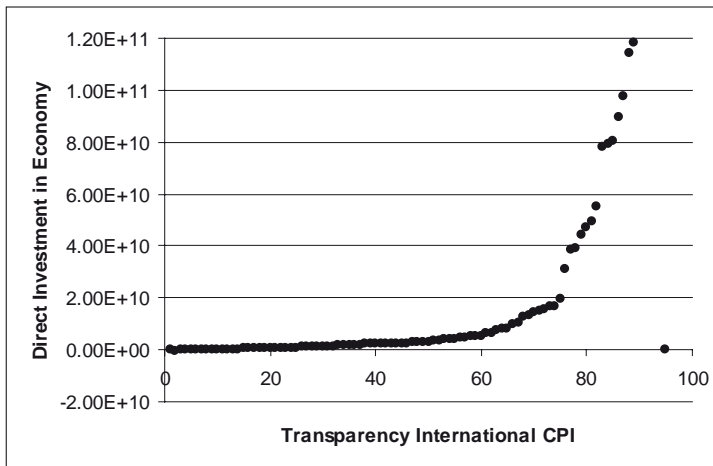


Figure 4.1 Foreign direct investment and corruption

Sources: International Monetary Fund, International Financial Statistics (online) and Transparency International Corruption Perception Indices 2000, 2001, 2002, 2003, 2004, 2005, 2006.

⁴ This figure represents 14 countries from 2000 to 2006. Because two sources are combined, data was lost when datasets did not contain information for the same countries. Contemporaneous figures are compared. Extremely positive and negative outliers are eliminated, reducing data points from 90 to 88.

These results suggest a positive relationship between foreign investment and corruption, although this is far less than a one-to-one relationship. It seems somewhat counterintuitive that the existence of corruption would attract foreign investment. Rather, one supposes that the presence of direct investment raises the benefits to be had from corruption.

Regression results One must also look for regression results and the signs in coefficients for CPI and FDI. This also allows us to examine causality factors – is corruption (measured through CPI) able to better in predicting FDI or is FDI better able to predict corruption?

Using the same data sources and composing a joint data set produces a panel data set with fourteen countries from 2000 to 2006. The explanatory power of regressions with untreated variables is quite low. When estimating simple regressions of:

1. $CPI = \alpha_1 + \beta_{11} \times Year + \beta_{12} \times FDI + \varepsilon_1$; R^2 is 0.08.
2. $FDI = \alpha_2 + \beta_{21} \times Year + \beta_{22} \times CPI + \varepsilon_2$; R^2 is 0.07.

However, if we log all of the variables, as below:

3. $\ln(CPI) = \beta_{31} \times \ln(Year) + \beta_{32} \times \ln(FDI) + \varepsilon_3$, and
4. $\ln(FDI) = +\beta_{41} \times \ln(Year) + \beta_{42} \times \ln(CPI) + \varepsilon_4$.

The explanatory power is quite strong (R^2 is 0.93 and 0.99, respectively). Including year as a variable was only useful in predicting FDI in equation 4. This suggests that corruption is not changing greatly over the period of 2000–2006 for these countries (see Table 4.1).

Corruption and FDI are significant in each regression where they serve as an independent variable. Their positive and significant coefficients suggest that FDI could be worsening corruption in the countries included here, while corruption does not decrease investment into a country.

The above results are not conclusive. Hines (1995) and Wei (1997) observed a negative relationship between corruption and FDI. These data sets are different from that used above. Hines' data include only US multinational firms, which could be affected by the Foreign Corrupt Practices Act. Wei looked at market entry decisions by foreign companies. Results were mixed or insignificant in Campos et al. (1999) and Mauro (1995). Overall, the literature is not definite as to which way the relationship is working.

It is clear however, that the significance of corruption in attracting or discouraging FDI decreases when one includes variables such as gross domestic product, market size, political stability and lack of restrictions on trade and investment in a model

Table 4.1 Statistical regression relationships between direct investment and corruption, 2000–2006

Dependent		Independent variables							n	R2
Variable	Intercept	Year	CPI	FDI	ln Year	ln CPI	ln FDI			
CPI	-199.88 (-0.85)	0.10 (0.87)		0.00 (2.59) ***				95	0.08	
FDI	3.31 E+15 (1.42)	1.66 E+12 (-1.42)	2.61 E+12 (2.59) **					95	0.07	
ln CPI					-0.07 (-1.40)		0.09 (4.74) ***	87	0.93	
ln FDI					2.48 (26.19) ***	2.44 (4.74) ***		87	0.99	

Note: ** = statistic is significant at .95 level of confidence; *** = statistic is significant at 0.99 level of confidence.

Sources: International Monetary Fund, International Financial Statistics (online) and Transparency International Corruption Perception Indices 2000, 2001, 2002, 2003, 2004, 2005, 2006.

(Eicher, 2002). This discounts a cynical view that foreign investors *as a whole* may be seeking out corrupt systems in order to avoid taxes, regulations, etc., or to fix deals between firms to the benefit of individual managers.

Regardless of data differences and their results, it is not surprising that FDI and corruption are positively related. FDI represents an inflow in cash into a country. The more the expendable funds flowing into the country are dramatically changing, the more likely it is that the local economy, its customs and norms are disturbed. We know that most FDI flows between developed countries, but when we look at which countries have experienced the *greatest percentage change* in FDI flows from 1988 to 2006, we see that nearly all are highly under-developed countries (see Table 4.2).

This list of top 20 countries represents countries with the greatest change in their FDI inflows – growth rates – from 1988 to 2006; these are not the top countries for total FDI inflows. Several of these countries are transition economies with changing institutions. A substantial number are in Africa. Only two of them are OECD most developed countries.

The countries whose FDI inflows are changing the most greatly are developing countries. These are countries with weak institutions and a general lack of experience with monetary inflows of this magnitude. The change is dramatic. One can imagine that the stress upon the integrity of public or private officials, who have never before handled so much money, is great. It is not surprising then that FDI inflows into a country can be associated positively with increases in corruption.

Table 4.2 Top 20 countries' growth in FDI over 1988–2006

	Country	Growth of FDI, 1988–2006 (%)
1	Haiti	846.40
2	Ghana	297.30
3	Gabon	292.90
4	Antigua and Barbuda	154.40
5	Zambia	135.90
6	Chad	128.50
7	Cameroon	119.20
8	South Africa	99.70
9	Argentina	98.30
10	Uruguay	88.00
11	United States	84.40
12	Moldova	84.20
13	Barbados	78.60
14	Belgium	77.80
15	Estonia	71.00
16	Brazil	69.10
17	Yemen	60.40
18	Congo, Dem. Rep.	59.80
19	Slovenia	59.70
20	Kazakhstan	57.20

Source: IMF International Financial Statistics (online).

Another illustration demonstrating this is to look at FDI inflows for both the best and worst countries for corruption according to the Economist Intelligence Unit. The EIU ranks countries for corruption on a scale of 1–5. The ones (rated worst for corruption) and the fives (least corruption) for 2006 are reported in Table 4.3. With these are the levels of FDI per person that entered the country over 2005.

The most corrupt countries are developing countries and the countries with the best corruption ratings are developed countries or fairly successful, as in the case of Singapore. The most corrupt countries enjoy per capita FDI inflows of only \$14–\$201. Countries that were reported to be the least corrupt by EIU in 2006 enjoyed FDI per capita inflows of \$413–\$2475, except Australia, from which more FDI flowed out than in over the year 2005. The difference in years of observation

Table 4.3 Foreign direct investment per person for best and worst corruption groups

Worst group in 2006 EIU report		Best group in 2006 EIU report	
Country	2005 FDI per capita	Country	2005 FDI per capita
Azerbaijan	\$201	Australia	-\$1 749
China	\$60	Denmark	\$2 409
Ecuador	\$126	Finland	\$869
India	\$6	Netherlands	\$2 475
Indonesia	\$23	New Zealand	\$413
Kazakhstan	\$130	Singapore	\$1 992
Nigeria	\$14	Sweden	\$2 221
Pakistan	\$14	Switzerland	\$1 438
Peru	\$92		
Russia	\$90		
Ukraine	\$166		
Venezuela	\$97		
Vietnam	\$23		

Sources: EIU Market Indicators data for corruption; IMF International Financial Statistics data for FDI inflows and population.

is not worrisome as the reports published in 2006 would be from experiences preceding 2006.

Wei (2000) supports the above observation. He finds that countries with worse corruption attract less FDI. 'A one-step increase in the TI corruption rating is associated with a 20 percent reduction in inward FDI. An increase in local corruption from the Singapore level (TI-index value of 0.9) to the level of Mexico (TI-index value of 6.7) is associated with a reduction in inward FDI by 68 percent.' In another paper, Wei with Smarzynska (2002) used the KKZ corruption indicator (discussed in Chapter 6) to show that increasing corruption from Estonia's level, which is low, to Azerbaijan's level, which is high, would decrease FDI by 15 percent. Similarly, Campos, Lien, and Pradhan (1999) estimate Investment-out-of-GDP and Private-Investment-out-of-GDP. Corruption as well as a lack of predictability in corruption levels decreased investment into a country.

While corruption is not optimal, it can allow one to cut through binding bureaucratic red tape in order to achieve objectives. Eicher (2002) estimates FDI-to-GDP flows into a country and finds that black market activity and smuggling are positive and significant variables in explaining FDI-to-GDP. Since foreign investors are not going to seek out countries with a strong underground economy before investing, the logical interpretation lies elsewhere. These activities could either capture a strong entrepreneurial spirit which benefits foreign investors or that such activities represent behavior that helps to circumvent restrictive regulations that would otherwise stymie business activities. This suggests that the 'grease' argument for corruption is possible – but it does not suggest that underground economic activity is preferable to freely operating markets. In another kind of regression, Wei (1999) uses an interactive term including both corruption and tax rate as an explanatory variable. This variable is not statistically significant from zero, suggesting with this dataset the grease theory cannot be supported. However, when Wei tested an interactive independent variable for corruption in the presence of capital controls, a positive and significant coefficient supports the 'grease money' argument.

How does FDI affect income inequality?

It would be interesting to link FDI, corruption, and income inequality. This direct relationship has not been shown. Instead, one can examine corruption and inequality or FDI and income inequality.

te Velde (2003) compares the benefits and costs that foreign companies may create. For example, FDI may create employment or it may crowd out employment by pushing up prices and create income inequality. FDI may lead to more competition or it may reduce prices and concentrate market power. Foreign firms may expand the local tax base or erode it, if there is a concentration of market power. te Velde (2003) finds that FDI can explain wage inequalities in Bolivia (40 percent), Chile (13 percent), and Columbia (6 percent).

Foreign investment can disturb income equality without the existence of income-distorting corruption payments. When foreign companies move into an economy, they bring new technologies with them. If productivity growth in an economy depends upon certain skills, growth in income will rise more in FDI industries than in domestic industries (te Velde, 2003). Figini and Gorg (1999) find that FDI was somewhat associated with skill acquisition and wage dispersion in Irish manufacturing in 1979–1995. Taylor and Driffield (2000) find that FDI affects wages in manufacturing in the UK.

One of the complaints against corruption is the image that corruption payments flow only into the hands of the elite. Secondly, money that is diverted from legitimate projects may actually reflect a decrease in services that the poor are able to receive, as the investment being made was to provide public goods and services.

Li et al. (2000) and Gupta, Davoodi and Alonso-Terme (2002) find that corruption worsened income inequality. Even corruption scandals among private firms in developed countries illustrate this point. Those who lost the most financially were household investors and workers; those who benefited were corporate senior managers who already were earning six and seven figure salaries. Dincer and Gunalp (2005) find that an increase in corruption in the US increases a state's income inequality and decreases its growth. Corruption worsens income inequality, both in developed and developing countries.

Private-Sector Movements against Corruption

In the 2007 presentation, 'Workshop on Corruption and the Private Sector' Kaufmann et al. (2007) discussed the experience of Volkswagen, British Petroleum, and Shell Oil. The Volkswagen presentation was made by Gerhard Pratorius, senior manager. VW created a company 'value system,' tried to support leadership in these values, and created an anti-corruption officer position who reported to the board of directors.

According to Graham Baxter, VP of CSR at British Petroleum, the company has a policy not to accept bribery and corruption, because it is bad business. The company works with local governments to improve accountability and transparency, with civil groups to monitor corruption, and with small business owners to encourage good ethical practices.

Hans van der Loo, head of the EU Liaison of Shell Oil, discussed how the company seeks to improve business ethics in fragile states. The Shell Group Business Principles serve as guidelines for its representatives.

Another way in which the private sector is joining forces against corruption is the Partnering Against Corruption Initiative (PACI) which the World Economic Forum helped to organize in 2004. PACI is an organization uniting corruption and development NGOs with private companies in extractive industries.⁵ The current chairman is the CEO of Fluor Industries, Alan Boeckmann.

When a company joins PACI, it obligates itself to two policies: intolerance of bribery and the development and implementation of a program for monitoring company activities and for controlling corruption. If a company already has such a program then PACI principles are used as benchmarks by which to evaluate the

5 Member companies of the 2005 PACI task force were: ABB Asea Brown Boveri, Alcan, Chevron Texaco, Eskom, Fluor Corporation, Hochtief, Japan National Oil Corporation, Newmont Mining Corporation, Occidental Petroleum Corporation, Pakistan State Oil Company, PETRONAS (Petroliam Nasional), Saudi Aramco, Skanska, and the Statoil Group. Facilitating NGOs have been the Basel Institute on Governance, Transparency International, and the World Economic Forum. World Economic Forum (2005) Partnering Against Corruption Principles for Countering Bribery <<http://www.weforum.org/en/initiatives/paci/index.htm>>.

company's code. Intolerance of bribery includes bribe offers to public officials, politicians or party officials, or representatives of private companies in order to either retain or attract business. Developing a program consistent with PACI principles includes developing a code of ethics, policies and procedures, methods for training employees, and an oversight system. This program must at the minimum include policies with respect to bribes, political contributions, charitable contributions, and sponsorship (which may be used as a front for bribes), facilitation payments, and goods or services offered as gifts (World Economic Forum, 2005). Not only must this program encompass all dealings with representatives of the organizations, but it must also include other third parties with whom the organization has a business relationship, such as subsidiaries, local partners, agents, and contractors.

PACI is gradually expanding its scope. Since its founding the World Bank, the European Bank for Reconstruction and Development, the Asian Development Bank, and the Inter-American Development Bank agreed in 2006 to work with PACI to require that any bidder on a large contract has an anti-bribery certificate and a code of conduct that prohibits bribery (World Economic Forum 'Key Achievements'). In 2007, the big four accounting firms (Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers) agreed to work with PACI and Transparency International to search for ways that accounting procedures can support PACI Principles.

George Soros has yet another option for private companies, the 'publish what you pay' strategy. This is a call for perfect transparency, especially with dealings with corrupt governments which have even fewer checks upon them than do private companies. 'The idea is to require natural resource companies to make public disclosure of taxes, fees, royalties and other payments to governments as a condition of being listed on leading stock exchanges' (Soros, 2003). Soros recognizes that there may be disincentives to any one company initiating this form of full disclosure, which is why the system must be imposed from outside the industry. Soros also recognizes that oil and mining companies, which are the big investors in developing, corrupt countries, will not be able to be 'good corporate citizens in this age of globalization,' until people living in corrupt countries can hold their officials accountable.

Oddly enough, while companies are striving on their own to work with NGOs, foreign governments, and foreign companies in more ethical ways, both to practice better corporate governance and to operate within U.S. or OECD norms, one can induce a developed country's government to allow corruption payments. Goldman Sachs received pre-approval from the US Justice Department and the SEC to pay \$67 million to Beijing power brokers to facilitate a joint venture in China. (Finney, 2005)

Conclusion

We know that foreign investment by private parties in one country in the assets of another country is a long-standing occurrence. Nevertheless, the rapid speed with which productive and service facilities have globalized since the 1970s is amazing.

We see capital being used to purchase assets abroad mainly to take advantage of economic opportunities as land, labor, and physical capital are far less mobile than financial capital. We observe risks from these international capital flows, such as currency crises, but we also observe the reallocation of investment funds around the world and potentially a source for economic development as a result of increasing foreign direct investments.

Although the corruption cost to private companies is quite high, the private sector engaged in international production, trade, and services is often blamed as the source of corruption payments. This argument in its extreme interpretation would suggest that if FDI decreased, corruption would as well.

When asking if the relationship between corruption and foreign investment is positive or negative, we are asking if the existence of corruption limits foreign investment or if the existence of FDI worsens corruption in a country. It is difficult to compare across different studies, as their data sources and time periods vary while their results differ. Results presented here suggest that corruption is not a deterrent to foreign investment and FDI may be worsening corruption in a country. Some explanations for these observations are given, such as the rapid change in FDI that is experienced in countries with weak institutions.

Another interesting question that remains to be answered by economists is whether FDI worsens income inequality through corruption. Both FDI and corruption are capable of worsening income inequality, though how much of this is interrelated has yet to be investigated.

There are interesting movements within corporations to address corruption and ethics in international business. These are facilitated by organizations such as Transparency International and the World Economic Forum. Some of these movements associate along industry lines. Some are independent movements within companies themselves. These suggest that one possible way to control corruption may be within markets, rather than through international pressure upon governments to scrutinize industry and judicial, police, and civil services and to punish offenders. Multinational corporations are playing an important role in reducing corruption. Increasing regulation in countries with weak institutions may not be as practical as judicious self-regulation.

Relying upon markets to self-regulate corruption requires that companies have a strong sense of corporate responsibility. When companies lacking in corporate responsibility engage in business in countries where governance is weak, corruption cannot be controlled.

Chapter 5

Quantifying the Immeasurable

Maks Kobonbaev and Sharon Eicher

Introduction

This chapter focuses upon the most commonly used indicators that approximately gauge corruption levels within a country, how they are created, and how to access these data. Some indicators focus upon the public sector and others have more broad emphases. Following this chapter is a discussion and critique of the current alternatives that are available for quantifying corruption.

Leys asked almost four decades ago, what is wrong with corruption? He pointed out that corruption has benefits – ‘under awful conditions, bribery and its close relatives may be socially and not just privately beneficial’ (Klitgaard, 2000). Leys urged scholars to measure the scale and economic effects of corrupt practices. At that time, he lamented, ‘but so far very few people have approached the subject of corruption in this spirit, aiming to describe, measure, analyze, and explain the phenomena involved’ (Leys, 1965).

Oftentimes it is quite easy to identify a ‘more corrupt’ society. We see that public officials demand bribes, that public funds are misdirected, or that business deals require plenty of *baksheesh*.¹ We have a sense that public and private business is not conducted in ethical ways and their norms violate legal norms existing abroad. Identifying a corrupt society may not be difficult, but actually measuring corruption is quite challenging. The main reasons for wanting to measure corruption are to be able to track changes within a society over time and to be able to compare two or more countries.

How Does One Begin to Measure Corruption?

The foremost reason why quantifying corruption is an art is that these data are not directly observable. Coleman (1998) in writing about criminal acts of white collar workers comments upon this: ‘By its very nature, crime is a secretive business.’ Corrupt behavior, both criminal and the merely illicit, is also hidden from view. Precise information on the quantity and size of bribes, for example, is not reported to authorities. Yet this is exactly the kind of information we seek, if

¹ From Persian, meaning a tip or bribe. Used commonly as a word for bribe to expedite service.

we wish to measure corruption. So, a next best approach is chosen; that is, in order to survey public and private officials, indices are created based upon these, and conceptual views are produced about corruption that are comparative across time and countries. Transparency International was an innovator in this technique.

This is not the only way that one can measure corruption. Kaufmann, Kraay, and Mastruzzi (2007) point out three techniques for measuring corruption:

1. Survey the stakeholders (business executives, public officials, individuals, observers from NGOs, aid agencies).
2. Measure institutional features (how procurement occurs, how transparent budgets are, etc.).
3. Conduct audits.

Research work on corruption focuses upon the first method. NGOs and international agencies work with countries to improve upon how the second method is done. Audits of financial records detect corruption through inconsistencies. Auditing serves to raise the probability of detection.

Corruption indices are often created using survey methods. With these one can see the improvement or worsening within a country and how corruption indicators compare across countries for each year. There has been movement towards creating and using a plethora of numeric tables and figures based upon the painstaking exercise of data collection and operationalizing corruption. Corruption indices have given rise to a large, new array of literature about public and private corruption, and policy-makers now often claim to be able to manage and monitor corruption, based upon what they can measure.

Two examples of corruption indicators are given in Appendix II, Tables AII.2–4. Table AII.2 shows the index number for each country which has been converted into a percentile ranking for each index. Table AII.3 shows the index number for each country, the number of surveys included in its creation, and the confidence interval for this index number. These tables illustrate measurements by Transparency International (2007b) for corruption perceptions and by the Economist Intelligence Unit for corruption levels. Examples of surveys that are used to create such indices are shown in Appendix II, Table AI.1.

Increasing Demand for Measuring Corruption

Who uses corruption statistics? The media fully exploits the annual publication of Transparency International's Corruption Perceptions Index. Businesses use these statistics to help gauge risks to foreign investment, joint ventures, foreign stock offerings, etc. Governmental agencies, development agencies, and NGOs use this information to help direct loans and grants and other forms of aid. Governments use improvements in this information to help show the world that their institutions are being strengthened domestically.

Notwithstanding the notable progress of quantitative analysis in social sciences, the concept of corruption has long remained immeasurable due to its complexity, secrecy and political sensitivity. The increase in movement of capital and business operations² over time has prompted investors to think through governance and corruption issues. In addition to corruption in host countries, corporate accountability has become a word of the day, especially after high-profile private-sector corruption scandals. Given potential risk exposure in countries with systemic corruption, it is no wonder that private-sector actors all over the world have started to factor in corruption in their decision-making.³ Arndt and Oman (2006) note, ‘as international investors, aid donors, and development analysts have increasingly come to understand the importance of governance, they have sought to render the concept operational for decision making purposes.’ International donors face their own risks in offering aid to dysfunctional governments. Because of the mounting demand by private investors and policy-makers to grasp the risks they face in politically fragile and corrupt environments, the need for measurement of the corruption has become ever-increasing.

Addressing corruption is also about improving governance to insure that scarce resources are used effectively. In the case of public corruption and governance, ‘citizens in developing countries can use measures of governance to hold governments accountable for their actions – at the micro-level for the quality of service provision, at the aggregate level for the responsiveness of government action to the public interest, at all levels for the probity of using resources’ (*Global Monitoring Report 2006*: 123).

The private sector has begun fighting back against public corruption and is now participating in the process of creating good information about corruption. TRACE, a non-profit organization that specializes in anti-bribery compliance, launched its online corruption-reporting tool ‘BRIBeline’ in July 2007. The service is multilingual and reports can be made anonymously. ‘Companies need help. Currently they bear the entire burden of anti-bribery compliance. While government is increasingly cracking down on the payment of bribes, there are no resources to track where and how government officials are asking for bribes’ (TRACE, 2007). TRACE aims to autonomously accomplish what governments and international organizations have struggled to do – gather real corruption data

2 FDI has grown from \$10 billion in 1980 to \$67 billion in 1992–4, and over \$150 billion from 1997. Portfolio investment by pension funds and major institutional investors increased from \$2 million in the late 1980s to about \$20 billion in bonds and \$26 billion in portfolio equity in the 1990s (Arndt and Oman 2006: 15–16).

3 There is a strong correlation between companies with good corporate governance and long-term financial performance. Research also indicates that institutional investors place equal value on corporate governance and financial indicators when evaluating investment decisions. Hence, investors are willing to pay a premium for good corporate governance and need accountable, predictable and transparent environments in which they can invest (Putrajaya Committee on GLC High Performance, 2006).

and empower firms to fight back against corruption; however, it only collects information on public, not private, corruption.

Indicators of Corruption and Governance

Each corruption indicator measures corruption uniquely. Some clearly focus upon public corruption and omit private corruption. Some specifically focus upon certain experiences by asking questions such as ‘How likely is it in Country X to complete a business transaction without paying a bribe?’ In most cases, the words bribery and corruption could be interchanged in these measurements.

We look at both corporate governance and public-sector governance, but generally when the simple term, ‘governance,’ is being used it refers to quality and timing in the delivery of the public goods and services that are being discussed. When referring to the private sector, usually ‘corporate governance’ is used. The concept of governance captures how well services are provided, how honestly and directly patrons are served, and how accountable an organization is to its patrons.

A broad list of indicators is included in Table 5.1.

These indicators are produced by both private and international agencies. The majority of the private producers have fee-based services that cater to multinational business interests. The indicators discussed below do not represent an exhaustive list of all available corruption indicators. These are the oldest or more commonly used and most accessible indicators.

Table 5.1 Indicators and reports on corruption and governance

Agency	Corruption and governance indicators and reports
African Development Bank (ADB)	<i>Country Policy and Institutional Assessments</i>
Afrobarometer	<i>Afrobarometer</i>
Asian Development Bank (ADB)	<i>Country Policy and Institutional Assessments</i>
Bertelsmann Foundation	<i>Bertelsman Transformation Index</i>
Brown University	<i>Global E-Governance</i>
Business Environment Risk Intelligence (BERI)	<i>Business Risk Service</i>
	<i>Qualitative Risk Measure</i>

Table 5.1 *Concluded*

Columbia University	<i>State Capacity Project</i>
Economist Intelligence Unit (EIU)	<i>EIU Market Indicators and Forecasts</i>
European Bank for Reconstruction and Development (EBRD)	<i>Transition Report</i>
Freedom House	<i>Countries at the Crossroads</i> <i>Nations in Transition</i> <i>Freedom in the World</i>
Gallup International	<i>Voice of the People Survey</i>
Global Insight (DRI)	<i>Global Risk Service</i> <i>Business Conditions and Risk</i>
Heritage Foundation	<i>Economic Freedom Index</i>
IJET Travel Intelligence (IJT)	<i>Country Security Risk Assessment</i>
Institute for Management and Development	<i>World Competitiveness Yearbook</i>
International Research and Exchange Board (IREX)	<i>Media Sustainability Index</i>
Latinobarometer	<i>Latinobarometro Surveys</i>
Merchant International Group (MIG)	<i>Grey Area Dynamics</i>
Political and Economic Risk Consultancy (PERC)	<i>Corruption Survey</i>
Political Risk Services (PRS)	<i>Country Risk Guide</i> <i>Corruption in Asia Report</i>
Reporters without Borders (RSF)	<i>Reporters without Borders</i>
US State Department	<i>Trafficking in People Report</i>
World Bank Institute	<i>Business Enterprise Environment Survey</i> <i>World Business Environment Survey</i> <i>Country Policy and Institutional Assessments</i>
World Economic Forum (WEF)	<i>Global Competitiveness Report</i>

International Country Risk Guide

The ever-increasing interest of investors has provided an impetus for consulting firms to offer various institutional and political indicators to help investors manage risk. For example, the *International Country Risk Guide* (ICRG) by the Political Risk Service Group (PRS) of Syracuse, NY, has produced political risk indicators since the 1980s.⁴ The ICRG indicators assess financial, economic and political risks that investors are likely to face in 140 countries. The financial and economic indicators are objective measures, such as foreign debt-to-GDP ratio, international liquidity, inflation, etc. Political risk ratings rely upon experts' subjective assessments. Corruption is included as part of the subjective measurement of political risk.

The ICRG indicator of corruption (see Table 5.2) attempts to capture 'potential corruption in the form of excessive patronage, nepotism, job reservations, favor-exchange, secret party funding, and suspiciously close ties between politics and business' (ICRG website). Disclosure to the public of this kind of corruption can increase political risk by causing a popular backlash, social unrest, lawlessness, overthrow of the government, or reorganizing of political institutions. PRS constructs the corruption indicator by calculating how long a government has been in power. Corruption is taken as a matter of course in unelected governments; one-party states are usually given the lowest ratings. For elected governments, 'it has been our experience, almost without exception, that things begin to go wrong after an elected government has been in office for more than two consecutive terms' (Galtung 2005).

ICRG has produced numerous variables, including government stability, internal and external conflict, law and order, democratic accountability and corruption. It has been used widely by institutional investors, banks, multinational corporations, foreign exchange traders and recently by development community and academics.⁵

ICRG is a subscription service. ICRG's full database is less accessible to the general public and scholars because of its cost;⁶ however, many indices are available online through the 'free samples' link.⁷ Much of the data produced by ICRG, as well as by similar business risk services, focus narrowly on the risks for investors in foreign countries.

4 The editors of international reports created the ICRG model for forecasting financial, economic, and political risk in 1980 to meet the needs of clients who required an in-depth analysis of possible risk.

5 Knack and Keefer (1995), Hall and Jones (1999) and other studies have used the ICRG indicators to examine the impact of institutions on economic performance.

6 For instance, the political risk ICRG data for available countries and years costs more than US\$10 000. Economic data for all available countries for all years costs around \$7000. Based the cost estimates in downloading dataset from the ICRG website.

7 <<http://www.prsgroup.com/FreeSamplePage.aspx>>.

Table 5.2 ICRG political risk points by component

A	Government Stability	G	Military in Politics
B	Socioeconomic Conditions	H	Religious Tensions
C	Investment Profile	I	Law and Order
D	Internal Conflict	J	Ethnic Tensions
E	External Conflict	K	Democratic Accountability
F	Corruption	L	Bureaucracy Quality

COUNTRY	A	B	C	D	E	F	G	H	I	J	K	L	Risk Rating 01/08	Risk Rating 12/07
Albania	8.0	5.5	8.5	10.5	11.0	1.5	5.0	5.0	2.5	4.5	4.5	2.0	68.5	68.0
Algeria	9.0	6.0	8.5	8.5	10.5	1.5	3.0	2.5	3.0	3.5	4.5	2.0	62.5	62.5
Angola	9.5	2.0	8.0	9.0	11.0	2.0	2.0	4.0	3.0	3.0	2.0	1.5	57.5	57.5
Argentina	9.5	5.0	6.5	10.0	9.5	2.5	4.5	6.0	2.5	6.0	4.5	3.0	69.5	69.5
Armenia	9.0	4.0	8.5	10.0	7.5	1.5	3.5	5.0	3.0	5.5	3.0	1.0	61.5	62.0
Australia	10.0	10.5	12.0	10.0	9.5	4.5	6.0	6.0	5.5	4.0	6.0	4.0	88.0	88.0
Austria	8.0	9.5	12.0	11.5	11.5	5.0	6.0	5.0	6.0	4.0	5.5	4.0	88.0	87.5
Azerbaijan	9.5	8.0	9.5	9.0	7.5	1.5	4.0	5.0	3.5	4.5	1.5	1.0	64.5	64.5
Bahamas	9.0	7.5	11.5	11.0	12.0	4.0	6.0	6.0	4.5	4.0	5.5	3.0	84.0	84.0
Bahrain	8.0	8.5	11.5	10.0	11.0	2.0	3.0	3.5	5.0	5.0	4.5	2.0	74.0	74.0
Bangladesh	8.0	2.5	7.0	6.0	8.5	2.5	1.5	3.5	2.5	2.5	3.0	2.0	49.5	49.5
Belarus	10.0	5.5	5.5	10.0	8.0	2.0	3.0	5.0	4.0	5.0	1.0	1.0	60.0	60.0
Belgium	8.5	8.5	11.5	11.5	11.5	3.5	6.0	4.5	5.0	3.0	6.0	4.0	83.5	80.0
Bolivia	8.5	4.5	3.0	8.5	9.5	2.0	3.0	6.0	3.0	3.0	5.0	2.0	58.0	58.0
Botswana	10.5	6.0	10.5	10.5	11.0	3.5	6.0	5.0	3.5	4.5	3.5	2.0	76.5	76.5
Brazil	8.5	6.0	7.5	10.0	10.5	2.0	4.0	6.0	2.0	3.0	5.0	2.0	66.5	65.5
Brunei	11.5	10.5	11.5	12.0	11.5	2.5	5.0	5.0	5.0	5.0	0.5	3.5	83.5	83.5
Bulgaria	8.5	6.0	11.5	10.5	9.5	2.0	5.0	5.0	2.5	4.5	5.5	2.0	72.5	72.5
Burkina Faso	8.5	4.0	9.5	10.0	8.5	2.0	2.5	5.0	3.5	4.0	3.0	1.0	61.5	61.5
Cameroon	10.5	3.5	9.0	10.0	10.0	3.5	4.0	5.0	2.0	4.0	3.5	1.0	66.0	66.0
Canada	8.0	9.0	11.5	10.5	11.0	5.0	6.0	6.0	6.0	3.5	6.0	4.0	86.5	86.5
Chile	7.0	8.0	11.5	10.0	9.0	4.5	4.5	6.0	5.0	5.0	5.0	3.0	78.5	79.5
China	11.0	9.0	7.0	10.0	10.0	2.5	3.0	5.0	4.5	4.5	1.5	2.0	70.0	70.5
Colombia	9.0	3.0	8.5	5.5	8.5	2.5	2.0	5.0	1.5	5.0	4.5	2.0	57.0	56.5

Table 5.2 *Continued*

Congo, Dem. Rep.	8.5	1.5	6.0	6.5	6.5	1.0	0.0	4.0	1.0	1.0	2.0	0.0	38.0	38.5
Congo, Rep.	11.0	3.0	9.0	8.0	10.0	2.0	0.0	3.0	2.0	4.0	3.0	1.0	56.0	55.0
Costa Rica	6.5	7.5	8.0	10.5	10.0	2.0	6.0	5.0	3.5	6.0	5.5	2.0	72.5	73.0
Cote d'Ivoire	8.5	2.0	5.0	8.0	8.5	2.0	1.5	2.0	2.5	2.0	2.0	0.0	44.0	44.0
Croatia	7.5	5.0	9.5	11.5	9.5	2.5	5.0	5.0	5.0	5.0	5.5	3.0	74.0	73.5
Cuba	8.5	6.5	3.5	10.0	10.0	2.5	2.0	4.0	4.0	6.0	0.0	2.0	59.0	59.0
Cyprus	8.5	10.5	12.0	11.0	9.5	4.0	5.0	4.0	5.0	2.5	6.0	4.0	82.0	82.0
Czech Rep	7.0	7.5	11.5	10.5	10.5	2.5	6.0	6.0	5.0	4.0	5.5	3.0	79.0	79.5
Denmark	8.0	11.0	11.5	9.0	8.5	5.5	6.0	6.0	6.0	4.0	6.0	4.0	85.5	85.5
Dominican Rep	8.5	4.0	9.5	11.0	10.0	2.0	3.0	5.0	2.5	5.0	5.0	1.0	66.5	66.5
Ecuador	8.0	4.5	4.5	8.0	9.0	3.0	1.5	5.0	2.5	3.5	4.5	2.0	56.0	55.5
Egypt	9.5	5.0	6.5	8.5	10.5	2.0	3.0	3.0	3.5	5.0	2.0	2.0	60.5	60.5
El Salvador	8.5	4.5	8.0	9.0	10.5	2.5	3.0	6.0	1.5	6.0	5.0	2.0	66.5	66.5
Estonia	10.0	9.0	10.5	11.5	10.0	3.0	5.0	5.0	4.0	2.5	5.5	2.5	78.5	78.5
Ethiopia	8.5	2.0	7.0	7.0	5.5	2.0	1.0	5.0	4.5	2.5	4.5	1.5	51.0	51.0
Finland	9.5	9.5	12.0	11.0	11.5	6.0	6.0	6.0	6.0	6.0	6.0	4.0	93.5	94.0
France	9.5	8.0	12.0	10.0	10.0	5.0	5.5	4.0	5.0	2.5	6.0	3.0	80.5	79.5
Gabon	9.0	4.0	9.0	8.5	9.5	1.0	2.0	5.0	3.0	4.5	3.0	1.0	59.5	59.5
Gambia	9.5	4.0	8.5	10.5	11.0	2.5	2.0	5.0	4.0	5.0	2.0	2.0	66.0	66.0
Germany	10.0	8.0	12.0	11.0	10.5	5.0	6.0	5.0	5.0	4.0	6.0	4.0	86.5	87.5
Ghana	8.5	5.5	8.5	9.5	11.5	1.5	3.0	6.0	2.5	3.5	5.0	2.5	67.5	67.5
Greece	8.5	8.0	10.5	8.5	10.5	2.0	5.0	5.0	4.5	5.0	6.0	3.0	76.5	77.0
Guatemala	8.0	4.5	9.5	9.0	9.5	1.5	5.0	6.0	1.0	3.0	3.0	2.0	62.0	62.5
Guinea	7.0	3.5	4.5	7.5	7.5	2.0	0.5	3.0	2.5	2.0	2.0	2.0	44.0	43.5
Guinea-Bissau	6.5	2.0	7.5	9.0	10.0	2.0	1.5	5.0	3.0	3.0	5.0	1.5	56.0	56.0
Guyana	7.0	3.5	6.5	9.5	9.5	2.0	4.0	6.0	2.0	2.0	5.0	3.0	60.0	60.0
Haiti	9.5	0.0	4.5	9.0	7.0	1.0	0.0	6.0	2.0	5.0	2.5	0.0	46.5	46.5
Honduras	7.0	2.0	6.5	10.0	10.5	2.0	4.0	5.0	1.5	5.0	4.0	2.0	59.5	59.5
Hong Kong	10.5	9.5	12.0	11.0	10.5	4.0	5.0	5.0	5.0	5.0	2.5	3.0	83.0	83.0
Hungary	6.5	7.0	11.0	10.5	10.0	3.0	6.0	5.5	4.0	4.0	6.0	3.0	76.5	76.5
Iceland	10.0	10.5	10.0	11.5	10.5	5.5	6.0	6.0	6.0	5.5	6.0	4.0	91.5	91.5
India	6.0	5.5	8.5	6.5	10.0	2.5	4.0	2.5	4.0	2.5	6.0	3.0	61.0	61.5
Indonesia	7.5	7.0	9.0	9.0	10.5	3.5	2.5	1.0	3.0	2.0	5.0	2.0	62.0	62.0

Table 5.2 *Continued*

Iran	8.5	5.5	6.5	8.5	6.0	2.0	5.0	2.0	4.0	3.5	4.5	2.0	58.0	58.0
Iraq	5.0	0.5	7.5	3.5	5.5	1.0	0.0	1.5	1.5	2.5	4.0	0.0	32.5	32.0
Ireland	9.0	10.0	12.0	11.5	11.5	3.5	6.0	5.0	6.0	5.5	6.0	4.0	90.0	90.5
Israel	5.5	7.0	10.0	7.5	7.5	3.0	2.5	2.5	5.0	2.0	6.0	4.0	62.5	63.0
Italy	6.5	8.5	11.5	10.0	11.0	2.5	6.0	5.5	4.0	4.5	5.5	2.5	78.0	79.0
Jamaica	9.0	6.0	9.5	10.0	11.5	1.5	6.0	6.0	2.5	5.0	4.0	3.0	74.0	74.0
Japan	6.5	8.0	11.5	10.5	9.5	3.0	5.0	5.5	5.0	5.5	5.0	4.0	79.0	79.0
Jordan	11.0	4.5	10.0	10.0	11.0	3.0	5.0	4.0	4.0	4.5	3.0	2.0	72.0	72.0
Kazakhstan	10.5	9.0	8.5	11.0	11.0	1.5	5.0	5.0	4.0	5.0	2.0	2.0	74.5	74.5
Kenya	6.0	2.0	9.5	8.0	9.0	0.5	4.0	4.0	2.0	3.0	5.5	2.0	52.5	56.6
Korea, DPR	8.5	1.5	6.0	10.0	7.5	1.0	1.0	6.0	5.0	6.0	0.0	0.0	52.5	53.0
Korea, Rep	7.0	10.0	10.0	10.0	9.0	3.0	4.0	6.0	5.0	6.0	6.0	3.0	79.0	78.0
Kuwait	9.5	10.0	11.5	9.5	11.0	3.0	5.0	4.0	5.0	5.0	3.0	2.0	78.5	78.5
Latvia	8.0	7.0	11.0	11.0	11.0	2.0	5.0	5.0	5.0	3.0	5.0	2.5	75.5	72.5
Lebanon	6.5	5.0	8.5	8.0	7.0	1.0	2.0	2.5	4.0	5.0	5.0	2.0	56.5	56.5
Liberia	9.0	2.5	5.0	9.0	8.5	2.5	3.0	4.0	2.5	3.0	5.5	0.0	54.5	54.5
Libya	10.5	5.0	10.0	11.5	10.5	1.5	3.0	5.0	4.0	5.0	1.0	1.0	68.0	68.0
Lithuania	7.0	7.5	11.0	11.5	10.0	2.0	5.0	5.5	4.0	4.0	5.5	2.5	75.5	75.5
Luxembourg	10.0	9.5	12.0	12.0	11.5	5.0	6.0	6.0	6.0	5.0	6.0	4.0	93.0	93.0
Madagascar	9.5	4.0	7.5	9.5	11.0	4.0	1.0	5.0	2.5	2.5	5.0	1.0	62.5	62.5
Malawi	5.0	2.5	8.5	8.0	11.0	1.5	4.0	2.5	3.0	3.5	4.0	2.0	55.5	55.5
Malaysia	9.0	10.0	9.5	10.5	10.5	2.5	5.0	4.0	4.0	4.0	4.5	3.0	76.5	75.5
Mali	10.5	4.5	8.0	6.5	10.0	2.0	3.5	4.0	3.0	4.0	3.0	0.0	59.0	59.0
Malta	8.0	9.0	11.5	11.5	12.0	3.5	6.0	5.0	5.0	5.0	6.0	3.0	85.5	85.5
Mexico	8.5	8.5	10.5	9.5	11.0	2.0	4.5	5.5	3.0	3.0	6.0	3.0	75.0	75.0
Moldova	8.5	3.5	6.5	9.5	10.0	1.5	4.0	6.0	5.0	2.0	4.0	1.0	61.5	61.5
Mongolia	8.0	3.5	8.0	11.0	11.5	2.0	5.0	5.0	4.0	5.0	4.0	2.0	69.0	69.0
Morocco	9.0	4.5	9.5	7.5	10.0	3.0	4.0	5.0	5.0	4.5	4.5	2.0	68.5	68.5
Mozambique	10.0	3.5	9.0	10.5	12.0	2.0	4.0	6.0	3.0	4.0	4.5	1.0	69.5	69.5
Myanmar	9.5	4.0	2.5	7.5	8.5	1.5	1.0	5.5	3.0	3.0	0.0	1.0	46.5	46.5
Namibia	10.5	6.0	10.0	11.0	11.5	2.5	6.0	6.0	5.0	4.5	4.0	2.0	79.0	78.0
Netherlands	7.0	9.5	12.0	10.0	12.0	5.0	6.0	2.5	6.0	4.5	6.0	4.0	84.5	84.5
New Zealand	6.0	9.5	12.0	11.5	10.5	5.5	6.0	6.0	5.5	3.5	6.0	4.0	86.0	86.0

Table 5.2 *Continued*

Nicaragua	7.0	4.0	9.0	11.0	9.5	2.5	3.0	5.0	4.0	5.0	6.0	1.0	67.0	67.5
Niger	7.5	2.5	7.0	8.0	11.5	1.5	3.0	2.0	2.0	3.0	4.5	1.0	53.5	53.5
Nigeria	7.0	1.5	6.0	5.5	9.0	1.5	2.0	2.0	2.0	2.0	3.5	1.0	43.0	43.5
Norway	8.0	11.0	11.5	11.0	11.0	5.0	6.0	5.5	6.0	4.5	6.0	4.0	89.5	89.5
Oman	11.0	10.0	11.5	10.0	10.0	2.5	5.0	4.0	5.0	5.0	1.0	2.0	77.0	77.0
Pakistan	4.0	5.0	7.5	5.5	8.5	2.0	1.0	1.0	3.0	1.0	1.0	2.0	41.5	43.5
Panama	9.5	6.0	10.0	10.0	11.0	2.0	5.0	5.0	3.0	5.0	6.0	2.0	74.5	74.5
Papua New Guinea	9.0	3.5	8.0	10.0	10.5	1.0	4.5	5.0	2.5	2.0	4.5	2.0	62.5	62.5
Paraguay	7.0	3.5	8.5	7.5	10.5	1.0	1.5	6.0	2.0	5.0	2.0	1.0	55.5	55.5
Peru	6.5	4.5	8.0	7.5	10.5	2.5	5.0	6.0	3.0	3.0	5.0	2.0	63.5	63.5
Philippines	5.0	5.0	9.0	6.5	11.0	2.0	3.5	3.0	2.5	5.0	5.0	3.0	60.5	60.5
Poland	8.0	6.0	11.0	9.5	9.5	2.5	6.0	5.0	4.5	6.0	6.0	3.0	77.0	77.0
Portugal	8.5	8.5	12.0	9.5	9.5	4.0	6.0	5.5	5.0	6.0	6.0	3.0	83.5	83.0
Qatar	11.5	8.0	10.0	9.5	8.5	2.5	4.0	4.0	5.0	6.0	2.0	2.0	73.0	73.0
Romania	6.5	6.0	9.0	10.5	11.0	2.5	5.0	5.0	4.0	3.5	6.0	1.0	70.0	70.0
Russia	11.5	7.0	9.5	8.0	8.5	2.0	4.5	5.5	4.0	3.0	2.5	1.0	67.0	67.5
Saudi Arabia	10.0	6.5	11.0	9.0	10.0	2.0	5.0	3.0	5.0	5.0	0.5	2.0	69.0	69.0
Senegal	11.0	4.5	8.0	8.0	10.0	2.5	2.0	3.0	3.0	3.0	3.5	1.0	59.5	59.5
Serbia	8.0	2.5	7.5	9.5	9.0	2.0	4.0	5.0	3.5	3.0	5.5	2.0	61.5	62.0
Sierra Leone	10.5	2.0	7.0	9.5	10.0	1.5	2.5	5.0	3.5	5.0	4.5	0.0	61.0	61.5
Singapore	11.0	9.5	12.0	10.5	10.5	4.5	5.0	4.5	5.0	6.0	2.0	4.0	84.5	84.5
Slovak Rep	8.5	8.0	11.0	11.5	11.0	2.5	6.0	4.0	4.0	3.5	6.0	3.0	79.0	78.5
Slovenia	8.0	6.5	11.0	11.5	10.5	3.0	5.5	5.5	4.5	3.5	5.0	3.0	77.5	77.5
Somalia	5.5	0.0	2.0	4.0	4.0	1.0	1.0	3.0	0.5	2.0	1.0	0.0	24.0	24.0
South Africa	7.5	4.0	10.5	9.5	10.5	2.5	5.0	5.0	2.5	4.0	5.0	2.0	68.0	69.0
Spain	9.0	8.5	12.0	9.5	10.0	4.0	5.0	4.5	5.0	4.0	6.0	3.0	80.5	80.0
Sri Lanka	7.5	3.5	7.5	7.5	10.5	2.5	2.0	2.0	3.0	1.5	4.0	2.0	53.5	53.5
Sudan	8.5	2.5	7.5	6.0	9.0	1.0	0.0	2.0	2.5	1.5	2.0	1.0	43.5	43.5
Suriname	7.0	5.0	7.0	9.0	9.5	2.0	3.0	6.0	3.0	4.0	5.5	2.0	63.0	63.0
Sweden	7.5	9.0	12.0	11.5	11.0	5.0	5.5	6.0	6.0	5.0	6.0	4.0	88.5	88.5
Switzerland	9.0	10.5	12.0	12.0	11.0	4.5	6.0	4.5	5.0	4.0	6.0	4.0	88.5	89.0
Syria	10.0	5.5	5.0	10.5	7.5	2.0	2.0	5.0	5.0	3.0	1.0	1.0	57.5	57.5
Taiwan	8.0	9.5	11.5	11.0	8.0	2.5	4.0	6.0	5.0	5.0	5.0	3.0	78.5	74.5

Table 5.2 *Concluded*

Tanzania	10.0	3.0	6.5	9.0	10.0	3.5	4.0	3.0	5.0	4.0	4.0	1.0	63.0	63.0
Thailand	7.0	7.0	7.0	8.0	10.0	1.5	3.5	2.0	2.5	2.0	4.5	2.0	57.0	56.0
Togo	10.5	2.5	7.5	9.5	9.5	1.5	0.0	5.0	3.0	2.0	2.5	0.0	53.5	53.5
Trinidad & Tob	9.5	6.0	11.5	9.0	11.0	2.0	5.0	5.0	2.5	3.5	4.0	3.0	72.0	72.0
Tunisia	11.0	6.5	8.5	10.5	11.0	2.0	4.0	5.0	5.0	5.0	2.0	2.0	72.5	72.5
Turkey	9.0	6.5	8.0	8.0	7.5	2.5	2.0	4.5	4.5	2.5	5.0	2.0	62.0	62.0
Uganda	10.0	4.0	8.5	7.0	7.5	2.0	2.0	2.5	3.5	3.0	2.5	2.0	54.5	54.5
Ukraine	8.5	6.5	8.0	10.5	10.0	2.0	5.0	5.0	4.0	4.0	5.5	1.0	70.0	70.0
UAE	11.0	10.5	11.5	10.0	11.0	2.0	5.0	4.0	4.0	5.0	2.5	3.0	79.5	79.5
UK	8.0	9.5	12.0	9.5	7.0	4.0	6.0	6.0	5.5	4.0	6.0	4.0	81.5	82.0
USA	6.0	8.0	12.0	10.0	7.0	4.0	4.0	5.5	5.0	5.0	6.0	4.0	76.5	77.0
Uruguay	9.5	5.0	9.5	10.0	9.0	3.0	4.0	5.0	2.5	6.0	5.0	2.0	70.5	70.5
Venezuela	10.0	5.0	2.5	8.5	8.0	1.0	0.5	4.0	2.0	5.0	3.5	1.0	51.0	51.0
Vietnam	10.5	6.0	9.0	10.5	11.5	3.5	3.0	4.0	4.0	4.5	1.0	2.0	69.5	69.5
Yemen	10.5	5.5	8.0	7.0	10.0	2.0	4.0	4.0	2.0	4.0	4.0	1.0	62.0	62.0
Zambia	7.5	2.0	6.0	10.5	10.0	3.5	5.0	5.0	4.0	5.0	4.0	1.0	63.5	63.5
Zimbabwe	6.0	0.5	1.0	7.0	9.0	0.0	2.5	5.0	3.0	4.0	2.0	1.5	41.5	41.5

Source: PRS (2008) Excerpt from International Country Risk Guide.

Transparency International and the Corruption Perception Index

The most comprehensive distillation of corruption evidence has been undertaken by Transparency International (TI) and the World Bank Institute (WBI). In 1995, TI constructed the first publicly available dataset on the perceived level of corruption in 41 countries. Since then, TI has published a yearly report that ranks countries according to their Corruption Perceptions Index (CPI) among public officials and politicians.⁸ The CPI today enjoys a broad audience and has become a powerful tool in the campaign against corruption.

The CPI is a survey of surveys, which aggregates various corruption-related data sources into a single number index. The index ranges from ten to zero (ten

⁸ The CPI originally focused on corruption in the public sector and defined corruption as the abuse of public office for private gain. This definition has since been broadened to include the private sector as well. The surveys used in compiling the CPI ask questions that relate to the misuse of public power for private benefit, with a focus, for example, on bribetaking by public officials in public procurement. The sources do not distinguish between administrative and political corruption or between petty and grand corruption.

being the ‘least corrupt’ and zero being the ‘most corrupt’). The 2008 publication of corruption perceptions indices from 2007 (see Appendix II, Table 2) ranked 180 countries and territories utilizing, on average, six surveys and expert assessments per country from 12 independent institutions (Transparency International, 2007a).

The CPI is aggregated from three groups of sources (see Table 5.3). The first group of sources covers the perceptions of non-residents from developed countries. A second group of sources focuses on non-residents from neighboring countries. Lastly, a third group of sources assembles the perceptions of residents.

The CPI is an aggregate measure based on conventional statistical premise that the larger the sample size, the closer estimates are to their true population values. In other words, by aggregating the varieties of perceptions, a more comprehensive picture of corruption is believed to be obtained. The various sources of data are assembled, an unweighted index is created, averages from standardized values are computed, and they undergo a standardization procedure (beta-transformation). This produces the Corruption Perception Index and its corresponding confidence values.⁹

Investment Climate Assessment

Bribe-takers make up the demand side of corruption while bribe-payers constitute the supply side of corruption. There has been an upsurge of surveys that capture the most common demand and supply side of corruption. The World Bank, with other donor and research institutions, has developed one of the most comprehensive of these surveys, the Investment Climate Assessment, (ICA), also known as the Investment Climate Surveys and Enterprise Surveys.

The ICA measures bottlenecks and constraints to the private sector, caused by the public sector, including various forms of corruption. The surveys gauge the actual experiences of company managers and employees from a combination of large, medium, and small service and manufacturing enterprises. An ICA consists of two parts: (i) obstacles to doing business, and (ii) productivity measures such as production costs, investment flows, balance sheet information and workforce statistics compiled from accounting information (World Bank, 2003; ICA website).

To minimize bias, private contractors collect the data.¹⁰ Every year, the World Bank conducts 10–20 ICA surveys; an update follows the survey every three to five

⁹ For detailed methodological discussion, see Lambsdorf (2005).

¹⁰ The survey analysts use simple random sampling or random stratified sampling which further helps reduce bias in the data. Research institutions, independent consulting firms and local researchers with experience in survey implementation partner in conducting and analyzing the surveys (International Bank for Reconstruction and Development, 2003). Coordination with governmental statistics agencies is often required either by law or by necessity, as they may be the only source for much of these data. Responses are anonymous.

Table 5.3 Corruption Perceptions Index sources

Source	Non-residents from developed countries	Subject of interest
CU	US-resident country experts (policy analysts, academics and journalists)	Severity of corruption within the state
EIU	Expert staff assessment	The misuse of public office for private (or political party) gain
FH	Assessment by US, regional and in-country experts	Extent of corruption as practiced in governments, as perceived by the public and as reported in the media as well as the implementation of anti-corruption initiatives
MIG	Expert staff and network of local correspondents	Corruption, ranging from bribery of government ministers to inducements payable to clerks
WMRC	Expert staff assessment	The likelihood of encountering corrupt officials, ranging from petty bureaucratic corruption to grand political corruption
Source	Residents and neighbors	Subject of interest
IMD	Executives in domestic and international companies	Bribing and corruption exist in the economy
PERC	Expatriate business executives	How bad do you consider the problem of corruption to be in the country in which you are working as well as in your home country?
UNECA	National expert survey (between 70 and 120 in each country)	Control of corruption including corruption in the legislature, judiciary, and at the executive level and as well as in tax collection
WEF	Senior business leaders; domestic and international companies	Undocumented extra payments or bribes connected with various government functions

Note: CU = The State Capacity Survey by the Center for International Earth Science Information Network at Columbia University; EIU = the Economist Intelligence Unit (EIU); FH = Freedom House Nations in Transit; MIG = Grey Area Dynamics Ratings by the Merchant International Group; WMRC = the World Markets Research Centre; IMD = The International Institute for Management Development; PERC = the Political and Economic Risk Consultancy (PERC); UNECA = United Nations Economic Commission for Africa, African Governance Report 2005 (UNECA) and WEF = the World Economic Forum.

Source: Kobonbaev (2008), compiled from Transparency International (2005) and Lambsdorff (2005).

years. The recent ICA covered more than 60 countries and included almost most of the post-Communist countries. The units of analysis are business establishments. ICA survey questions are standardized, making cross-country comparisons possible. Sampling is constructed so as to correctly reflect the true contribution of companies to the economy by their size.

The ICA surveys cover ten general characteristics of business establishments and the investment climate in which they operate, from general information about the firm to business–government relations, crime, and investment climate constraints.

ICA surveys ask three questions related to public corruption in the courts, taxes, and governance. These questions are designed to establish a value for the percentage of sales that goes towards corruption payments (the bribe tax), percentage of firms expected to give ‘gifts’ to tax inspectors, and the percentage of a government contract that goes towards corruption payments to a government official. These three questions focus specifically on corrupt interactions between firms and public officials.

PERC corruption indicator for Asian countries

Similar to the ICA surveys which specialize in the former communist states are the Political and Economic Risk Consultancy (PERC) surveys that specialize in Asian countries. PERC is a private company based in Hong Kong that was created in 1976 to provide risk information. It specializes in regional reporting on corruption, business climate, and governance issues. Data are collected through personal interviews of professionals working in Asian countries to produce *Asian Intelligence Studies*, which produces reports on corruption in Southeast Asian countries, country studies, and the *Corruption in Asia Report*. The personal interviews are conducted via mailed survey forms and face-to-face interviews. Surveys’ average sample size is 100, with a minimum of 54 surveys for Macao (PERC website, www.asiarisk.com). PERC interviews expatriates working in Asia and regional managers of multinational firms.

PERC’s main coverage includes only Asian countries: China, Hong Kong, India, Indonesia, Japan, Macao, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, and Vietnam.

The reports produced by PERC are available in print and online formats, but nearly all are available by subscription service only.¹¹

World Bank corruption and governance indicators

The World Bank Institute, led by Kaufmann, has created four indicators that may be used to ascertain corruption levels. These are the Worldwide Governance

¹¹ Twenty-five monthly Asian Intelligence Studies per year cost \$645; the full set of country risk monitoring reports costs \$1175.

Research Indicators (GRI), the Business Environment and Enterprise Performance Survey (BEEPS), the World Business Environment Survey, and World Governance Indicators Dataset (www.worldbank.org/wbi/governance/data). These indicators may contain as little as a single source of data. The World Bank began estimating corruption and governance measures in 152 countries in 1996 and now publishes annually, reporting on 204 countries.

Kaufmann-Kraay Indicator By the late 1990s, economists at the World Bank Institute had developed a comprehensive data set covering broad governance concerns, the Kaufmann-Kraay (KK) Indicator. Like the CPI, the KK indicators combine hundreds of individual variables from 31 separate data sources, compiled from 25 different data sources, and covering 213 countries and territories for 1996–2005.¹² Unlike the CPI, the KK is designed to measure perceptions of governance, not corruption itself. One of the key dimensions in this governance indicator is control of corruption. The other dimensions include voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, and rule of law.

The KK control of corruption indicator measures ‘the extent to which public power is exercised for private gain, including petty and grand forms of corruption, as well as “capture” of the state by elites and private interests’ (Kaufmann, Kraay and Mastruzzi, 2006).

Another general governance indicator is the *Country Policy and Institutional Assessment* (CPIA) created by the World Bank staff.

The Business Enterprise Environment Performance Survey The Business Environment and Enterprise Performance Survey (BEEPS) is designed to gauge business climate in Eastern Europe and Central Asia through nationally representative surveys of firms. BEEPS is a database created by the World Bank and European Bank for Reconstruction and Development. Its sources are owners and managers of 200–600 firms in each country across 26 countries.¹³ Surveys were conducted in 1999, 2002, and 2005. Surveys attempt to quantify problems that foster corruption, such as unofficial payments, red tape, customs, etc., and other issues related to non-corruption problems in doing business, such as labor

12 The KK governance indicators are aggregated from data sources that consist of surveys of firms, individuals, non-governmental organizations, and donors (Kaufmann et al. 2006).

13 The 2005 round of the BEEPS consisted of 9655 interviews and surveys in 26 countries: Armenia, Azerbaijan, Belarus, Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Serbia and Montenegro, Slovak Republic, Slovenia, Tajikistan, Turkey, Ukraine, and Uzbekistan. See ‘Transition Economies Enterprise Survey’ <web.worldbank.org>.

problems, financing, legal issues, etc. BEEPS Interactive is a publicly available database, hosted at web.worldbank.org.

BEEPS includes surveys from a wide variety of companies. This allows for comparisons between firms; for example, one may ask ‘which industries or which size firms have to pay greater bribes?’ Information specifically about the manufacturing sector is available from the ‘Manufacturing Overlay.’

The designers of BEEPS built corporate diversity into their sampling technique. Single proprietorships of one employee and companies with more than 10 000 employees, companies that had been in business for less than three years, and companies whose prices were government-regulated were not included (World Bank, 2008). The surveys were created to take into account size by number of employees, ownership composition (foreign vs. domestic), location (rural vs. urban), and age.

The results of these surveys are available online and allow anyone to access BEEPS’ data and to compare across factors, such as business environment, corruption, financial development, firm behavior or performance, influence and lobbying, the legal system, public services, and regulation.¹⁴ An example of BEEPS data’s results is shown in Figure 5.1.

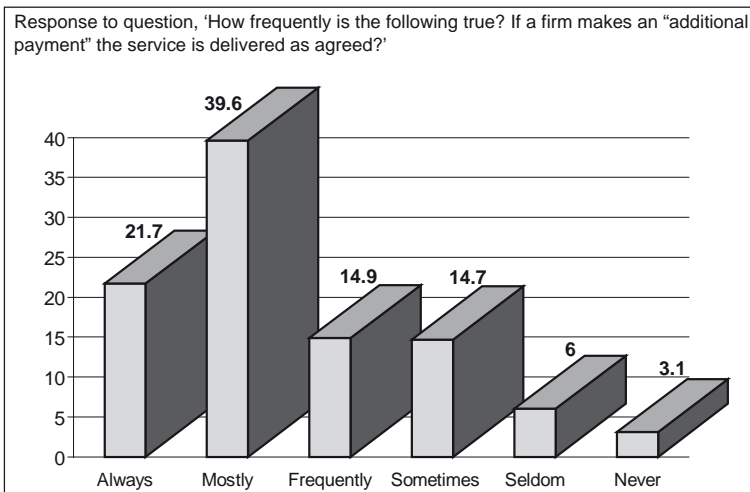


Figure 5.1 BEEPS corruption data sample output

Source: World Bank¹⁵

¹⁴ <<http://info.worldbank.org/governance/beeps>>.

¹⁵ Group Observations All Firms and Countries: 2275, Source: World Bank, ‘Governance & Anti-Corruption: RESULTS – DATA & CHARTS’ <<http://info.worldbank.org/governance/beeps/results.asp>> (accessed March 22, 2007).

BEEPS is a useful for those who would like some guidelines about the pervasiveness of corruption in the formerly communist countries. BEEPS Interactive answers questions such as:

- How much is the ‘usual payment’ and the percentage of revenues for such payments for a firm in a particular industry?
- How many officials will require payment for the same service?
- Is the service provided, as agreed, if payment is made?
- What services require bribes?
- What is the percentage of revenue?
- What is the negative impact of corruption upon a firm’s business?

World Competitiveness Yearbook

The World Competitiveness Yearbook is created by the the IMD Business School. It measures 55 countries on the basis of 323 criteria and ranks countries by their ability to maintain a pro-free enterprise competitive environment. This includes political, social, and cultural dimensions, as well as productivity and income. The yearbook results include statistical data and an executive opinion survey which measures perceptions about management practices, labor relations, environmental concerns, and corruption. These annual data are compiled into scores for each country (see Figure 5.2).

Countries that are ‘more competitive’ should have fewer obstacles to business, such as corruption. The 2006 Corruption Perceptions Index by Transparency International is compared with the 2007 World Competitiveness Yearbook scores. Competitiveness is highly correlated with corruption indices, suggesting a more open economy limits corruption or that less corruption creates a more open economy and fosters competition.¹⁶

Irrespective of the level of aggregation, few of the aforementioned governance and corruption data sets are objectively measurable. The data mostly reflect subjective perceptions of expert assessments and the perceptions of citizens and firms. While the use of expert assessments and perception-based data is ubiquitous in the social sciences, careful attention should be paid to the likely margins of uncertainty and to the interpretation of overall results. Although composite governance indicators are subject to a number of serious measurement and attribution problems, it is important to examine such data, if for no other reasons than to have some idea of which broad governance and corruption problems are most significant in which countries or regions.

16 The World Competitive Yearbook scores for 2007 are highly correlated with EIU corruption scores and with TI’s CPI. These are .843 and .837, respectively.

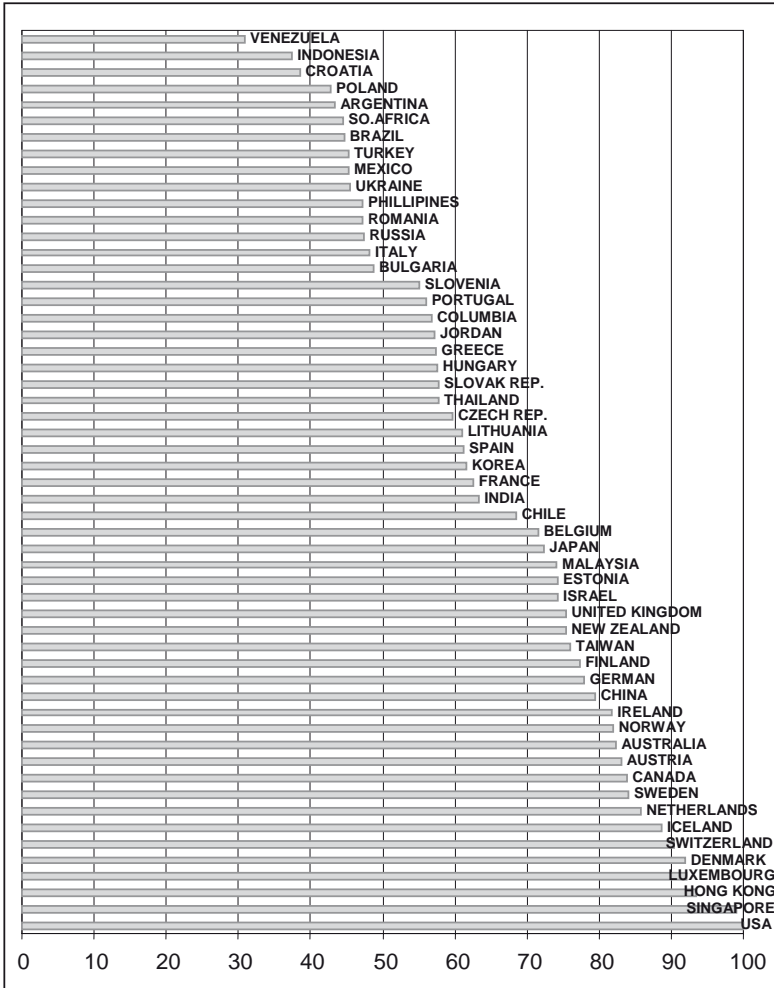


Figure 5.2 2007 World Competitiveness Yearbook scoreboard

Correlation Among the Indicators

If the data from surveys truly reflect the populations in the world, then results for rankings of countries should be correlated. Unfortunately, if there is an inherent bias in the survey results, which is a data problem (bias by respondents, interdependence, etc.), the same result would occur.

Lederman, Loayza and Soares (2001) calculate pair-wise correlations for the same year's data across six corruption indicators. Correlations ranged from 0.58

to 0.90. All were statistically significant at the 1 percent level. World Bank and Transparency indices are highly correlated at .98 in 2004 (Treisman, 2007).

Correlations among five of the indicators using current publications is shown in Table 5.4.

Whether positive correlation across surveys is due to 'good data' or 'data problems' is not clear. Certainly there are arguments to be made for both views. The next chapter discusses problems in some of the corruption and governance indicators.

Table 5.4 Correlations between indicators of corruption

	CPI (2006)	EIU (2006)	ICRG (2007)	1/PERC (2006)	WCY (2007)
CPI (2006)	1.000				
EIU (2006)	0.946	1.000			
ICRG (2007)	0.869	0.879	1.000		
1/PERC (2006)	0.823	0.707	0.843	1.000	0.694
WCY (2007)	0.837	0.843	0.748	0.694	1.000

Note: The scale for the PERC indicator was opposite of the others, so correlations were made with its inverse.

Conclusion

The most interesting research questions come from messy and complicated questions and dilemmas. Corruption is such an issue. It is hidden, due to shame, desire to avoid public censure, or concern over legal matters. Even if corruption were not hidden, it is difficult to define and difficult to quantify.

As shown in the following chapter, measuring 'the immeasurable' factor of corruption has not yet been perfected and each indicator comes with its own issues and problems. However, researchers, supranational organizations, and NGOs have made tremendous strides in collecting and disseminating useful corruption data in a few decades. The very existence of such data is changing how societies perceive corruption and is lowering tolerance levels for both public and private corruption.

Most indicators are limited to public corruption. Little is being done to measure corporate corruption. In fact, not a great deal of progress has been made to quantify this since the work of Lane (1954), who examined corporate corruption in the shoe industry, metal industry, etc. How people think about corruption is changing today; similar improvements in measuring corporate corruption are sure to follow.

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Chapter 6

Critiquing the Indicators of Corruption and Governance

Maks Kobonbaev, Donald Jacobsen, and Sharon Eicher

Introduction

This chapter examines the indicators discussed in the previous chapter and problems in creating such indicators or in employing them. An indicator is generally not the data directly observed, but rather is a proxy for such data. As we rely upon human beings to supply us with information about corruption, this information may be skewed through the reporting process. This chapter looks at measurement error, sample size, reverse causation, and spurious correlation as sources of problems in model endogeneity. Difficulties in making cross-country, and even cross-temporal, comparisons are discussed. The indicators that are currently in use have aided in making a hidden behavior somewhat quantifiable, however, improved techniques are warranted, for the reasons discussed in this chapter.

Problems with Quantitative Measurement of Corruption

When we attempt to measure corruption, we are attempting to measure something indirectly, that directly is not possible to quantify. One cannot directly observe corruption. It must be inferred through other means. ‘Corruption’ is a catch all phrase for a myriad of behaviors that differ in their impact upon stakeholders and their economic value. Because the indicators are based upon subjective reporting, comparing across countries and time is very approximate, at best. We use the indicators that have been developed, because they are the best that we have. One must be aware, however, of the problems in how they are constructed, what they are measuring, and in making inferences using such statistics.

Corruption is quantitative, such as how much corruption payments cost companies to do business. It may also be evaluated qualitatively. That is, how coercive or unpleasant is corruption?

Chapter 5 discussed alternative methods of measuring corruption. This chapter looks at various problems associated with the previously discussed corruption indicators. The chapter begins with the mechanics of corruption indicator measurement – with the statistics of attempting to measure something unobservable and difficult to quantify indirectly.

Statistical Problems in Creating Corruption Indicators

Even assuming that one can find the best possible quantitative measure of corruption, one is still only able to create a statistical model that attempts to measure something that is only indirectly quantifiable. Throughout the discussion that follows, emphasis is placed upon the Kaufmann-Kraay model (KK) measures, the BEEPS measures, which are based on some of the same methodology, and the TI measures that fall victim to some of these general problems.

Model endogeneity

'Endogenous' in economics refers to an internal process, such as income rising when education (the endogenous factor) increases. Model endogeneity consists of changes that come from inside the model and are explained by the model itself. This creates a problem, because while it may be thought that an independent variable is influencing a dependent variable, in fact, the 'influence' is really due to the manner in which the model is constructed.

The Kaufmann model is an example of an indicator that is subject to three kinds of possible endogeneity problems: (i) measurement error in both forms of measurement utilized by Kaufmann et al as well as in their weighting and compilation of the indices; (ii) reverse causation; and (iii) spurious correlation. That is not to say that these problems ruin the credibility of the KK measurements. Rather, indicators created as these are may contain these problems. Unfortunately, it is difficult to know for certain how fallible constructed indicators are, since one is unable to compare them with the true population (actual corruption levels). The discussion that follows discusses each possible type of data problem that might exist.

Measurement error Kaufmann et al's data are derived from two sources: polls of experts and cross-country surveys of firm managers or citizens.

Expert polls are often derived from the opinions of country analysts, who assess the conditions in the countries upon which they are expert, based on publicly available information and direct knowledge. The inherent problem is that these qualitative assessments must be reduced to quantitative form to be useful statistically. Experts are unlikely to rate variables in exactly the same way. Despite this inherent flaw, the ratings of the two experts are compared directly with one another. This problem is known as 'intercoder reliability.'

There are methods of correcting for intercoder reliability problems. One may subject raters to training on specific, objective standards to be utilized in giving a ranking. One may review the raters' ratings by a central agency or individual.¹

¹ This is typically done, for instance, by professors who utilize graduate students as raters. The professor will take a random sample of each graduate student's ratings and personally confirm them.

Another possibility is to expose the raters to multiple subjects under study and an attempt to draw correlations between the ratings given to situations observed by multiple observers. Each of these methods involves a tremendous commitment of time and energy as well as the ability to work individually with each rater.

Kaufmann et al do not attempt to correct for intercoder issues. The very use of country experts means that a central agency or individual with knowledge of all of the conditions for rating probably does not exist. An intensive training of the raters on specific objective standards is confounded by the essentially subjective nature of the tasks they must undertake.

The researchers admit that this is a problem, for in other work, Kaufmann et al. (2002) has attempted to control for what he and his co-authors there refer to as the 'kvetch factor.' The method of controlling the 'country perception bias of experts' is to measure responses on questions that correspond to empirically observable outcomes and to compare responses with those observable outcomes. One might compare, for example, the variance of an expert opinion on a country's exchange rate with the actual measure of a country's exchange rate variance. If a country perception bias does not exist, this expert's opinion and the model are validated, according to the authors.

One problem with such a validation method is that experts would probably respond with statistics they already knew about a country's conditions, such as its exchange rate, rather than give a perception about the variable. Another critique is that if a variable has an objective measurement already in existence, it itself would, or should, be used. Why would one be including experts' subjective views? This validation method is one attempt to rectify intercoder issues, but it is not itself without problems.

Kaufmann et al do not utilize this strategy in the *Governance Matters* series. Instead, in a paper written in 2005, *Measuring Governance Using Cross-Country Perceptions Data*, they defend subjective indicators, stating that insights are valuable; some concepts are not directly measurable by objective indicators; and that objective indicators also have high standard error rates, too. Essentially, the argument is that they are doing the best that can be done with the problems that exist. While this may be true, it is also possible that the best information, albeit not sources that are readily quantifiable into the kinds of numbers that can be used statistically, are qualitative ones from the country experts.

Sample size Finally, expert polls are subject to a small-sample problem. The purpose of a statistical sample is to capture conditions that exist in the true world, the 'population.' We do this best when sample sizes are larger. There is no 'minimum number' for sample size, but people generally stay away from small samples.² When few experts are available, a small sample size creates a problem

² The number 30 is often bandied about as the minimum sample size, but this is a subjective view.

with the data, because the sample may not accurately reflect the true population closely enough.

The number of experts polled for many of their data sources that utilize expert opinions is not given in the Kaufmann model. The Business Environment Risk Intelligence (BERI) ratings consist partly of the opinions of a panel of 105 experts. Kaufmann et al (1999) discuss a 'global network of sources,' but it is not clear how many sources each poll has in each country.

Cross-country surveys have weaknesses as well. They consist of the opinions of ordinary citizens across countries. Though the cross-country surveys solve the problem of having few experts on any given question in each country, their responses are interpreted in a heavily context- or culture-specific manner. Most ordinary citizens simply have no comparator. How can a 4 on a scale of 1–7 rating of the Zambian telephone network from a Zambian who has never been to the United States be compared with a 4 from an American rating the American telephone network who has never been to Zambia?

Another source of measurement error consists of the manner in which the responses on the expert polls and cross-country surveys are compiled and weighted. Kaufmann et al standardize measures by reorienting the data so that higher values correspond to better outcomes and then rescaling each indicator on a zero to one scale, utilizing the maximum and minimum possible scores. No weighting is applied; each independent source of measurement counts the same toward the ultimate score in a category as each other independent source of measurement. The standardization results in measurement error, because values that have similar meanings may not result in similar scores. Take, for example, the simplest example, a five-point Likert scale versus a seven-point Likert scale. Typically, respondents will be presented with a statement, and with a five-point Likert scale, they will respond strongly disagree, disagree, neutral, agree, or strongly agree. With a seven-point Likert scale, the responses are typically strongly disagreeing, disagree, slightly disagree, neutral, slightly agree, agree, or strongly agree. A response of 'agree' would be coded 0.80 on a five-point Likert scale and 0.86 on a seven-point Likert scale. Furthermore, such standardization into an interval variable creates a problem of inaccurate comparisons across the scale. For example, the distance on a five-point Likert scale between 'neutral' and 'agree' may not be the same distance as between 'agree' and 'strongly agree.'

Failure to even attempt to weight the data results in even more measurement error. Of course, if Kaufmann et al were to attempt to weight the data, they would be faced with an entirely new set of thorny methodological questions concerning how to properly compile a governance indicator: What factors are most important? By how much? In determining whether a country has a good infrastructure or a bad infrastructure, is the telephone network more important than the postal system? By how much? Kaufmann et al decide to sidestep the entire issue by weighting every variable equally. This hardwires into the model the assumption that each of the measured factors is of equal importance.

Reverse causation The Kaufmann model also holds the potential for reverse causation. Reverse causation occurs when the outcome, or dependent variable, that is purportedly measured itself influences the independent variables that are purportedly measures of it. So, for instance, in *Governance Matters*, Kaufmann et al propose six aggregate indicators: voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and graft. They then run ordinary least squares regressions to attempt to show relationships between these aggregate indicators and per capita income, infant mortality, and adult literacy. But does a higher per capita income increase the rule of law or voice or accountability? Does decreased infant mortality decrease political instability and violence? Does increased adult literacy increase voice and accountability, graft, government effectiveness, or the rule of law? As any political scientist steeped in democratic theory will gladly volunteer, there are sound theoretical reasons for believing each of these to be the case.

If reverse causation affects the model, then, this theoretical innovation is in question: better governance may not cause economic development; rather, countries that are more highly developed may have evolved better governance systems. The model neither accounts for nor tests for this possibility.

Spurious correlation Spurious correlation occurs when two factors that appear to be caused by one another are, in fact, both caused by a third factor. The most famous example is that a statistical correlation can be demonstrated between the number of storks in a given area and the number of children born per family. However, when the variable of urbanization is included, it is discovered that the real cause of both an increased stork population and increased family size is whether the area being described is rural or urban.

In the Kaufmann model, there is cause to believe several of the independent variables may be correlated with democracy, as may be the outcome of better governance. Looking only at the aggregate indicators, democratic governments tend to be better in voice and accountability; tend to have less political instability and violence; may arguably have more effective governments; may have a stronger rule of law; and may have less graft. Few if any of the countries at the bottom of Kaufmann et al's rankings have what anyone would term effective, functioning democratic governments, while almost all of the countries at the top of the ratings are members of the OECD.

Model Uncertainty

Each of the econometric models mentioned in the first part of this chapter suffers from model uncertainty. Model uncertainty refers to the problem of what is included in the model and what is not. Essentially, why are the indicators that are included in the model included, while others are left out? How does one know what variables are to be included in an appropriate model? Typically, these decisions are

informed by theory. An overall theory is developed which posits that a certain outcome, i.e., governance, may be affected by certain factors. Then, one proceeds to find appropriate measures of the factors to ascertain whether or not one's theory, operationalized into a hypothesis, is supported. This is how social science research is conducted.

TI's measures, the BEEPS, and Kaufmann et al's model each provides no theoretical justification for its choice of measurements. Rather, the choice seems to be informed by what is available and what other people have measured. Essentially, the development economists who have developed these measures appear to have gotten their scientific theory backwards: rather than working from conceptual definition to operational definition, they have decided to start by asking what is available and then categorizing the available indicators into aggregate indicators.

The result is that the reader does not know why or whether what has been selected is truly important to governance. Some fascist regimes have been well governed – arguably *too* well governed – in that the trains ran on time and there was economic growth. However, graft was rampant, there was no rule of law, and voicing one's opinion or attempting to hold the government accountable would land one in prison. Also, the reader does not know or have any theoretical viewpoint from which to select other potentially highly salient factors that might affect governance. Implicit in the assumptions hardwired into the quantitative model is the idea that only objectively measurable factors are important in bringing about good governance. However, it is highly probable that cultural variables that do not allow for ready quantification and measurement have been important in bringing about good governance in countries that have it.

Again taking the KK measures as an example, three assumptions are hardwired into Kaufmann et al's model by their choice of a linear unobserved components model. They are: measurement errors in individual indicators of governance are uncorrelated across indicators; the relationship between unobserved governance and observed indicators is linear; and the distribution of unobserved governance across countries is normal.

Kaufmann, Kraay and Zoido-Lobaton (1999) acknowledge that errors may not be independent, because 'in the case of polls of experts, it is possible that the perceptions of experts who rank countries on a particular indicator are influenced by their knowledge of countries' rankings on other indicators.' Additionally, 'the errors in surveys of residents might be correlated across countries if residents of a particular country have a tendency to systematically overstate regulatory and governance obstacles, due to a broad-based predisposition to report a worse situation than is objectively warranted.' Finally, 'it is possible that perceptions of governance from various indicators are unduly influenced by a single event, such as a high-profile scandal which is not representative of the level of graft in that country.' Since the effect of correlated disturbances is that 'the estimated standard errors associated with point estimates of governance are likely to be substantially understated under the assumption of independent errors,' and the standard errors

in the data make it nearly impossible to compare one country against another, the consequence of correlated disturbances, which Kaufmann et al state 'it is not possible to statistically identify' is to make the results less useful for comparative purposes.

The linearity assumption is particularly problematic. 'The assumption of a linear mapping from unobserved graft into observed scores implies that the difference in graft between a country with a score of 4 and one with a score of 3 ... is the same as the difference between two countries with scores of 3 and 2.' Furthermore, 'the fact that the observed data are discrete while our unobserved governance indicator is continuous violates the assumption of a linear relationship between the two.' Despite these admissions of non-linearity, Kaufmann et al present their data utilizing a linear model. They justify the usage of the linear model by stating that the alternative to utilizing a linear model is to simply aggregate ordinal indicators, and the result of this method would be even larger standard errors. Furthermore, when using the ordinal comparison method, 'it is much more difficult to obtain statistically significant differences among countries.'

Finally, the assumption of normal distribution embodies the assumption that countries are somewhat uniform in their quality of governance. As Kaufmann et al admit, 'it is not at all clear a priori that this provides an accurate depiction of the true cross-country distribution of governance.' Kaufmann et al attempt to deal with this problem by positing other distributions, but this test ends with the result that 'our results on the difficulty of distinguishing between countries do not change.' Furthermore, their means of relaxing the normality assumption, by testing other distributions, does nothing to help ascertain what the true distribution of governance scores is. Indeed, Kaufmann et al state that '[i]t is not clear how one might identify the shape of the true distribution of governance across countries, since it is difficult to disentangle the shape of this distribution from the shape of the distribution of the error terms,' a feature of the equation of the unobserved components model itself. Thus, there is no way to either verify or disprove the normalcy assumption.

Any model that utilizes a variant of ordinary least squares such as the unobserved components model hardwires into the model the assumptions of homoscedasticity³ represented in this model by the correlated disturbances problem, linearity, and normal distribution. The usual technique is to make certain that these assumptions hold. However, in the peculiar variant of the unobserved components model that is utilized here, it is impossible to know whether these assumptions hold, and there are substantial reasons to believe that they may not. The unobserved components model is an inappropriate means of testing a

3 Homoscedasticity is the statistical condition where all observations in a data sample have the same degree of variance from the predicted regression line. This is required for the result from a regression analysis to be correctly interpreted. One tests for homoscedasticity and when it does not seem to hold, one can transform the dependent variable or use a substitute for it in the analysis.

hypothesis when one does not know if the data are heteroscedastic, linear, and normally distributed.

Problems with Cross-Country Regression Models

Kaufmann et al utilize a cross-country regression model to attempt to measure governance. Cross-country regression models are innately imperfect because of the epistemological universalism that they employ. The very idea that one can apply a single equation everywhere in the world utilizing the same factors to measure a concept such as governance – the effectiveness of which is heavily dependent on the subjects or citizens governed – assumes that universal causal mechanisms exist that can explain human behavior the same way that universal causal mechanisms exist in nature.

The problem with this assumption is that the subjects and citizens governed by any given government are inherently different, and the conditions under which governments operate are inherently different. To give an obvious example, the issues that present themselves when a government attempts to govern a country the size of Russia are very different than the issues that present themselves when a government attempts to govern a country the size of Monaco. Economics attempts to universalize these issues into amorphous categories such as ‘provision of public goods,’ and it attempts to universalize all meaningful human behavior as ‘rational utility maximization.’ These attempts at universalization present even greater problems when global comparisons are attempted.

A cross-country regression study with a worldwide scope, such as Kaufmann et al’s *Governance Matters* series, operates on the assumption that all economic processes, everywhere, are, in principle, knowable and quantifiable, and that all operate the same without regard to the effect of non-economic factors. In the specific case of the *Governance Matters* series, these assumptions have been expanded to include the assumption that just about all of the factors necessary to know the economic processes that result in every corner of the globe in good or bad governance just happened to be in the preexisting indicators that Kaufmann et al chose to include in their six factors. They incorporate the assumption that the indicators that Kaufmann et al aggregated the individual data elements into, operate in the same manner in Botswana as they do in Palau, Germany, and Argentina.

Culture: The 800-Pound Gorilla?

Of course, the above assumption is questionable. Western economic principles have been demonstrated to work extremely well – in the West. However, the cultural factors that led to the rise of modern Western economies are complex and developed over hundreds, if not thousands, of years. The missing factor is culture, and cultures differ all over the world. The French economic system works

very well in France, and the Japanese economic system works very well in Japan. However, if the two systems were exchanged *in toto*, it is uncertain whether French workers, who are accustomed to activism, would be productive in the conformist attitude of the Japanese workplace.

The assumption that certain conditions that work well in some countries and that result in good governance there – even if this assumption is true – will likewise create good governance in other countries is not affirmatively justified by Kaufmann et al or by any other researchers on governance who have attempted to utilize cross-country regression techniques founded on concepts of epistemological universalism. With a complex concept such as governance, which is highly dependent upon that which is governed, and when that which is governed differs so radically from country to country, it is unjustified to say that factors that work well in some countries will also work well in others.

Conclusion

Critiquing the work of others is always easier to do than is creating one's own work. The critic has the benefit of hindsight while the creator attempts to work within the limited parameters that are available. The purpose of this chapter is to make the student of international corruption aware of the problems observed in the set of tools that we currently have available at our disposal.

Because corruption is not directly observable, researchers must use proxies. These proxies have problems. Some of the problems are basic issues involving assumptions about how internal mechanisms of countries work. Some are statistical problems in how the corruption indicators are created.

It is necessary to be able to establish benchmark norms of tolerable corruption levels and to analyze corruption levels in different societies before it is possible to create effective anti-corruption strategies. Before we can do this, corruption indicators must be improved. This is an ongoing process. Fortunately, as more parties become involved in reporting corruption, information will improve, as will the ability to better measure corruption.

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Chapter 7

Corruption in Chinese Sports Culture

Benjamin Ostrov

Introduction

Corruption is not a new phenomenon in China. One Chinese source considers it to be an inherent deficiency within Chinese culture (Liaozhou, 2006). Nearly 3000 years ago, during the Zhou dynasty, a case was recorded of a nobleman who bribed judges to avoid charges of appropriating farmland and slaves (China Daily, 2006a). Indeed, cases of corruption occur throughout Chinese history, though one can speculate, there is no consistent indication of what triggers corruption in China. In other cases of pre-modern society, causes are known. For example, patron–client relations were largely responsible for nepotism and corruption in the Middle East, both past and present (Kaiden 2001: 29).

Since its founding, the People’s Republic of China has undergone anti-corruption campaigns. However, it is doubtful this regime can ever eliminate this phenomenon. Corruption is usually considered to ‘undermine political decisions, lead to inefficient use of resources, and benefit the unscrupulous at the cost of the law-abiding’ (Rose-Ackerman, 1978, in Kaiden 2001).

In the four years since 2003, China has punished 67 505 government officials. More than 17 505 were prosecuted and punished in the first eight months of 2006. About 36 000 people are employed in anti-corruption efforts in China (China Daily, 2006b).

China’s ability to eradicate corruption is discussed in this chapter. The sports and gambling cultures in China and Hong Kong are used to illustrate corruption’s pervasiveness and difficulties in curbing corruption.

‘Functional’ vs. ‘Dysfunctional’ Corruption

Corruption can be seen as taking two forms: functional and dysfunctional. Dysfunctional corruption affects China by undermining the regime’s legitimacy in the public eye and reinforcing inherent structural limits upon any campaign. Dysfunctional corruption is borne of the arrogance of those who have maintained power for too long. In a ‘monopolistic regime’ (to use Fabre’s phrase) like that of China, an unlimited campaign would be bound to reach the pinnacle of power and threaten the leadership itself (Fabre, 2000).

This can be found not only in monopolistic regimes like China's, such as those of former Soviet Central Asia, but in democracies as well. Consider the difficulties of Germany's Christian Democratic Party in the latter days of the Kohl leadership, the problems of some Conservatives near the end of the Thatcher/Major era, and even the difficulties that afflict many local governments. For example, in New York City in the 1980s many around Mayor Ed Koch fell to charges of corruption even though he remained untainted. Indeed, 'power tends to corrupt and absolute power corrupts absolutely' (Acton, 1955).

Functional corruption in general greases the wheels of non-market and limited-market economies (Fabre, 2000). To use the language of organization theory, in such economies these activities can reduce transaction costs (Dellasoppa, 2001). Resources which are not otherwise available can be obtained through informal or even illegal channels.

The functionality of corruption has been recognized. One of its effects is to 'stimulate economic development by providing a supplemental allotting mechanism for investment purposes and mobilizes the bureaucracy for more energetic action on behalf of private entrepreneurs' (Kaiden, 2001). However, Kaiden claims that evidence does not show that corrupt officials contribute to economic and social development. Conversely, Hendrischke has made a case that strongly suggests otherwise: corruption promoted the Sino-Vietnamese cross-border trade and aided economic development there (Hendrischke, 2000).

As long as the economy is a significantly closed state sector, there remains a need to reduce transaction costs, again allocating pathways for functional corruption. As the regime continues as a monopolistic system, as opposed to an open one, the foundation for development of arrogance by those in positions of power persists. Therefore, dysfunctional corruption will not be eliminated. As one specialist states: 'corruption is deeply rooted, cancerous, contaminating, and impossible to eradicate because controls tend to be formalistic, superficial, temporary, and even counterproductive' (Kaiden, 2001).

The most realistic, most beneficial situation that can be created is that these two types of corruption can be reduced to the point where they are barely detectable, thereby no longer threatening the survival of the regime. This can be done through 'political will, democratic ethos, fragmented countervailing power, legal-rational administrative norms, inculcation of personal honesty and integrity, and effective enforcement of public ethics' (Kaiden, 2001).

Gambling in Hong Kong Today

Gambling and sports are tied into corruption in China. Corruption can be explained both in terms of factors specific to the activity of professional sports and upon the type of regime in which the activity occurs. In the former case, professional football in China ('soccer' in the USA) is marked by conditions exacerbating corruption. The players and referees earn far less than those in the West for an activity that

nets very large revenue (China Daily, 2006c). This discrepancy between individual salaries and potential revenue in the sport provides excessive temptation. The size of potential revenue can be explained largely by the prevalence of gambling in Chinese culture.

From over 20 years' experience living in Hong Kong, I am aware of the fondness of Chinese for gambling, viewed by some as a traditional vice among them (Finckenauer and Chin, 2006). Before 1997, many in Hong Kong would say that, as long as Beijing continued the Jockey Club's horse racing and dim sum (a noisy Chinese brunch in which small dishes are brought around on carts), people would be content. This is indicative of the comfort people in Hong Kong feel with gambling.

This tendency is visible not only in the popular habit of betting on horses but also by the universal popularity of the game mah-jong. This game is played by young and old, male and female. It is largely played for money – even among family members. Mah-jong parlors throughout the territory are even honored by the euphemism 'mah-jong schools.'

Chinese Culture

There is a debate over whether some cultures, such as the Confucian one, have a greater affinity with corruption. Its lack of concern with process and reliance on personal ethic seem to make this kind of society vulnerable to corruption.

Some cultures treat corruption as a universal principle. In the *Muqadimmah*, Ibn Khaldun treated corruption as a phenomenon of the natural cyclical decline of dynasties (Ibn Khaldun cited in Kaiden, 2001). Others single out particular cultures as having a greater linkage to corruption.

Corruption within the Chinese Football Association, which is the central example of corruption in this chapter, can be easily explained by resorting to a cultural argument. Chinese commentators claim that Chinese culture suffers from a defect – corruption is an ancient tradition in China. Corruption in football in China illustrates what remains a defect in Chinese national character (Liaozhou, 2006).

Vietnam, which shares the Confucian culture, has been experiencing similar problems to those of the Chinese. In late 2005, two players were arrested for betting on games while five members of Vietnam's team were suspected of fixing matches during the December 2005 Southeast Asian games. Altogether, over 20 referees, coaches, and officials also faced charges of match-fixing (BBC, 2005b).

Mass Organizations

Even before Deng Xiaoping embarked on his reforms in 1979, disregarding the formal state and party units, there existed another kind of organ with nominal

independence: mass organizations. China's Ministry of Foreign Affairs uses this designation for several organizations, including the All-China Federation of Trade Unions, the All-China Youth Federation, the All-China Women's Federation, and the All-China Federation of Industry and Commerce (Ministry of Foreign Affairs of the People's Republic of China, 2000). Such organizations are meant to convey the impression of widespread public participation in politics and society. They are also used to transmit Party messages to the public and to attain information from the public – what Mao Zedong called 'the mass line.'

However, this situation is actually one of pseudo-independence. Leadership of these mass organizations has been dominated by members of the Communist Party. The Chinese Football Association, another mass organization, is no different (Committee, 2004). Its director at the time corruption charges emerged, Yan Shiduo, was concurrently the Director of the Personnel Department of the State Sports General Administration. When he was dismissed from his Chinese Football Association post in 2005, he was made Director of the Training Bureau of the State Sports General Administration (Xinhua) This is indicative of how the government permeates areas far removed from government in Western countries.

These mass organizations are technically neither private nor public, but fall somewhere in between. As such, they can be viewed as analogous to public corporations in capitalist economies. Still, due to the historic use of mass organizations by the Communist Party to substitute for what in the West would be civil society, an examination of how the Chinese Football Association has become corrupt can be used as a prism to view the same phenomenon within the Communist Party and state at large.

The Corruption of Football

Corruption in the Chinese Football Association (CFA) first came to light in 2003. At that time, an online survey conducted by Chinese Central Television indicated that football fans thought over half of the first division matches in 2003 were rigged. Suspicion in this regard led fans to boycott the games (Bezlova, 2004). In 2004, 130 million Chinese on average tuned in to games. This figure was down 42 percent from the previous year. Meanwhile, average match attendance dropped 38 percent (Mackie, 2005).

In January 2004, the CFA addressed the problem not by attacking the sources of corruption but through the superficial measure of creating a new Super League, with only 12 instead of 15 teams, plus tighter rules (Bezlova, 2004). Corruption caused the Super League's launch to be postponed one month until April 2. Clubs needed more time to replace sponsors who withdrew out of frustration with dirty dealings, plummeting TV ratings and empty terraces. The CFA later lost its main sponsor, Siemens, which had contributed \$10 million. The company terminated its agreement in January 2005 (Mackie, 2005).

In October of that year, crisis ensued. Seven clubs complained of league corruption and mismanagement, threatening boycotts unless the problem of 'black whistles' (corrupt referees) was addressed. These clubs also demanded that the CFA make public its balance sheet for the past ten years. The CFA agreed only to make its balance sheet for 2004 public and its head, Yan Shiduo, rejected calls for his resignation (Bezlova, 2004). However, in early 2005 Shiduo did resign and was replaced by Xie Yalong (Xinhua), former deputy president of Beijing Sports University and the author of *On Sporting Athleticism* and a thesis on football marketing (China Daily, 2005b).

This transition of power marked a significant change. Yan Shiduo, as evidenced by his government posts, was from the old-line cadre. There was little evidence that he possessed any particular expertise about sports or physical education. His replacement was a sports professional, with extensive administrative and teaching experience in sports, as well as toting previous athletic experience (Committee, 2004). This should have boded well for progress in cleaning up professional football in China.

The problem of corruption in Chinese football was made more apparent by the failure of China to secure a place in the 2006 World Cup. The departing Dutch coach, Arie Haan, blamed the team's poor performance on the CFA scandal, saying it demoralized the players (Bezlova, 2004). This was not a case of sour grapes since neither fans nor officials blamed him (Markus, 2004).

In November 2004, the CFA faced revolt when leading teams refused to play. The CFA responded by agreeing to surrender up to 80 percent of the Super League's TV revenues to the clubs. In effect, the clubs would share \$2.6 million. In addition, the CFA, actually an arm of the Communist Party like the mass organizations before it, gave teams liberal rights to negotiate with players and sponsors (Mackie, 2005).

One theory was that the cause for conflicts lay in the large sums involved. Ma Lin, chief coach of Chongqing Lifan, first said the teams would not 'introduce foreign players and second, [would] have more young players from the youth team [semi-pro league team]. By going down this route, they'll have more of a chance' (Mackie, 2005). Financial retrenchment went further when in March 2005, 78 percent of the previous season's Super League players lost their jobs (Mackie, 2005). However, there is another explanation for the financial cutbacks other than attempts to fight corruption. In the previous year, 2004, lost sponsorships cost the teams about \$21 million. Considering that 70 percent of a club's revenues came from such sponsorship and advertising, this was a serious hindrance (Mackie, 2005).

Chinese fans apparently no longer trust the plays and results of football matches in their country. They have switched their interest to overseas matches, especially the English Premiership (Griffiths, 2006). The Chinese have a great interest in foreign teams, including Manchester United, Chelsea, and Everton (Mackie, 2005).

Despite, or maybe because of these problems, international cooperative efforts are being explored. Beijing Guoan and Real Madrid have come to an agreement in which the Spanish will buy a 60 percent stake in the Chinese team for \$12.1 million. Arsenal's top management visited Chongqing late in 2004 to consider some kind of cooperation with the city's Lifan team. There seems to be hope that foreign management can achieve for the CFA and its teams what local management cannot. As a last resort, Xie Yalong has threatened to close down the Super League if match-fixing, gambling, and bribery do not stop (AFP, 2006a).

The CFA's problems were noticed outside of China. The Asian Football Confederation (AFC) chief, Velappan, expressed disappointment in the Chinese team's performance and warned the CFA. His main intention though was to bring fans back into the stadiums. Again, the causes of corruption were not addressed. Instead, Velappan helped launch the AFC's Vision Asia program. This consisted of a semi-pro football league, which started in Wuhan and Qingdao, but was to include 284 other cities in China. The State Council finally took action on the problem from April 2005 when it ordered a crackdown on match-fixing and hooliganism (China Daily, 2005a).

Sports scandals have gone beyond football and have increased and spread, touching the Communist Party. In October 2006, Yu Zhifei, the general manager of the Shanghai circuit, which hosts both Formula One and Motor Grand Prix racing, was questioned. This was in connection with a corruption scandal leading to the dismissal of Shanghai Communist Party Chief, Chen Liangyu. Liangyu and Zhifei were friends who had worked together when Chen was Huangpu District Chief in Shanghai (AFP, 2006b).

The State Council's desire to crack down on corruption in football was acted upon only in 2006. That year, the CFA joined forces with China's police to establish a task force to tackle football-related corruption. The focus would be on gambling and match-fixing in the Chinese Super League. The task force is currently being led by the CFA's Nan Yong and the State Police's Wu Mingshan. During the last World Cup alone, police smashed gambling rings that took in hundreds of million yuan in bets (Reuters, 2006).

China now has a website for the public to report corrupt officials, launched in 2006. The site is run by the Communist Party's Central Commission for Discipline Inspection. Considering that China has the world's second largest population of Internet users, over 100 million people online, such an initiative would seem to be able to bear results (Associated Press, 2006).

Conclusion

This chapter examines the Chinese love for sport and gambling and uses these to illustrate the pervasiveness of corruption throughout Chinese culture. It is not meant to comment on China's overall corruption situation or its overall anti-corruption campaigns. Fundamental causes for corruption in China and

anti-corruption campaigns are discussed further in the chapter 'An Institutional Approach to Understanding Corruption in BRIC Countries.'

China has taken some worthwhile steps to combat corruption in professional football. The establishment of a website dedicated to public reporting of incidents of corruption is a step in the right direction. The public's input can be a powerful tool, because the public possesses valuable information about how and when corruption is occurring. However, whistle-blowing has never been encouraged in China. The political culture of the Communist State has militated against this.

Replacing Yan Shiduo with Xie Yalong, a man who is a scholar on sport and its marketing, also appears to be an improvement. However, can one man at the top of an organization transform the organization entirely? Certainly not overnight.

These two measures, though positive, are not adequate solutions, primarily because they do nothing to attack the causes of corruption. Corruption in China's sports offers great monetary gain with minimal risk. Steps need to be taken to address this condition.

Cracking down on gambling and match-fixing with a joint national police-CFA taskforce is a step towards addressing the underlying causes of the problem. However, the CFA itself is tainted by corruption. Were the police not corrupt, there would have been no need a few years ago to establish the Anti-Smuggling Investigation Bureau to stop smuggling. A clean, incorrupt force needs to be established to fight corruption in professional football.

The Communist Party was supposed to be an incorruptible force. Since the 1950s, there have been political campaigns launched against corruption. The 'Socialist Education Campaign' and 'Great Proletarian Cultural Revolution' of the 1960s were, in part, supposed to be waged against corruption. Instead, they – especially the latter – increased corruption. The results of these campaigns were to put new people in positions of unchallengeable authority, strengthening the basis for new corruption.

Furthermore, experience shows that an uncorrupted police force would be unlikely to remain clean for long. Zhang Jingrong, holding office simultaneously as deputy director of the Huidong Customs Office under the Shenzhen Customs Bureau and head of the Huidong branch of the Anti-Smuggling Investigation Bureau, came under investigation a year and a half after the Bureau commenced operations, for selling information to smugglers and taking bribes from them (Ostrov, 2005). This must have come as a grave disappointment to an organization that was supposed to be China's version of Eliot Ness' Untouchables. China's culture, as it is today, makes it possible for few people to be held accountable.

Still, there is some reason for hope given advances in technology, access to input from the general public, and China's integration into the global market. An example of the power of this combination is seen in the battle in China against human trafficking. Trafficking in women and children had become one of modern China's major scandals. When citizens went to the authorities demanding help and received none, they resorted to the Internet to disseminate and gather information.

Eventually, Beijing was embarrassed into taking action and launched a major dragnet to catch the traffickers and release their victims (Elegant, 2007).

Another example of public outcry and the Internet having an effect on the Chinese administration was the 2007 melamine scandal. Including this ingredient in products exported to North America not only made pets ill, but revealed the carelessness of the pet food industry in China. Public revelation led to public embarrassment and action by the State.

As Chinese society becomes more open, authorities can be more easily embarrassed into doing the right thing. This is the main source of hope for the reduction of corruption in football, as well as for the reduction of corruption in general in China.

Chapter 8

Exploring Corruption in the Petroleum Sector

Maks Kobonbaev and Sharon Eicher

Introduction

The fruits of the earth belong equally to us all, and the earth itself to nobody!
(Rousseau, 1754)

Rousseau correctly understood the conflicts that arise from ownership of natural resources. The economic bounty to be had from extraction rights of oil, gas, and minerals induces many to lowly behavior in the quest to gather these ‘fruits’ for oneself. This chapter looks broadly at the link between petroleum and corruption. Pertamina, an Indonesian oil company, is used here as a case study to illustrate how corruption may manifests itself in the petroleum sector of developing countries. A number of recent initiatives that have been undertaken at the global, national and company levels to address petroleum corruption are also highlighted.

The Significance of Petroleum

Petroleum is the lifeblood of industrialized economies. Its products are indispensable commodities (Yergin, 1993). We rely upon petroleum products for our transportation, to operate our vehicles; to fuel our power plants; for the manufacture of all plastic products; and for residential energy use, one-quarter of which comes from oil (Tsalik and Schiffrin, 2005). Oil is our most strategic commodity, supplying more than one-third of the world’s primary energy needs. Gas accounts for nearly one-quarter, and oil and gas combined supply more than 60 percent of world’s energy needs.¹

¹ This is including commercially traded fuels, and excludes wood, peat and animal waste, which are unreliably documented (British Petroleum, 2006).

Table 8.1 Hydrocarbon-rich countries, 2000–2003

Country	Average annual hydrocarbon revenues 2000–2003		Average annual hydrocarbon exports 2000–2003	
	% total fiscal revenue	% GDP	% total exports	% GDP
Algeria	69.9	25.8	97.1	35.5
Angola	80.9	33.9	90.3	67.9
Azerbaijan	47	11.9	88.3	32
Bahrain	71.2	23.5	72.1	49.3
Brunei Darussalam	85.8	52.7	88.2	80
Cameroon	26.6	5.3	44.9	9.7
Colombia	9	2.7	27.8	44.6
Congo, Republic of	70.6	20.2	89.5	67.1
Ecuador	26.4	6.9	43.5	10.6
Equatorial Guinea	-	84	21.6	93.4
Gabon	60.5	19.6	79.9	45.3
Indonesia	31.3	6.1	22.6	8.1
Iran	59.3	16.8	82	19.9
Iraq	58.4	93.1	-	-
Kazakhstan	21	5.1	49.7	22.3
Kuwait	68.4	47.6	91.9	45.9
Libya	72.5	36.1	97	36.6
Mexico	32.2	7	14.9	2.5
Nigeria	77.2	32.6	95.8	43.8
Norway	24.4	13.3	43.2	18.8
Oman	78.3	32.4	80.1	43.9
Qatar	71.3	25.3	83	54.8
Russia	39.7	6.8	52.8	17.5
Saudi Arabia	81.6	27.4	89.2	35.2
Sudan	43	4.6	73.3	10.6
Syria	45.7	13.4	69.5	18.9
Trinidad and Tobago	27.4	6.6	60.6	29.3
Turkmenistan	42.8	8.7	83.6	35
United Arab Emirates	76.1	32.4	49.1	35.1

Table 8.1 *Concluded*

Country	Average annual hydrocarbon revenues 2000–2003		Average annual hydrocarbon exports 2000–2003	
	% total fiscal revenue	% GDP	% total exports	% GDP
Uzbekistan	-	-	-	-
Venezuela	52.7	14.3	79.9	21.3
Vietnam	31.8	7.1	21.4	10.4
Yemen	68.6	25	91.5	34
Average	52.7	20.8	67.2	33.7

Source: IMF (2005).

We recognize that the bulk of energy demand comes from developed countries, one-quarter of which is consumed solely by the United States.² Source countries for oil and gas are located in the Middle East, Latin America, Africa and the former Soviet countries.

Petroleum products have highly elastic demand – Oil and gas are essential goods for all modern economies. Hence, countries that are exporting petroleum products should have the resources needed to improve economic development and income per capita. Oil and gas export revenues make up the bulk of government revenues for resource-rich (‘extractive-industry’) countries. These revenue sources consist of royalties paid for extraction rights, corporate taxes, fees, and other costs imposed by government upon mostly foreign firms. Despite this source of cash inflows into resource-rich countries, case after case demonstrates that, rather than being a source for growth, many of these countries are often caught in poverty traps.

Such countries, being less-developed countries administratively as well as economically, tend to have less administrative oversight and high levels of corruption. Recent experience speaks to this, with increases in oil and gas revenues posing particular governance challenges in Angola, Chad, Azerbaijan, Sudan and Iraq. The concern is that these countries spend too much, too fast, with limited accountability – eroding state institutions and promoting unprecedented opportunities for corruption (Friedman, 2006).

2 The United States alone consumes more oil than Japan, Germany, Russia, India and Canada combined. The United States and Canada consume 70 000 barrels of oil per million per day, whereas Japan consumes 40 000 barrels of oil per million per day. Rapidly developing China and India use fewer than 5000 and 2300 barrels, respectively, per million per day (British Petroleum, 2006).

Extractive Industry Countries

Countries that export oil and other mineral resources are categorized as 'extractive industry' (EI) countries. EI countries are generally dependent upon export revenues from these natural resources, rather than taxes upon personal income and corporate profits. The International Monetary Fund's *Draft Guide on Resource Revenue Transparency* (IMF, 2004) defines countries that are dependent on hydrocarbons or mineral resources with these criteria:

- an average share of hydrocarbon or mineral fiscal revenues out of total fiscal revenue of 25 percent or more during the last three years, or
- an average share of hydrocarbon or mineral export proceeds out of total export proceeds of 25 percent or more during the last three years (see also Liebenthal, Michelitsch and Tarazona, 2003).

Natural resources are considered to be public goods by most countries, such that they are a communally owned, natural endowment. Their extraction is expected to benefit the citizens of an extractive-resource-dependent country, as revenues from their export belong to the general population, not to a private owner.

The benefits to a country of extracting and exporting its oil, gas, and mineral resources include:

- revenue from taxes and royalties;
- infrastructure development of roads, railroads, etc.;
- direct and indirect employment;
- growth in related sectors (for example, finance, construction, etc.);
- foreign direct investment and greater private sector development;
- gains in human capital, through the transfer of training and knowledge;
- and
- technological innovation.

Since EI can offer all of these benefits, it is expected to create economic growth.

In most politically unstable countries, EI is the only hope for attracting investors and fostering economic growth. For example, in Angola, Nigeria and the Republic of Congo, hydrocarbons annually generate more than 70 percent of the total fiscal revenue (IMF, 2005). In Algeria, Yemen and Azerbaijan, hydrocarbons constitute more than 80 percent of their total exports (IMF, 2005). These countries lack many of the attributes that would attract foreign investment, but the value of extractive resources is so high, that companies are willing to take the risk associated with conducting business in such environments. After the collapse of the Soviet Union, donor assistance and foreign investment in oil and gas projects became one of the major sources of government revenue. In the next decade, it is estimated that more than \$100 billion will flow to African countries with extractive

industries – thereby becoming the main source for financing social and economic development in the region (Gary and Reisch, 2004).

Resource curse or the paradox of plenty

Countries rich in natural resources are prone to poor management and ‘leakages.’ Leakages represent those funds which are supposed to be received as state revenues, but somehow go missing. Counter-intuitively, much of the literature on resource endowments suggests that, rather than aiding in development, oil and gas windfalls hinder development and erode institutional quality (Gary and Reisch, 2004). Resource wealth, instead of being a blessing, has become a curse. It is strongly associated with poor economic performance and unsustainable growth (Auty, 1994; Karl, 1997; Sachs and Warner, 1995). Being a resource-rich country also has economic externalities through the loss of the natural environment and deleterious health consequences to the destruction of local communities’ economic bases, property rights violations and increased corruption (Thomas, 2004). In addition, a country dependent upon natural resource export revenues is dependent upon external price conditions. Revenues are likely to fluctuate greatly. Because so much does flow into the country from these resource exports, EI countries are often slow to diversify and to develop other industries. All together, the costs for such natural endowments is great.

The case for sound governance of resources

Some EI countries have performed relatively better than their neighbors, with or without oil. Russia has enjoyed rapid growth, due largely to its hydrocarbon exports. Kuwait and Malaysia enjoy a much higher standard of living than other oil-rich countries, such as Angola and Nigeria. What explains the difference?

Some scholars look to the failure to promote a competitive manufacturing sector and poor allocation of export earnings across the economy (Saraf and Jiwanji, 2001; Usui, 1997). Others blame weak institutions and poor governance conditions, such as rent-seeking and patronage systems (Robinson, Torvik and Verdier, 2002). Not surprisingly, governments of EI countries are less accountable to their populations, and are the most authoritarian (Leite and Weidmann, 1999). Moore et al. (1999) find that governments that are dependent on taxation of their citizens are more effective at converting financial resources into development projects. Countries that rely upon resource royalties for revenue do not rely upon taxation of the citizenry.

There is an emerging consensus that many of these negative outcomes are the results of corruption, made possible by pre-existing *governance weaknesses*. Politically and economically underdeveloped countries often suddenly find themselves with a surge of financial inflows into their country when a new natural resource reserve is exploited. These may be countries without established accountability structures, whereby citizens can hold governments accountable

for resource use, with weak policy, administrative, economic, and financial management systems. This is especially true for the collection, allocation and actual disbursement, and control of public resources. These may be countries where the rule of law and regulatory policies to minimize associated costs and risks and to promote productive investment are underdeveloped.

This suggests that the solution to the 'paradox of plenty' may lie in the improvement of policies, governance, and institutions. A comparison of 31 oil-rich countries by UK Save the Children demonstrated significantly higher levels of income per capita in those oil countries with relatively better governance scores (UK Save the Children, 2005). How much would eliminating these 'leakages' improve income per capita?

Corruption in the Petroleum Industry

Systemic corruption in petrostates

Oil and gas projects generate cash flows that provide motive and opportunity for corruption. According to Transparency International (2002c) the oil and gas sector is perceived the third most likely to involve bribes, followed only by public works contracts and the defense industry. Another extraction industry, mining, ranks seventh.

While most corruption in EI countries is a consequence of poor governance, corruption in the petroleum sector is complex and involves the collusion of a network of players, including transnational energy companies, state-owned enterprises, governments, banks, and others.

Many of the transnational energy companies may renege upon this corrupt relationship. Multinational companies are issuing public statements and joining forces to combat this corruption. In March 2005, 61 institutional investors representing \$8.3 trillion dollars called upon corporations to support the EITI Initiative and to ensure 'that all relevant payments and revenues paid to governments are captured' (Payments Disclosure Group of Investors, 2005).

Transparency in the petroleum sector

'Transparency' implies that business operations are reported accurately and clearly, and that they may be scrutinized. 'Transparency is at the heart of good governance and the trust which is essential for the establishment of an open thriving economy. Transparency has to work within a company; between a company and its shareholders and between a company and the countries in which it invests' (Browne, 2003). Much of the revisions in corporate governance imposed upon American firms by Sarbannes-Oxley are in response to perceptions that transparency, while necessary, has not always been a priority among firms' managers.

Companies have recognized that rampant corruption can be inimical to their operations, due to high uncertainty and additional costs of doing business. Moreover, institutional investors have recently paid higher premiums for companies committed to sound governance practices. McKinsey and Co. (2002) surveyed over 200 institutional investors and found that 80 percent of the respondents would pay a premium for well-governed companies. The size of the premium varies by market, from 11 percent for Canadian companies to around 40 percent for companies operating in countries where the regulatory backdrop was less certain, such as Egypt, Morocco, and Russia. It is reasonable that such premia for governance are sought after. The underlying principles of transparency and accountability reflect standards that provide legitimacy to an organization and, in the case of corporations, broaden their access to capital resources. Thus, it is to the advantage of the company to be ethical, for whatever motivations, and to establish a set of anti-corruption and whistleblowing policies for safeguarding its reputation.

A cross-corporate study of transparency is by the UK Save the Children (2005). Twenty-five companies in six countries are included. The three categories of transparency include (i) revenue payments, (ii) disclosure and (iii) anti-corruption and whistleblowing. These were aggregated into an index, from 0 (no transparency) to 100 (perfect transparency).

The average score among oil and gas companies is 20, i.e., transparency in this industry is poor.³ Thirteen out of 25 surveyed energy companies have codes of ethics covering whistle-blowing and corrupt acts, procedures for censoring employees involved in corrupt activities, mechanisms for protecting whistleblowers.

Fifteen companies have no policies for revenue transparency in their management systems or implementation strategies for such. Neither do they disclose revenue payments nor their contracts in their countries of operation. The operation of these companies is opaque, which implies that they are vulnerable to corruption. Top performers, such as Talisman, Shell, TransAtlantic, BP and Statoil, publicly disclose their payments but may not uniformly do so for all countries of operation. For instance, Shell reports most its revenues in Nigeria, but it fails to do so in Venezuela. BP represents best practices in Azerbaijan, but its revenue transparency is less spectacular in other countries of operation. Individual oil and gas companies can improve their disclosure of benefit streams to states of production entitlements, royalty payments, taxes, and fees.

In a highly competitive global business environment, the ethical action of isolated business leaders and firms may not be sufficient, and may even harm the value of a company, as discussed in Chapters 4 and 12 of this book. And, herein lies another layer of the answer to solving corruption – individual firms can work together to support each other and press for change in the operating

3 Companies such as Talisman, TransAtlantic, Shell, Chevron Texaco, Nexen and BP performed well, whereas Petronas, PetroChina, Lukoil, CNPC and Total performed the most poorly.

environment. With collaboration, an individual firm does not lose while those not complying benefit, because the major players in an industry have banded together. The model of collective action can be found in industry wide groups that cross local, national and regional boundaries such as Publish What You Pay, Extractive Industries Transparency Initiative and others. The Extractive Industries Transparency Initiative is discussed at length in the chapter, 'Risk Management – Playing By the Rules.'

The Publish What You Pay (PWYP) campaign aims to create transparency especially for EI countries. This coalition includes over 300 NGOs worldwide. They are calling for disclosure of the payments made by oil, gas and mining companies to governments in the extraction of natural resources and for these governments to publish full details concerning their revenues (PWYP website). The campaign is sponsored by CAFOD, George Soros, Global Witness, Oxfam, UK Save the Children, and Transparency International UK.

Transparency, which is particularly weak in these industries, might just be improved through such grass-roots movements. These actions are initiated and facilitated by NGOs, on one end, and are executed and maintained by multinational corporations, at the other end. Such anti-corruption strategies may ultimately prove more effective for resource-wealthy, institutionally poor countries, than government initiatives.

The cases concerning corruption in petrostates demonstrate how lack of transparency and accountability of leadership accounts for corruption.

The Case of 'Kazakhgate'

Kazakhstan endorsed the Asian Development Bank's 'Anticorruption Action Plan for Asia' in 2002, and both Kazakhstan and the US joined the OECD Convention against Corruption. However, governments of both states seem to be suppressing information regarding at least one large oil deal involving public corruption. This is one side of corruption in petrostates.

Kazakhstan has a state Anti-Corruption Committee, which works with the state prosecutor, Tax Committee, Ministry of Finance, national security services and national tax, customs, border, financial, and military police units. The US has its Foreign Corrupt Practices Act supported by the criminal division of the Department of Justice. In one case, the objectives of both seem to be nullified.

In 2003, J. Bryan Williams, former senior executive with Mobil Oil, pleaded guilty to tax evasion regarding more than \$7 million of income he received for negotiating oil deals in Kazakhstan. Also in 2003, James Giffen, a US investment banker, was accused of transferring \$78 million in payments from the Mobil Oil corporation to senior, unnamed, Kazakhstani government officials in 1996. Among these officials' names is, allegedly, Nursultan Nazarbayev, the president. Giffen was indicted for violating the US Foreign Corrupt Practices Act. The prosecution

claimed that he transferred \$1.05 billion to officials in multiple transactions in order to close the Tengiz oil field deal.

This led to ‘Kazakhgate’ in the Kazakh and Western media. Nothing, however, has been done to investigate this story within the government of Kazakhstan. Rumors are that the president received a large chunk of these bribes and deposited them in Swiss bank accounts. This case led to an indictment within the US court system, and Giffen was to have been sentenced in January 2005. To this date, to public knowledge, he has not been sentenced and all court records regarding this case are under seal.⁴

This illustrates several points regarding corruption in petrostates:

- The governments of developed countries, as well as multinational corporations, may be complicit in some cases in propagating corruption through payments made to heads of state.
- Anti-corruption legislation may not always be supported, and this process may lack transparency, even in developed countries.
- The amounts of money involved in these corruption payments is extremely large.

Only when the US court has removed the seal on this case will the extent of the complicity by government administrations in Kazakhstan and the United States be known.

The Case Study of Pertamina

Indonesia adopts the French approach to natural resources; its minerals, metals, and gas, and oil belong to the country (Article 33 of the Indonesian Constitution). Corruption often allows public sector activity to be privatized. Such is the story of Pertamina, the Indonesian state oil company.

In 1960s and 1970s, Pertamina was a symbol of national pride and regional aspiration. Inspired by the success of Pertamina in creating production-sharing contracts and consolidating the petroleum industry in Indonesia, eminent officials in Malaysia sought technical assistance and guidance in forming a national petroleum company of their own. In 1974, Malaysia granted Petronas the exclusive right to extract Malaysia’s hydrocarbon resources; Pertamina became the logical role model for Petronas (Gale, 1981). Several decades later, Pertamina was barely

4 Under seal means that by court order, the information regarding a case is not available, even the status of the case – whether it is pending or settled. The most recent information regarding the Giffen case is a record by the Second Circuit Court of Appeals, which issued a decision on an interlocutory appeal in the case on December 8, 2006. Information about the status of this case was provided by K. Hamann, Fraud Section, Criminal Division, US Department of Justice in an email of July 5, 2007.

competing with Petronas. The decline was due to crass mismanagement and blatant corruption.

The rise of Pertamina

Royal Dutch-Shell, Stanvac,⁵ and Caltex⁶ were granted concessions to Indonesia's oil reserves until 1957 (Klapp, 1982). In 1957, the government of Indonesia created its own national oil enterprises, which took over holdings of foreign firms. In 1966, Ibnu Sutowo became the chairman of the National Oil Committee. Indonesia's three energy companies were consolidated into Pertamina in 1968, and Sutowo became its president.

Pertamina introduced a production-sharing contract, in which foreign companies were to pay a percentage of crude production. Pertamina had access to the growing Japanese energy market.

Between 1967 and 1975, production trebled, and oil prices rose. Pertamina became a conglomerate in the 1970s. It acquired a chain of fuel stations, a fleet of tankers and supply boats, a petrochemical company, port facilities, and a fertilizer company. Its non-energy holdings included hotels, a steel mill, an automobile dealership, a stadium, hospital, television station, and various businesses (Ascher, 1998; Glassburner, 1976).

The financial crisis in Pertamina (1975)

The company relied upon retained earnings for investment funds, but outside, foreign loans were also obtained for long-term projects. The debt was short-term. International oil prices stabilized and Pertamina defaulted upon a \$40 million loan to the First Republic National Bank of Dallas (Glassburner, 1976).

Initially, Pertamina's debt was declared to be \$1.5 billion; this grew to \$10.5 billion (The government's entire foreign debt was only \$8 billion; Liddle, 1977). Pertamina turned to the State Bank of Indonesia, and the government met Pertamina's obligations. Pertamina's crisis endangered the financial stability of the entire country. It revealed mismanagement, corruption and the capture of the industry by powerful vested interests.

Investigating corruption in Pertamina

Only after its financial crisis, did the scope of Pertamina's corruption and mismanagement become known. President Suharto appointed a commission to investigate Pertamina. The commission prepared two reports which focused upon Pertamina.

5 Owned by Standard Oil of New Jersey and Mobil.

6 Owned by Standard Oil of California and Texaco.

Pertamina violated several clauses of Law No. 19-1960. By law, all state enterprises paid 55 percent of their profits to the government until 1965; Pertamina had failed to do so. Pertamina deposited funds in the Chase Manhattan Bank and the First National City Bank in Djakarta in violation of Article 6 of the law, which required that deposits be held in the state bank. State enterprises cannot own subsidiaries. Pertamina owned the Far East Oil Trading Company, Tugu Insurance; and Indonesia Tanker Terminal Inc.

Pertamina did not publish its balance sheets and its profits were never revealed. Arthur Young and Associates audited Pertamina and found six uncoordinated accounting systems operating simultaneously (Liddle, 1977). Pertamina's project costs were inflated two or three times.

The commission concluded that the Sutowo, the president-director of Pertamina, personally diverted revenues. His personal business empire became vast, and his children built business empires through Sutowo's wealth, connections, and Pertamina contracts. Sutowo held political influence; he boasted that he could obtain permission from the government for a Singapore company to quarry in Indonesia and he would gain 50 percent of the profits (Crouch, 1970).

Rebuilding Pertamina

The investigating commission's report sparked a wave of public protests, which led to Suharto's condemnation of corruption.⁷ The government authored an anti-corruption bill, created a regulation for the registration of personal property of civil servants and military officers, and limited 'tours of duty' for public officials (Mackie, 1970).

Sutowo was dismissed from Pertamina in March 1976 with no criminal charges. His replacement, Major-General Piet Harjono, began with a purge of mid-level managers and administrative reorganization (Liddle, 1977). Pertamina's projects were scaled down.

Production-sharing contracts with foreign companies were reconsidered. Caltex and Stanvac were required to reduce their profits by one dollar per barrel, generating \$300 million in revenue. Many foreign firms left, which reduced exploration investment and production.

Arthur Young and Associates restructured Pertamina's books. The Financial Audit Board and the State Accounting Directorate were delegated to maintain control of Pertamina's financial operations. A committee including members from the Bank of Indonesia, Finance Ministry, and the Planning Agency were appointed to supervise financial and investment decisions of all government agencies and state enterprises.

⁷ While these activities were undertaken with wide publicity and fanfare, many believe it was a political move to unveil behind-the-scene players to make sure that important economic activities were centralized under the President Suharto.

Under its stricter and less corrupt management, Pertamina's accounts improved. It maintained modest non-oil sector activities and channeled revenues to the treasury. However, Pertamina's accounts were still not adequately transparent by international standards – its accounting methods confused auditors from Price Waterhouse and its accounts were never available for inspection on time (Ascher, 1998).

After Suharto

Corruption was pervasive throughout Suharto's regime. Only after his resignation in 1998 did the full extent of corruption in Pertamina become evident. In October 1999, the IMF mandated that PricewaterhouseCoopers audit the company for the period between April 1996 and March 1998. The auditing firm identified 159 contracts thought to be awarded to Suharto's family and friends (*Tempo Magazine*, 2004).

The audit found that Pertamina incurred billions of dollars in losses from bloated management, illicit deals, inflated contracts and forgone income opportunities, running nonprofitable wells, and not hedging its debt's currency (*Oxford Analytica*, 2000; *Octane Week*, 1999). Leakages in the company totaled 5.2 billion from the Directorate of Exploration, Directorate for Shipping, Directorate for Processing, Foreign Contractors Monitoring Agency, and the head office (*Alexander's Gas and Oil Connections Company's News*, 1999).

Parliament passed the Oil and Gas Law No. 22 (2001) to convert Pertamina into a limited liability, state-owned company. Pertamina lost its monopoly power in granting oil and gas contracts. The proposed law deregulated the Indonesian energy market and granted foreign firms access to the market. Pertamina sold off assets and undertook a public offering of its stock. Since the deregulation of Pertamina, Caltex (ChevronTexaco Affiliate), Shell, and Petronas have entered the Indonesian energy market.

Government Regulation No. 27/1968 granted Pertamina a sole control over Indonesia's hydrocarbon resources and thus made it a state monopoly. This power, lack of transparency and accountability, social networks linking Pertamina with Indonesia's political and military elite are to blame for this debacle. Media exposure and management changes rooted out this corruption, but did not necessarily eradicate it.

Conclusion

States reliant upon extractive industries for government revenues appear to be more likely to suffer poor governance. By default, they lack independence, as they are always dependent upon foreign demand and prices set in markets outside their borders. Perhaps there is something debilitating in this very relationship, for countries such as these tend to be poor, despite their resource wealth.

Oil and gas export industries attract large foreign investment and control vast inflows of capital. With such cash flows comes immense economic power. The lure seems to be too attractive to resist as these states are generally recognized as lacking good transparency, accountability, and suffering worse degrees of corruption. Rather than offering a financial means for rebuilding infrastructure and health and education systems, in order to enjoy future growth, these inflows frequently seem to destabilize EI countries. The voluntary EITI Initiative may assist in creating more effective use of resource revenues through better transparency and accountability.

Revenue transparency is, however, only one side of the problem. Efforts should be expanded from revenue transparency to budget allocation. One of the issues in petrostates concerns the oil resources that are off-budget. These are less likely to be subject to scrutiny, such as of audits and public oversight. Some countries have managed to institute special oil funds, which are nationally managed, separate accounts for saving revenues from resource extraction. These enjoy greater accountability, although there still are no 'best practice cases' in less-developed countries. While the importance of bringing these resources into the budget process has been recognized, substantial amounts of oil revenues in many oil-rich countries still remain outside the budget process.

Pertamina is a case study in how *not* to manage one's natural resources. Extractive industries are supposed to be the cash engines for building a better society and economy. The revenues that were to have gone to the state, not only were not paid, but government officials did nothing to try to collect these. Even if these funds had not been diverted into private hands, they were not going to the public coffers for building public works, as they were intended to. There was no public inquiry or censure of Sutowo or Pertamina.

Other EI countries establish a state oil fund. This fund collects the revenue from royalties from extraction contracts or export earnings of natural resources. This separates the business operations of extraction and export from the financial management of the nation's resources. Another measure is to create a stabilization fund, for when prices fall below expectations. However, these measures would have required sound management of the political system and its strategic state enterprise. This does not seem to have been a goal of Suharto's regime.

Actions by the government alienated foreign firms and granted monopoly powers to a state company, while failing to regulate and supervise its actions. Only after billions of dollars were known to be lost, did the state create a system of oversight and regulatory controls. This may have been largely a social problem – elites were benefiting from this arrangement. In fact, predatory state representatives are at the heart of the corruption issue in the petroleum sector. One can strengthen the capacity of institutions and create sophisticated revenue management arrangements, but, it is ultimately the leaders who have the ability to channel revenues from EI activities towards developing their countries. This is not an easy task. As seen in the Pertamina case, Sutowo's children and cronies themselves accumulated personal wealth through the company and contracts

with the company and Suharto's regime was known to be blatantly corrupt. This suggests that in EI countries, the most critical key component to fighting corruption and directing revenues to their proper uses is ethical and responsible state leadership.

Chapter 9

Risk Management – Playing By the Rules

Sharon Eicher

Introduction

Corruption, as a type of risk management, has changed how we view risk. Legal norms may restrict one's activities, even when one is out of the jurisdiction of the particular law-making body. 'Following the rules' now requires that one work within the guidelines of the place where one is doing business and the place where one is a permanent resident, as well as according to one's personal moral guidelines. Any, or all, of these ethical guidelines may be challenged while engaged in international business.

Risk Management

Where does risk from corruption come from? Risk is anything that increases the potential for future loss. From the perspective of an NGO or development organization, it comes from possibility that funds to be used in projects aimed to improve welfare are diverted and do not achieve their aim. (These organizations minimize this risk with improved auditing methods.) From the perspective of firms operating locally and citizens, it comes from the chance of receiving poorer quality of services and infrastructure due to the diversion of funds from these projects. This can hurt any firm operating locally as operating costs rise because transportation, communications, etc. are more expensive and less reliable. Corruption raises business costs. Companies pay not only regular taxes, but corruption taxes as well. These are explicit types of costs and risks.

Firms also face implicit risks. It is more difficult to do business in a corrupt climate. The person receiving a favor or payment may change the terms mid-deal, and there is no certainty that services will be delivered even after payments are made.

Another implicit risk arises from lost contracts when a culture of corruption is tolerated and a firm follows non-corrupt practices. Everyone must work collaboratively to improve the long-term business climate. Currently most people see corruption as a major cost to international businesses: 43 percent believe that their companies failed to win a contract or gain new business in the last five years because a competitor paid a bribe (Bray, 2007). This creates a situation where legally firms cannot indulge in corrupt practices but they are hurt competitively

if they do not. This creates an incentive for law-abiding firms to unite with other firms, anti-corruption organizations, and local governments to even out the playing field by eliminating corruption advantages.

Lastly, many acts of corruption are now illegal through international conventions, such as the OECD Convention, and national legislation, such as the Foreign Corrupt Practices Act. Though these may not be strictly enforced, many have been fined and jailed after violating these norms. A violator of the United States' Foreign Corrupt Practices Act (FCPA) is subject to foreign and US criminal charges, fines, possible jail time, loss of financing and insurance, loss of rights to bid on public contracts, and damage to the company's reputation.

To minimize risk, a company must review its internal controls and procedures, both in domestic and foreign operations. The SEC and US Department of Justice, for example, have said that companies are legally required to report any improper conduct or breakdowns in internal controls related to the US Foreign Corrupt Practices Act. This implies that companies should be proactive; 'For example, companies should be developing audit trails and budgets to track things like promotional activities, charitable giving, entertainment expenses, payments to middlemen or distributors in foreign countries – in short, how money is moving, to whom it is going, why is it going there and who knows it's going there' (Pell, 2005). It is no longer sufficient to have a 'slush fund' from which payments and gifts can be made with or without senior management's knowledge. In other words, practices that are unlikely to be used in a developed country are now no longer acceptable in foreign operations.

Part of risk management is due diligence. Failure to take this care may be regarded as negligence. Due diligence in fighting corruption requires that companies' managers have training and compliance programs to inform employees of both home-country and foreign legal requirements, along with general ethical training. Role-playing to prepare firm representatives and discussions about alternatives to corruption payments can be included in this training program to help prepare people before they are sent into the field. Similarly, training programs must discuss foreign norms about gifts and how relationships are cemented. Training must include both domestic and foreign staff members.

The above assumes that a firm is actually trying to abide by anti-corruption norms and regulations. Many companies try, quite subtly, to cover the tracks of corruption expenses. Dummy firms are created to serve as conduits for corruption payments. The parent company writes off the expense and claims ignorance of wrongdoing. One example is Northrop Corporation and its dummy, Economic and Development Corporation (Heidenheimer and Johnston, 1989). Other examples include Gulf Oil, which used a Bahamas subsidiary to launder \$12.3 million for political purposes, and 3M, which set up a Swiss bank account for the same purpose, both in 1976. Some companies make payoffs through their sales agents, who are locally known but not regular employees of the company.

Instead of monitoring the day-to-day activity of subordinates, managers may simply use output measures such as sales, market shares, or profit margins to

evaluate their inferiors. Indeed a firm may go further and purchase the service of independent entrepreneurs to do the firm's dirty work rather than hiring them as employees. The outsider provides specialized contacts with decision makers or expedited service through a government bureaucracy, and the seller asks no questions about how the service was performed (Ruff, in Heidenheimer and Johnston, 1989).

This way, multinationals avoid direct contact with bribe recipients. These acts flaunt the principles of anti-corruption practices, but it is the less apparent forms of participation in corrupt practices that threaten most firms.

Bribe-makers seem to have more to lose than bribe-takers. Bribe-makers face public censure as well as legal proceedings, fines, and jail sentences. Bribe-takers are more likely to be dismissed than prosecuted (Coleman, 1998). This creates greater incentives for conscientious corporate officers to work against corruption in their company and a need for disincentives for corruption beneficiaries, as they currently have more to gain than to lose.

Many enterprises have responded to concerns about globalization and corruption 'by developing internal programmes, guidance and management systems that underpin their commitment to good corporate citizenship, good practices and good business and employee conduct. Some of them have called upon consulting, auditing and certification services, contributing to the accumulation of expertise in these areas' (OECD, 2000c). Such efforts from the private sector have promoted discussion about what constitutes socially good business practices. Such firms have responded proactively to the changing institutional framework for international business.

Changes in global anti-corruption institutions, discussed in this chapter, require changes to corporate culture. Today, we hear the phrases 'culture of compliance' and 'corporate social responsibility' used frequently, whereas they were seldom used in the past. A culture of compliance implies that the company is raising awareness in its employees about corruption practices and anti-corruption controls. Corporate social responsibility implies that the corporation is a joint-stakeholder in the community, and the entire community, including the firm, benefits when socially-responsible management practices are followed.

'Zero tolerance' is a phrase often used in codes of conduct, but zero tolerance is a difficult achievement, one that can only happen with concerted effort and training. Business and government representatives in other countries will simply not understand why bribes, which in many cases they require to supplement insufficient incomes, are being denied to them. Employees must understand both the local cultural norms and how skirting the rules will hurt themselves and their employer.

Corporate ethics and anti-corruption policies, as well as all behavior that falls under the corporate social responsibility heading, are not achieved without strategic planning. Graham Baxter, VP of BP, claims that we have created parallel universes, which separate business purpose from CSR goals (Allen, 2007). Global CSR management is a new and difficult strategy, because it requires that officers and

representatives of firms must expand their thinking beyond 'traditional business strategy.' Being competitive in this new institutional framework means managing risks that arise from working in corrupt business environments and avoiding legal sanctions and scandal that arises when workers and corporate officers fail to do this well. As Allen (2007) states, 'the firm must integrate business and social strategy to create competitive advantage.'

Pell (2005), a partner at White & Case, states that, 'in today's stricter regulatory environment, the cost of ... non-compliance has simply become too high.' Companies and their representatives may face fines, jail sentences, public censure – which hurts the bottom line – unhappy shareholders, loss of financing and insurance, the loss of the right to bid on public contracts, and disgrace if embroiled in a nasty public scandal involving corruption.

Historical Background to International Efforts to Control Corruption

In the mid 1970s the Security and Exchange Commission (SEC) of the US surveyed companies about corruption payments. More than 400 openly admitted paying foreign government officials, politicians, and political parties.

By 1976, the SEC was investigating kickbacks, political payoffs, and bribes involving at least 54 large corporations. The IRS was probing others (*Time*, 1976). This sparked public discontent. Why were American companies engaging in unethical practices and encouraging corruption in other countries? Consequently the US Congress created and passed the Federal Corrupt Practices Act (FCPA) in 1977. Allegedly, this was to restore public confidence in the integrity of corporate America. This law applied to US companies as well as foreign corporations listed on US stock exchanges.

Fraud offices often became the parties responsible for enforcing anti-corruption policies. The US FCPA was the first such example. The U.S. law covered only public corruption of offers, promises or payments to foreign political parties, candidates, or officials. The European Commission (EC) established the European Anti-Fraud Office – Office Européen de Lutte Anti-Fraude (OLAF) in 1999. This is supported by EC Treaty Articles 274 and 280. The former covers budget implementation and the latter covers fraud and illegal activity that affect financial interests of EC members.

The FCPA made it illegal for any US citizen, and some foreign issuers of securities, to make a corruption payment to a foreign official for the purpose of gaining or retaining business for oneself or for another. It became illegal in 1998 for a foreign firm or person to attempt to bribe an official within the United States (USDOS, 2001a). Attempts at bribing officials did not have to be successful to be illegal. All that was necessary was corrupt intent. Companies with securities listed on US exchanges also had to meet accounting provisions specified in US Code, Title 15, Chapter 2, § 78m. This required corporations to accurately represent their transactions and to have internal accounting controls.

Supposedly, this put US-based companies in a position of disadvantage. While companies based in other countries could facilitate foreign operations with grease money and use such expenses as taxable business expenses, US companies were prohibited from doing so. Perhaps partly to expand values of honesty and integrity, but also to protect US business interests without having to give up anti-corruption values, the US government began lobbying other governments to adopt legislation similar to the FCPA. In 1988, the US Congress directed the executive branch to negotiate FCPA-type legislation with the Organization of Economic Cooperation and Development (OECD).

In 1997, 34 countries signed the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. About this time, Transparency International began reporting its international corruption indices. The UN, World Bank, and IMF all became involved in reporting and combating corruption. Many countries began to seriously examine corruption practices for the first time. In 2005, the UN Convention against Corruption united most countries in at least nominally fighting corruption practices in government and markets. Within this period (mid 2000s) many regional organizations and national governments initiated anti-corruption protocols.

The Public Company Accounting Reform and Investor Protection Act of 2002, known as the Sarbanes-Oxley Act (SOX), is the most recent development to combat corrupt behavior, specifically fraud within the private sector. Fraud by corporate executives violates the US Internal Revenue Code. Fraud is characterized in SOX by its scale and complexity and the negative impact that it has upon others. This act holds corporate officials accountable for actions taken by their subordinates in reporting financial information to the public and tax returns to the government.

During fiscal years 2004–2006, SOX investigations fell from 107 to 40, while the incarceration rate rose from 61 to 86 percent and the average sentence rose from 34 to 49 months (US Dept. of Treasury, IRS web data). SOX has only had a few years to take effect in the United States. It has not yet had the time to mature and to influence anti-corruption institutions in the world as the FCPA has done.¹

Anti-Corruption Conventions, Laws, and Unions

Conventions and laws to prevent corruption must cover several dimensions to be effective: specifying which actions are illicit, a method for detecting these, a method for investigating these, and both the codified penalties associated with behavior and the power to enforce these penalties. When one of these dimensions

¹ It could be appropriate to include SOX among anti-corruption conventions as a US law that responds to corrupt management such as that shown by Enron, Tyco, Peregrine, and WorldCom. This chapter does not focus, per se, upon national laws, but upon multinational developments to control public and private corruption. Hence, SOX is only discussed with respect to the historical overview of anti-corruption developments.

is lacking, an anti-corruption convention is reduced to being a political show piece rather than an effective piece of policy. These conventions vary in how they define corruption (which actions are illicit). They also vary in geographical range. Some are national, some are regional, and some are international, reflecting the work of supranational agencies. Not all anti-corruption legislation, treaties, and acts can be discussed here. This chapter seeks to present those most discussed. The chapter's discussion is organized from the global to the local – first international conventions are discussed, then regional, then industrial and international, and finally national organization and laws.

Anti-corruption conventions are often seen as being useful for encouraging countries to improve their corruption climate. They are also helpful in other ways. They provide a framework for addressing cross-border issues, such as extradition and recovering ill-gotten gains (Dell, 2006). They help to standardize what is 'corrupt,' thereby integrating institutions across borders. They serve as means by which citizens are better able to hold their government accountable. They often allow for input from members of civil society, fostering democracy.

Conventions usually use language that allows for varying degrees of compliance. For example, the OAS Convention includes mandatory and optional provisions.² The UN Convention includes three categories: required provisions, required to consider provisions, and optional components.³

Oftentimes, countries ratify international or regional agreements and lack follow-through. Signing a convention or treaty indicates a government's intention to ratify a document. Ratification requires a domestic, national legislative procedure. So long as the government has not ratified a convention or treaty, it is not bound by its conditions. Lack of ratification may be due to a lack of political will and inexperience or it may be due to state-capture (when corrupt parties hold the ability to mold policy to benefit themselves).

Countries may ratify a convention or treaty and then never see the agreement through by failing to create effective monitoring and enforcement mechanisms. Dell (2006) outlines the key features of an effective monitoring system:

- commitment by members of government;
- information, including governmental self-assessment and experts' evaluation;
- study of a country's corruption climate and independent reporting which includes assessment and recommendations;
- an administrative unit with adequate resources;
- open discussion;

2 Mandatory requirements use the language 'shall adopt;' optional provisions uses phrases 'agree to consider' or 'may adopt.'

3 Mandatory requirements use 'shall adopt;' non-mandatory, but necessary for consideration provisions use the language 'shall consider adopting' or 'shall endeavor to.' Wholly optional provisions use 'may adopt.'

- public disclosure of a country's final report;
- follow-through on recommendations made in the final report.

Any international agreement requires time and effort to hammer out details agreeable to signatories. Time and effort are then required to implement the conditions signatories agreed to and for the regional or international organization to review the progress of countries in implementing the agreement's conditions. An example of the process for implementing an anti-corruption convention is the OAS procedure (Dell, 2006). This includes a preparatory phase and a review phase. Preparation consists of choosing aspects of the Convention to be reviewed, choosing a methodology for analysis (a uniform questionnaire created for all signatories is part of the process), creating a schedule for reviewing countries, and creating groups to review each country. The review phase begins with countries' self-assessments which are published on the OAS website. Civil groups are asked to respond to the questionnaire in writing, which are also published. The country review groups, the OAS Secretariat, and the Committee of Experts meet. The review groups report to the Committee of Experts. Meetings are held with members of civil society. The Committee of Experts then reviews four to six countries at each biannual meeting. The process concludes with the approval of a country report. These reports include evaluations as well as recommendations.

Supranational organizations

The most effective anti-corruption agreements are those enacted internationally. International agreements offer prestige and a sense of legitimacy to governments of developing countries; they also show developed countries that are signatories to such agreements to be leading by example. International agreements are preferable to regional and industry agreements as they are broader in scope and help to harmonize standards. Such agreements also give voice to concerns held by policy-makers in developing countries which might not otherwise be aired.

Although supranational organizations, such as the United Nations, are able to orchestrate international agreements, such agreements are binding only when ratified by sovereign governments and then implemented with national laws in each country. These agencies can help orchestrate change, but they themselves lack the ability to implement legal change.

UN conventions are the most wide reaching international controls on corruption. The UN's Office in Drugs and Crime is the agency that oversees both the UN Convention Against Corruption (UNCAC) and the UN Convention against Transnational Organised Crime (UNTOC).

UNCAC In December 2005, the United Nations Convention against Corruption (UNCAC) became the first global anti-corruption agreement. Eighty countries did

not ratify the UNCAC,⁴ though only 26 failed to sign the agreement.⁵ Many of the signatories formally limited their agreement with the document. Even with limited agreement with the UNCAC, it took from January 2002 until October 2003, and seven sessions of the Ad Hoc Committee for the Negotiation of the Convention against Corruption, to reach a deal on the wording of the document (United Nations, 2007b).

Countries that obligate themselves to the UNCAC agreement are required to criminalize corrupt behaviors, such as bribery, public-fund embezzlement, money laundering, and obstruction of justice. They are encouraged to make acts such as influence trading illegal also (United Nations, 2006). This convention also provides for extradition for criminal proceedings of those accused of corruption who have fled their country.

UNCAC expands past definitions of corruption. It requires signatories not only to criminalize bribery and public fund embezzlement, but also areas of private-sector corruption; influence trading; concealing and laundering corruption payments; and obstructing justice (United Nations, 2007b).

One chapter of UNCAC is dedicated to corruption prevention in both public and private sectors. Included are the creation of anti-corruption agencies and transparency for campaigns and elections, public service delivery, codes of conduct, financial disclosure, procurement, and the inclusion of civil society inputs to curb corruption.

In some ways, UNCAC makes joining another agreement, such as the Extractive Industries Transparency Initiative, or EITI, irrelevant. All of the provisions of UNCAC compel companies to adhere to rules, such as those imposed by EITI. Jennett (2006) discusses the points where UNCAC enforces EITI standards:

- promoting standards, such as codes of conduct, in private companies;
- promoting transparency;
- preventing abuse by regulatory agents;
- preventing conflicts of interest by restricting private-sector activity by public employees;
- requiring audits of private firms and enforcing auditing and accounting standards, including prohibiting off-the-books accounts;
- prohibiting using corruption payments as tax-deductible expenses.

4 It would seem that many of the developed country governments that signed the agreement but did not ratify it, but deemed signing it to be a sufficient act. If a country signs the agreement, it seems reasonable to expect that it would follow through with ratification, but this is often not the case.

5 Countries which neither signed nor ratified the UNCAC are Cook Islands, Democratic Republic of the Congo, Equatorial Guinea, Estonia, Gambia, Georgia, Guinea-Bissau, Guyana, Iceland, Kazakhstan, Kiribati, Lebanon, Maldives, Micronesia, Monaco, Nauru, Niger, Oman, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, San Marino, Slovenia, Suriname, Uzbekistan, and Vanuatu.

UNTOC The United Nations Convention against Transnational Organized Crime (UNTOC) was adopted by the UN's General Assembly in 2000. As of 2006, 116 countries have ratified and 147 countries have signed this agreement.⁶

The focus of this agreement is that signatory states align their domestic laws to criminalize participation in a criminal group, money laundering, corruption, and obstruction of justice. UNTOC creates standards for extradition, legal assistance, joint investigations, victim and witness protection, and training programs. UNTOC's various protocols can serve to help countries to coordinate better in their fight against several types of international crime, including international corruption, although the focus of the agreement is upon other criminal issues.

Different components of the convention have different numbers of signatories, ranging from 52 for the Protocol against the Illicit Manufacturing of and Trafficking in Firearms (2005) to 147 for the general UNTOC agreement (United Nations, 2007a).

Regional Organizations

OAS

The Organization of American States (OAS or OEA)⁷ adopted B-58 'Inter-American Convention against Corruption' in March 1996 in Caracas. The treaty went into effect one year later. Thirty-four countries have signed the OAS convention.⁸

Transparency International Latinoamerica y el Caribe (TILAC) works with OAS countries on implementing and improving OAS Convention adherence. TILAC emphasizes both public finance and the private sector.

The 'Implementation of the Inter-American Convention against Corruption' (MESICIC) specifies follow-up procedures for enforcing the Inter-American Convention against Corruption.

6 Countries that have not yet ratified UNTOC – though they may have signed it – include: Andorra, Angola, Bahamas, Barbados, Burundi, Congo, Côte D'Ivoire, Czech Republic, Gabon, Greece, Guinea-Bissau, Haiti, Iceland, India, Indonesia, Iran, Ireland, Japan, Jordan, Kazakhstan, Liechtenstein, Luxemburg, Maldives, Mongolia, Nauru, Nepal, Pakistan, Qatar, Republic of Korea, Saint Lucia, Saint Vincent and the Grenadines, San Marino, Sierra Leone, Singapore, Swaziland, Syrian Arab Republic, Thailand, Timor-Leste, Trinidad and Tobago, Vietnam, Yemen, and Zimbabwe.

7 OAS is the abbreviated English name; OEA the abbreviated French, Spanish and Portuguese. The regional organization will be referred to as OAS in this chapter.

8 Argentina, Antigua and Barbuda, Bahamas, Barbados, Belize, Bolivia, Brazil, Canada, Chile, Columbia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St Kitts and Nevis, St. Lucia, St. Vincent & Grenadines, Suriname, Trinidad and Tobago, USA, Uruguay, and Venezuela (OAS, 1997).

Article III of the OAS Convention focuses upon public corruption. It includes reporting of income, assets, and liabilities of civil servants and officials, hiring practices, procurement practices, revenue collection, protection of whistleblowers, and financial reporting by publicly held corporations.

The OAS Convention is less binding than the UNCAC (Dell, 2006). This agreement prohibits bribing foreign and national public sector officials. It includes optional prohibitions against (i) embezzlement, misappropriation or other diversion of entrusted property by a public official; (ii) illicit enrichment by a public official; and (iii) improper use of classified or confidential information by a public official. The UNCAC includes private sector corruption as well as additional prohibitions for public officials.

Governments conduct a self-evaluation as to how well they comply with the OAS Convention's requirements. Policy-makers also evaluate one another's programs. The peer-review process may include formal recommendations and discussion. Comparisons and rankings to other OAS countries may also be used.

The OAS Convention, passed in 1996, initiated monitoring in 2001. Twenty-eight of the signatories participated (Dell, 2006). The goal is to evaluate all 28 countries over five years with two annual meetings of experts per year, organized by a staff of six full-time professionals. This does not include in-country visits. Following the evaluation phase, follow-up began in 2006. The budget for this program (in 2005) is \$350 000 per year (Dell, 2006).

COE Conventions and the Group of States against Corruption (GRECO)

The Council of Europe (COE) passed criminal and civil law conventions against corruption in 1999 which were widespread in that they included private- and public-sector corruption, harmonized extradition and sanctions across member states, and allowed for suits to recover damages suffered due to inequalities created through corruption.

Signatories to the COE treaties include both member and non-member states and the European Union. Forty-one out of 46 COE member states signed the civil treaty.⁹ Forty-four countries signed the criminal treaty and 36 ratified it.¹⁰ Many of the countries that did not ratify the treaty are developed countries failing to lead by example. All of the non-member states of the Council of Europe except for Belarus (Belarus, Canada, Holy See, Japan, Mexico, and USA), also failed to

9 COE states of Monaco, Portugal, Russia, San Marino, Switzerland, and Liechtenstein did not sign the treaty. States which signed the treaty, but failed to ratify it include: Andorra, Denmark, Germany, Iceland, Ireland, Italy, Luxembourg, Montenegro, Netherlands, Norway, Serbia, Spain, and the UK (Status as of: 25/8/2007) (Council of Europe, 1999a).

10 Andorra, Austria, France, Georgia, Germany, Greece, Liechtenstein, San Marino, Spain, former Yugoslav Republic, and Ukraine are COE states that failed to ratify the Criminal Law Convention on Corruption (Status as of: 25/8/2007) (Council of Europe, 1999b).

support either convention with ratification, although some signed the convention agreements.

‘Corruption’ is defined generally as, ‘requesting, offering, giving or accepting, directly or indirectly, a bribe or any other undue advantage or prospect thereof, which distorts the proper performance of any duty or behaviour required of the recipient of the bribe, the undue advantage or the prospect thereof’ (Council of Europe, 1999a). Compensation for such actions may cover loss of profits, non-financial losses, and material losses (Council of Europe, 1999a). Lawsuits have a limitation period of three years following the date when a person who suffered damages should reasonably have been aware of them.

The treaties prohibit (Council of Europe, 1999b):

- active and passive bribery of domestic public officials (Art.2-3);
- bribery of members of domestic public assemblies (Art.4);
- bribery of foreign public officials (Art.5);
- bribery of members of foreign public assemblies (Art.6);
- active and passive bribery in the private sector (Art.7-8);
- bribery of officials of international organizations (Art.9);
- bribery of members of international parliamentary assemblies (Art.10);
- bribery of judges and officials of international courts (Art.11);
- trading in influence (Art.12);
- money laundering of proceeds from corruption offences (Art.13).

This includes corporate liability (Art.18) as well.

The Group of States against Corruption (GRECO) shall monitor the implementation of this Convention by the signatories (Council of Europe, 1999a). Member states of GRECO include 43 European countries and the USA. The Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL), created in 1997, monitors compliance with money-laundering standards. These treaties require binding arbitration to be conducted through the European Committee on Legal Cooperation (CDCJ).

Organisation of Economic Cooperation and Development (OECD) Convention

The OECD Convention’s beginning took place with the ad hoc Working Group, established in 1989 (OECD, 2000a). It began with a comparison of member states’ legal norms concerning corruption. OECD decisions must be unanimous (OECD, 2000a). Hence it took until 1997 to pass the OECD Convention.

This agreement was the first movement to expand anti-corruption efforts from an item on the American agenda to an international cause. Thirty-six countries

(30 OECD and six others) have ratified the convention¹¹ which imposes criminal sanctions against bribery of foreign officials.

The 36 countries that signed the OECD Convention are major exporters (OECD, 2007a). It makes business professionals who engage in bribe-making of foreign officials criminals. This attempts to cut off bribes from the supply side. Some countries used to allow bribes to be written off as tax deductions – this benefit was also removed in the OECD Convention.

‘The OECD Convention on Bribery of Foreign Officials in International Business Transactions (OECD Convention) is the most focused of the major anti-corruption conventions in terms of subject matter’ (Jennett, 2006). The Convention addresses the supply size of bribery by providing a framework for countries to coordinate policies to control bribery of foreign public officials in international business transactions. Off-books accounts and other means for disguising bribery are prohibited by the Convention. The OECD (2000c) guidelines for international companies urge them to follow these guidelines:

- Disclose all activities ‘for the enterprise as a whole.’
- Support the norms of developed economies with respect to rights of labor and norms concerning forced labor, child labor, discrimination, etc.
- Protect the environment, public health and safety and promote sustainable development.
- Do not offer, give, or demand any ‘undue advantage to obtain or retain business’ with bribes.
- Allow the transfer of technology and intellectual property in a reasonable manner.
- Refrain from unfair competition.
- Pay corporate taxes in a timely manner.

The guidelines concerning corruption focus upon bribes. They are also required to demonstrate appropriate remuneration; transparency in anti-bribery and extortion measures; promotion of employee awareness of company policy and compliance with it; and to make no illegal political contributions.

The monitoring process began in 1999. It begins with a questionnaire and follows with peer review and plenary discussion. In the enforcement phase, the goal is to monitor six countries per year with five working group meetings per year (Dell, 2006). This process is estimated to cost 1.5 million euro per year.

¹¹ Countries that ratified the OECD Convention (June 21, 2000) were Australia, Austria, Belgium, Bulgaria, Canada, Czech Republic, Finland, Germany, Greece, Hungary, Iceland, Japan, Korea, Mexico, Norway, Slovak Republic, Spain, Sweden, Switzerland, UK, and USA. Countries that added by June 19, 2007 include Argentina, Brazil, Chile, Denmark, Estonia, France, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Slovenia, South Africa, and Turkey. This makes 36 countries that have ratified the OECD Convention (OECD, 2000a, 2007b).

The OECD's anti-corruption efforts are conducted through 6 specialized groups. Different groups are organized to investigate fiscal conduct, development assistance, investments, public governance, bribery, and export credits (OECD, 2006).

Countries that ratify the Convention must set up National Contact Points (government agencies to ensure adherence to OECD Convention conditions) and must adopt fair practice with respect to national treatment (not allowing a bias for domestic goods, once imports have paid import duties and cleared customs) (OECD, 2000c). In the case of domestically producing firms, foreign-controlled enterprises operating in a country could not be treated less favorably than a domestic company. By eliminating 'national treatment' one large opportunity for extorting bribes is eliminated.

Since the enforcement of the OECD Convention, the number of investigations and prosecutions for corruption has risen (OECD 'Anti-Bribery Convention'). There have been more than 50 investigations and over 30 convictions for foreign bribery. Prison sentences have been handed down and companies and their representatives have been fined as much as two million euro.

The OAS, COE, and the OECD anti-corruption agreements do not reflect all of the regional anti-corruption efforts in existence. Regional groups, such as the African Union, and free trade associations, such as ASEAN, as well as many other groups have concerted efforts to reduce corruption. These three may perhaps have the better established anti-corruption conventions.

Industrial collaborative organizations

Industry organizations to combat corruption have no legal binding, but they reflect a commitment by leaders in the business world to change from a 'culture of compliance' to becoming proactive actors who can affect corrupt practices. Two examples are given here, the Extractive Industries Transparency Initiative and the UK Defence Industry Anti-Corruption Forum.

Extractive Industries Transparency Initiative

It has long been the case that countries rich in natural resources, particularly minerals, attract foreign direct investment. These are also countries that are often less-developed and more corrupt.¹² This 'natural resource curse' is demonstrated by Angola, where an IMF audit could not account for hundreds of millions of dollars (Palley, 2003), or Nigeria, Cameroon, and Congo, where oil revenues have not generated economic development.

¹² Except for Australia and New Zealand, the countries reporting significant exports of basic commodities in the IMF's International Financial Statistics database, such as petroleum, wheat, coal, tin, zinc, sugar, rubber, etc. are all developing countries.

Because of the nature of international capitalism with excess financial capital in developed countries and needed raw materials in developing countries, it is often the case that extractive industries are located in developing countries and owners of capital are often foreign corporations. This creates a situation where foreign corporations are part of a cycle of corruption and citizens of developing countries are locked into receiving poor government services and that part of income inequality arising from corruption payments. This in turn creates an opportunity for extractive industries to collaborate to improve corruption climates in the countries where their extractive facilities are located. Consequently, we have an incentive for EITI.

The EITI agreement was announced in 2002 at the World Summit on Sustainable Development in Johannesburg. Extractive industries' revenue offers profits to be used for development in countries relying upon export of raw materials. However, diversion and misappropriation of these revenues produces less sustainable development, more risk for companies investing large capital outlays in these countries, and higher 'taxes' (official tax plus corruption tax on foreign firms). This created an incentive for private and public sectors and development community to work together to control corruption.

Governments and firms participate in EITI want to be involved despite the fact that they have no legal obligation, in many cases, to do so. In the case of each actor, they have joined the initiative because they felt they had something to gain, whether it may be a more attractive environment for foreign direct investment, a signal of good governance which can attract donor nations and institutions, or improved corporate reputation/corporate social responsibility for business (Jennett, 2006).

The idea behind EITI is transparency, particularly about revenue flows from oil, gas, and mining companies to government coffers. Without transparency, these funds can be diverted. With transparency, citizens know how much is received and can question where funds are going.

EITI has the support of 29 large corporations¹³ and three major industry associations: the American Petroleum Institute (API), International Council on Mining and Metals (ICMM), and the International Organization of Oil and Gas Producers (OGP). Only 29 countries have agreed to participate in the EITI agreement.¹⁴ Several of the countries that *have* agreed to participate in EITI

13 Supporting companies of EITI include Amerada Hess, Anglo American, AngloGold Ashanti, Areva, Barrick Gold, BG group, BHP Billiton, BP, Burren Energy, ChevronTexaco, ConocoPhillips, DeBeers, Eni, ExxonMobil, Katanga Mining Limited, Lonmin, Marathon, Newmont, NorskHydro, Petrobras, Repsol YPF, Rio Tinto, Shell, Statoil, Talisman Energy, TOTAL, Woodside, and Xstrata (EITI website).

14 Countries participating in EITI are Azerbaijan, Bolivia, Cameroon, Chad, Congo, Equatorial Guinea, Gabon, Ghana, Guinea, Kazakhstan, Kyrgyz Republic, Mali, Mauritania, Mongolia, Niger, Nigeria, Peru, Sao Tome and Principe, Sierra Leone, Timor-Leste, and Trinidad and Tobago (EITI website).

have opted out of agreements such as UNCAC, Kazakhstan and Timor-Leste for example.

UK Defence Industry Anti-Corruption Forum

The UK's largest defense companies and trade organizations formed the UK Defence Industry Anti-Corruption Forum in 2006. Representatives from 11 companies and two Trade Associations met on 18 May 2006 for the inaugural meeting of the Forum (Society of British Aerospace Companies, 2006). The UK Defence Industry Anti-Corruption Forum reflects a shared emphasis upon the reduction of corruption in the international defense market. This was perfectly timed for the scandals which had begun in 1986 but which recently came to light, involving the £6 billion UK–Saudi arms deal involving BAE Systems, corruption payments, and the decision by the UK Serious Fraud Office (SFO) to drop the investigation for political reasons (Zagorin, 2007)¹⁵. This group was started by AgustaWestland, BAE Systems, Marshall Aerospace, MBDA, Rolls-Royce, SELEX, Smiths Aerospace, Thales UK, VT Group, and by the directors-general of the Defence Manufacturers Association (DMA) and the Society of British Aerospace Companies (SBAC) (Society of British Aerospace Companies, 2006). The SBAC represents 54 governmental agencies, industrial organizations, and companies. Collectively, they aimed to raise ethical standards and to expand these in the global marketplace.

In organizing such an industry forum, members can form their own policy goals with respect to corruption and can offer a practitioners' perspective to policy-makers. The group has begun to work with the Institute for Business Ethics, Transparency International, and the International Chamber of Commerce (Society of British Aerospace Companies, 2006).

Similar to the UK Defence Industry Anti-Corruption Forum, European aerospace and defense industry companies founded the 'Ethics and Anti-Corruption Working Group' in 2006 (AeroSpace and Defence Industries Association of Europe, 2006). This industry network aimed to implement and diffuse the EU's best practices based upon the OECD Convention and to achieve a global front against corruption in the aerospace and defense sector.

Conclusion

It took more than three decades to develop an anti-corruption culture that rapidly now is changing how business and government practices are conducted. Though the roots of this sense of justice and fair play are rooted in classical European thought, institutional change began in the United States and spread through political

¹⁵ The High Court in London ruled in 2008 that the Serious Fraud Office broke the law in 2006 by dropping the BAE investigation (Smith, 2008).

persuasion. From the US's FCPA to the OECD Convention to the UNCAC, public and corporate leaders are propagating a new culture that is far less tolerant of bribery, fraud, and other corrupt acts.

Today, corruption is being battled upon four fronts, three of which are discussed here: at the supranational level; regionally, at the national level; and through private industrial associations. This chapter looked at UN conventions at the supranational level, at the American, European, and OECD regional organizations, and two examples of industrial unions in the fight against corruption. At each level, a new culture is being promoted by creating new norms, monitoring how well these are upheld at the country level and how well violators are dealt with.

Part of this new culture is to hold corporate leadership accountable for actions committed by a representative of their corporation. Ignorance is legally no excuse, which is made more direct in the newest SOX legislation, which too shall probably bring long-term, global change as time passes. Private-sector leaders must ensure a culture of compliance in their firms or face risks to themselves and their companies.

Adapting to the new environment is not simple. Corrupt societies have not changed as quickly as legislation and conventions have been signed. Corrupt bureaucrats and elected officials, as well as representatives from other firms, still expect to receive a large share of their income from bribes, kickbacks, and other favors. The challenge is to maintain these business relationships without jeopardizing the reputation of the company and its officers.

Change is never easy. These new rules place great burdens upon corporate managers not only to do what businesses always do – supply goods and services and make a profit for the owners of capital – but to be good ‘global citizens’ as well. The stick is large and immediate. Companies that fail to demonstrate good corporate governance and social responsibility will be fined, their executives may be jailed, and public scandal may harm both. The carrot is not so discernible as the pay-off is really in the future. When corruption is controlled, the playing field is more even for all companies, when, for example, bidding on tenders. When corruption is controlled, managers will spend less time learning who must be paid off and finding non-traceable accounting methods. When corruption is controlled, firms pay only the legal corporate tax rate and customs duties; they do not also have to pay corruption taxes, which are now illegal to write off as taxable expenditures. We are asking international companies to change how they conduct themselves, with a great immediate consequence if they fail to do so and nebulous future benefits if they do.

Chapter 10

Changing the Rules: How the Transition Economy of Kyrgyzstan is Reforming Public Corruption

Talaibek Koichumanov

Introduction

Kyrgyzstan is a good example of a transition country undergoing institutional change with some grass-roots movements to combat corruption. It is neither the best or worst case. It is a relatively small country with extractive industries. These are conditions that increase corruption opportunities.

All of the cases used in this chapter are based upon the personal experiences of the author during his time in the government of Kyrgyzstan during 1994–8. These examples were experienced personally or were reported by his staff. Data are original from the National Statistics Agency of the Republic of Kyrgyzstan.

Brief introduction to Kyrgyzstan

Kyrgyzstan, or the Kyrgyz Republic,¹ was part of Turkestan in the nineteenth century. While Kyrgyzstan did not form a nation state following the Western model, it had its own political entity. The Kyrgyz Kaganate (or Khanate)² was formed in the sixth century but broke into smaller units when Genghis Khan's forces invaded. Russian expansion brought the territory now known as Kyrgyzstan into the Russian Empire. When the Bolsheviks took power in 1917, they absorbed Russia's colonies and created Soviet Socialist Republics. This land became the Kyrgyz Autonomous Republic in 1924, the Kyrgyz Kaganat in 1936, and remained a republic until the break-up of the Soviet Union in 1991, when it became an independent state.

Initially, Kyrgyzstan was lauded by those in the West as being the most progressive in reforming its economy and political system toward a free market and democratic government. Askar Akayev was elected as president of Kyrgyzstan in

1 Phonetically, the second syllable is a hard 'hh' sound which is spelled 'gh,' so Kyrgyzstan and Kyrgyzstan are correct alternative spellings. This country is also sometimes called Kirgizia.

2 Khanates were political states in Central Asia, ruled by a khan or emir.

1994. He soon promoted privatization. The president promised to step down when his term ended, but did not do so. Political protests (such as the Tulip Revolution of 2005) forced Akayev to flee. Kurmanbek Bakiev was sworn in as president in August, 2005.

Kyrgyzstan is approximately 200 000 square kilometers in size (about the size of the state of South Dakota). It is bordered by China, Kazakhstan, Tajikistan and Uzbekistan. Its 2007 population is estimated to be 5.3 million (Central Intelligence Agency, 2007).

Reforms and the Transition Process

The Kyrgyz Republic has improved its social and economic conditions through reforms. These have included privatization of state property; liberalization of prices and external trade; fiscal and budget reforms; deregulation of the economy; decentralization of government; creation of market institutions; banking and capital market reforms.

Reforms were comprehensive, but progress was hindered by a lack of follow through. The transition process, combined with poor policy execution, has resulted in major structural economic problems, such as the collapse of production, high inflation, large budget deficits, external debt overhand, and high levels of unemployment.

On the other hand, these policies have helped both production levels and the size of the federal budget to grow 1.6 times what they were in the early 1990s (and 4.5 times what they were in the mid-1990s). Despite this progress, Kyrgyzstan is still behind its Soviet levels of production.³

Per capita GDP in 2007 is estimated to be \$2 250 (Economist Data Services). Income has grown, although recent GDP growth rates were negative in 2002 and 2005.

Kyrgyzstan has enjoyed some years of high economic growth, but major structural reforms, such as those to stimulate employment, have failed. A low consumption rate indicates difficulties with maintaining sustainable economic growth. State intervention in the economy remains high.

The State continues to be heavily involved in strategic industries, such as agriculture, textiles, alcohol, tobacco, gold, energy, transportation, and communications. These are large, and it is perceived that their restructuring would cause problems in the domestic economy.

Good governance and combating corruption go hand in hand. Over the past few years, political pressure to improve the quality of government has strengthened.

³ Real GDP in 2005 was 80.3 percent of its Soviet level; employment exceeded its Soviet level by 8.3 percent. Labor productivity in 2005 was 74.1 percent of its 1990 level. Tax revenues and public expenditures are below their 1990 levels also (National Statistical Agency original data).

Table 10.1 Key economic indicators of the Kyrgyz Republic, 2000–2005

Key indicators	2000	2001	2002	2003	2004	2005
Nominal GDP (billion US\$ at PPP)	7.60	8.19	8.33	9.11	10.03	10.31
GDP (% real growth rate)	0.05	0.05	-0.02	7.03	7.08	-0.20
GDP per head (\$ at PPP)	1,540	1,660	1,670	1,810	1,970	2,010
Population (million)	4.92	4.95	4.98	5.04	5.09	5.14
Budget balance (% of GDP)	-1.91	0.39	-1.06	-0.81	-0.54	0.22
Inflation rate (consumer prices % change)	19.70	6.93	2.14	2.98	4.12	4.34
Exchange rate LCU:US\$	47.70	48.38	46.94	43.65	42.65	41.01
Current-account balance/GDP	-9.07	-3.71	-4.98	-5.15	-4.55	-8.34
Inward direct investment (million US\$)	-2.40	4.90	4.60	45.50	175.00	42.60
Private consumption (% of GDP)			65.68	64.82	67.53	77.91
Government consumption (% of GDP)			20.04	17.48	18.62	16.83

Source: Economist Intelligence Unit Data Services.

A redistribution of powers among the executive, legislative and judicial branches of the government directed at achieving checks and balances has occurred. For example, Parliament was restructured to be unicameral. The adoption of the ‘Governance Reform Strategy,’ ‘National Anticorruption Strategy,’ and the ‘National Government Decentralization Strategy’ have signaled that the Kyrgyz Republic envisions improving federal governance.

Unfortunately, it is impossible to tell which aspects of governance reform are sincere and which are ‘window dressing’ to impress transnational organizations or foreign governments. For example, a condition of the Millennium Challenge Account (MCA) and multilateral aid program is improving accountability⁴ and reducing public corruption. Kyrgyzstan’s performance in combating corruption

4 ‘President Bush called for ‘a new compact for global development, defined by new accountability ... Greater contributions from developed nations must be linked to greater responsibility from developing nations.’ The president pledged that the United States would lead by example and increase its core development assistance by 50 percent over the next three years, resulting in an annual increase of \$5 billion by FY 2006. These funds will go into a new Millennium Challenge Account (MCA) (statement given on March 14, 2002: The White House, ‘The Millennium Challenge Account’, <<http://www.whitehouse.gov/infocus/developingnations/millennium.html>>).

does not meet MCA criteria. The government must appear to demonstrate positive results in fighting corruption to receive this aid.

The institutions necessary to combat corruption continue to improve. In 2004, authorities established the National Good Governance Council, the Civil Service Council, the Agency of the Kyrgyz Republic for Civil Service Affairs, and the Law on Civil Service. These new structures have improved how political and administrative offices are organized.

The National Good Governance Council includes top-level officials from all branches of government as well as representatives from business and civil society. Its purpose is to reform public administration while considering the needs of all stakeholders to promote democracy and transparency in government.

After the 'Tulip Revolution' of March 2005, the National Council on Combating Corruption was established. The council consists of representatives from the public and private sectors as well as from civil society. It is headed by the Chief of Parliament as a policy-making body. The National Agency of Corruption Prevention is the executive body to execute the council's goals.

Part of the process of improving governance was to improve efficiency. This necessitated a functional analysis of all governmental positions. With job descriptions, duplicated or outdated administrative positions could be cut. For the first time, attempts were made to optimize state agencies' structure and staffing.⁵ This was seen as part of the movement towards a market-oriented economy.

Despite attempts to improve governance, the rise of public corruption in government and a lack of transparency have hindered development. According to international organizations, such as the World Bank, European Bank of Reconstruction and Development (EBRD), and Transparency International (TI), Kyrgyzstan consistently is among the countries with high levels of corruption.

Part of the process of transition is for new laws and codes to be created to replace Soviet ones which were discarded with the breakup of the Soviet Union. Kyrgyzstan has worked to create new legal institutions to replace Soviet norms and to provide for a new market system. The Constitution and the Civil Code of Kyrgyzstan guarantee basic rights for private entities. Business is regulated through various laws and codes, such as the Antimonopoly Law, Tax Code, Customs Code, and the Law on Inspections. Ministries in the government are given responsibility to monitor and enforce these legal norms. For example, the Ministry for Economic Development and Trade is responsible for supporting enterprise development.

Prior to the break-up of the Soviet Union, the private sector was minimal (small businesses providing services, sellers at street markets, etc.). Hence, the government is still learning how to regulate business while many old attitudes about restricting the private sector remain. The government has sought to strengthen its interaction in the private sector by increasing regulations and establishing new

5 The goal under the Soviet Union was to maximize production and employment. This did not lead to efficiency, but toward bloated administrations with many unnecessary positions to keep employment levels high.

administrative barriers for business. For instance, the number of the export-import procedures and the number of unannounced inspections have increased. Such increases in regulatory interference give rise to more opportunities for demanding corruption payments. Most regulations do not control corruption or improve how companies are managed.

Problems in Fighting Corruption and Anticorruption Measures

The fight against corruption in Kyrgyzstan is limited to public corruption. For example, the State Strategy on Corruption Control in the Kyrgyz Republic identifies problems in political activities, public administration, public finance, the justice system, law enforcement, the army, and social services. There is no mention of civil laws, regulation of firms, or other measures to combat private corruption. Private corruption is a concept that has not yet entered the dialogue.⁶ Some measures of the State Strategy of Corruption Control are intended to improve competition in the private sector. These are limited to measures against the underground economy and problems caused by unfair or excessive regulation of business. Most of the discussion below centers solely on issues with reducing public sector corruption.

Corruption has a significant negative impact upon Kyrgyz society. It destroys the fundamentals of the state's legitimacy. Double standards and inconsistent values are becoming 'normal' in the mentality of Kyrgyzstani people. Everything is for sale – judicial judgments, tax exemptions, drivers' licenses, graduate degrees, etc. This undermines any legislation that the state may pass.

The issue of corruption eradication in Kyrgyzstan is the most important sociopolitical problem at present. Corruption creates income inequality and is an obstacle toward economic development. Despite rather good economic indicators, such as growth rates and per capita GDP, large populations find themselves unable to benefit from the new market economy. This led to civil unrest and the surprise abdication of the former president in March, 2005. Today corruption appears to be an intrinsic component in the public administration system, which is a usual condition in many transition economies.

Despite statements by the former leaders of the country and attempts to promote anticorruption campaigns, real change, based upon experts' opinions, has been rather insignificant. The high level of corruption in the country is the main obstacle for Kyrgyzstan in its desire to fulfill goals set by the Millennium Challenge Account.⁷

6 In fact, many people in the former Soviet Union think that private corruption is a normal component of 'market economics.'

7 The Millennium Challenge Corporation (MCC) was created by the US government in 2004 (see footnote 4). It works with the world's poorest countries. It offers aid for which countries must demonstrate good governance, economic freedom and investment in its citizens.

The highest levels of corruption are observed in the judicial system, customs service, law enforcement bodies, state procurement system, and licensing of enterprise activity. These are sectors where governmental bodies regulate extensively and have access to businessmen and civilians. Lack of a monitoring and evaluation system for reform policies prevent success and increase mistrust by the public toward any anticorruption initiatives.

Laying the Foundation for Combating Corruption and Developing Civil Society

Kyrgyzstan is using the World Bank's comprehensive approach to reduce corruption in the public sector. With the assistance of the Organization for Security and Cooperation in Europe (OSCE) and the United Nations Development Program (UNDP) as well as local experts, the government of Kyrgyzstan hosted several missions whose purpose was to help the country design institutions for combating corruption. The baseline for developing new institutions for the Kyrgyz Republic was to study successful practices in Eastern Europe and the Baltic countries. Although these countries had very different pre-Soviet histories, they were seen as good models because they too were developing as transition economies. From these efforts, the Strategy on Combating Corruption was developed. The National Council on Anti-corruption and the National Agency on Corruption Prevention were established at this time.

The basic document identifying objectives, tasks and the sequence of implementation of anticorruption measures is the State Strategy of Corruption Control, approved by the Decree of the President on June 21, 2005. Its purpose is to reduce corruption levels in the Kyrgyz Republic by elimination of underlying causes. Its objectives include analyzing the depth of public-sector corruption, factors contributing to corruption payments, necessary legislation, political risks of combating corruption, and resources needed for implementing and monitoring an anticorruption program. It seeks to limit public corruption, develop public support for anti-corruption measures, investigate corruption crimes, and gain international cooperation in combating corruption. This is done with the assistance of NGOs and international aid organizations.

The strategy and action plan for its implementation include: (i) political reform based on creation of checks and balances, political competition, and transparency; (ii) participation by the civil sector in decision-making; (iii) creation of a competitive private sector along with economic deregulation and reducing the underground or shadow economy; (iv) management improvements in the civil service, better pay to government workers, and improved ethics; (v) legal reforms; and (vi) institutional reforms.

Of the above goals of the action plan, accomplishments by mid 2007 were modest. The National Agency for Corruption Control was established. The UN

Anticorruption Convention was ratified. These are mostly superficial ‘first steps.’ Much is still waiting to be accomplished.

Overly bureaucratic governments and lack of clear delineation of tasks worsen public corruption. In such a system, there are fewer checks on officials to limit demand for corruption payments. The Strategy for Public Administration Reform attempts to optimize governmental structure and consolidate bodies with overlapping functions. It also seeks to clarify the tasks of each department and division as well as the chain of authority between administrative units.

The National Anti-corruption Strategy attempts to contain and control corruption. The Anti-corruption Strategy seeks to reduce corruption by increasing legal penalties and by changing the image of offering and accepting corruption payments. The irony is that while governmental officials develop anti-corruption strategies, it is governmental officials who are propagating public corruption practices. The National Strategy on Decentralization establishes goals and tasks for decreasing state management of firms. In some cases, this may be a transfer of management control from the central government to the local government, rather than privatization.

The Kyrgyz Republic is undergoing its Country Development Strategy of 2010 (CDS) which is being implemented from 2007 to 2010. It was adopted by presidential decree⁸ in April 2007. The CDS includes a variety of measures to eradicate corruption, including reducing and regulating governmental intervention in market mechanisms, toughening accountability, improved reporting requirements, increasing transparency, and improving judicial operations.

Although the dialogue in Kyrgyzstan today is limited to public corruption, much is, at least nominally, being started to curb this form of corruption. The next section considers the main fronts by which corruption is being combated in this developing transition economy.

Corruption’s Impact upon the Private Sector

Several international organizations, including the World Bank, EBRD, and the Asian Development Bank (ADB), have noted substantial recent improvements in the of the business environment of Kyrgyzstan.⁹ Procedures for registering businesses; labor recruitment and dismissal; real estate registration; and protection of investors have been considerably simplified. This has resulted in the Kyrgyz

8 Many of these anticorruption and good governance measures are adopted by presidential decree, rather than through grass-roots developments that capture the public will. As such, they are likely to be less effective than democratically created movements.

9 In the World Bank publication ‘Doing Business – 2006’ Kyrgyzstan placed 78th in the world – relative to its place of 178th for GNP per capita on the of ease of creating a business.

Republic's making progress relative to many other Eastern European and the Central Asian countries.

Despite such improvements, problems remain in tax administration, international trade, contract law, and business closures. Economic losses due to these inefficiencies are estimated to be 1.5 percent of GDP (see <<http://russian.doingbusiness.org>>). Such inefficiencies offer opportunities for demanding corruption payments to act as 'speed money' cutting through government barriers.

It is a common occurrence for business professionals to bribe civil servants to avoid taxes, customs duties, etc. The development of market institutions and good governance are destabilized by the ease with which companies can avoid regulation and taxes.

Business professionals are hindered or helped by corruption in Kyrgyzstan, depending upon whether or not they engage in it. The judicial system in Kyrgyzstan is not an effective means of resolving disputes. Officers of the court are biased, particularly in resolving economic cases, because judges accept bribes for verdicts. Customs officials may reduce the value of imported goods to reduce customs duties or they may allow goods to be smuggled. Honest entrepreneurs are harmed by smuggling, because they are competing unfairly with firms that have lower costs. Regulators and enforcement officials may initiate cases against business professionals for allegedly violating local laws, but the same officials may drop the cases after receiving a bribe. The law requires that procurement is done through public tenders. Unfair tenders harm honest companies as well as citizens who pay for higher costs and inferior products through their taxes and the services delivered. Licenses needed to engage in different business practices may be purchased as well, allowing unprofessional specialists to compete with qualified ones.

Thus, the primary emphases in the Country Development Strategy of 2010 are reducing the bureaucratic pressures, further deregulation of the economy, and expanding economic freedom. What is needed to improve the business environment and to decrease the burden of corruption upon the private sector?

Reforming tax administration is a major necessary step. The existing Tax Code is not only contradictory; it is an obstacle for business development and effective tax administration. In recent years a new edition of the Tax Code has been completed by Parliament, which reduces outdated and contradictory articles. This will hopefully be adopted soon, as it will both improve the business climate and reduce corruption.

Efforts to streamline government and to improve regulation will enhance governance and the business climate. Getting a license from one agency will be much easier than obtaining licenses from ten agencies. The goal of a new law 'On Normative Legal Acts of the Kyrgyz Republic' is to reduce activities of some ministries and to streamline ministries and departments. It will also establish a hierarchy of statutes.

Priority is being given to reducing the number of inspection bodies authorized to inspect business operations and to eliminate duplication of effort. This is being done through a new law 'On The Order of Conducting Inspections of Economic Entities.' The kinds of regulatory and legal issues that face businesses and which the government is still working on include: lack of legal authority for specific agencies to regulate; firms are not presumed to be exercising due diligence; ambiguities in the current law may be used against firms; and inspections are not objectively limited to whether or not firms are satisfying regulatory criteria.

Another issue is that following the break-up of the Soviet Union the new governments established laws quickly and chaotically. As a result, there is no uniform legal code. Laws may contradict, be confusing, or offer loopholes. The government is working to create a uniform legal system as well as one-stop windows to issue business related documents. Partly this is being done through the new law, 'On State Registration of Legal Entities, Affiliations, or Representative Offices of Legal Entities and Individual Entrepreneurs.'

Although similar problems exist with respect to foreign and domestic investment, liberal investment legislation has elevated the image of the Kyrgyz Republic compared to other transition countries. Among East European and Central Asian (ECA) economies it received a high index score of second out of 28 countries (World Bank, 2007b). Its 'world score' for protecting investors was thirty-third out of 175 country indices. But the flip side of investment is access to credit. Here the Kyrgyz Republic scored sixty-fifth out of 175 in a global comparison and seventeenth out of 27 in a regional (ECA) comparison.

Obstacles to investment are, ordered by how much they limit potential: (i) poor quality of tax administration; (ii) uncertain policies from the government; (iii) corruption and excessive tax rates; (v) high rates of interest and credit constraints; (vi) macroeconomic instability; (vii) trade restrictions; (viii) lack of protection by the law; (ix) low skill level among workers; and (x) poor quality conflict resolution due to judicial weaknesses.

The impact of public corruption upon economic development is part of the motivation for the Country Development Strategy. Corrupt practices hinder competition, expand the shadow economy, and ultimately make budget forecasting more difficult while raising the price that consumers in Kyrgyzstan must pay. When taxes and customs duties are avoided, this also hurts firms and citizens as funds for public goods are less than what it should be.

Political Reform

Lack of professional ethics and bribery in the civil service, particularly in hiring and promotion, degrade the professionalism of state employees. The result is a less efficient public administration and a state sector that is even more open to 'selling government services.' Corruption reaches the highest government ranks. This state capture by elites influences the development and execution of new laws. Because

corruption is partly a struggle between elites (who receive the largest corruption payments) and the masses, it is also a political problem. The second reason for discussing political reform is that revision of how the government is designed and how it operates can also be useful in controlling public corruption.

The political system in the Kyrgyz Republic shares power between the president, Parliament and the government. Improved vertical integration of the political system with clear delineation of functions and duties will make it easier to hold departments accountable, and to control corruption.

The development of multiple political parties can aid in the creation of a system of checks and balances, making them effective tools against corruption. The current electoral system, which does not allow for voting based on party lines, results in the election of deputies without political programs. In this environment, it is even more difficult to ensure that deputies live up to their campaign promises. This also makes it more difficult to elect officials who will actively reform the government.

In order to allow the private sector to operate more efficiently, without being subject to public corruption, less government is preferable to more government. As Thomas Jefferson remarked, 'The government is best which governs least ...' One method of reducing the burden upon business caused by public corruption is the deregulating and reorganizing the government's role in the economy. Actions of this nature in Kyrgyzstan are described in the next section of this chapter.

The Process of Deregulating the Economy

Economic deregulation is seen as the panacea for improving public corruption and aiding economic development. (The 'less is more' philosophy.) This may be symptomatic of the intense frustration that public corruption has created. Greg Mankiw's sixth economic principle, 'markets are usually a good way to organize economic activity,' works well in a developed economy where negative externalities, such as pollution, need to be regulated. However, in a country such as Kyrgyzstan, public officials' access to extortion must be limited. One philosophy is the Libertarian one: eliminate government interference from the economy and the economy will work much better. It remains to be seen whether this will be the best long-term strategy.

Governance reform

The primary objective for improving governance in Kyrgyzstan is to reduce the government's involvement in the economy and to improve quality of public goods. The secondary objective is to clearly separate duties of federal and local government organizations.

Organizations such as the UN Development Programme (UNDP) and Technical Aid to the Commonwealth of Independent States (TACIS) assisted Kyrgyzstan in

recent years to improve ministries and administrative bodies through reorganization. The first step was the functional analysis of all positions and departments already discussed. This process also attempted to eradicate clear conflicts of interest. The lack of an oversight process for government agencies makes it difficult to evaluate how well recommendations for revision of the government have been carried out. There also remains a lack of externally imposed criteria for how agencies monitor, regulate, and tax private enterprise and citizens.

Currently, public administrators are free to act subjectively on issues of monitoring, regulation, fines, etc. The country is still waiting for an overall policy reform on implementing standards for the above for all ministries. In any country, transparency and accountability are necessary in the public financial system. Kyrgyzstan has not yet undertaken policy reform of how its budget is created and how funds are dispersed for operating programs.

Modern technology may aid the country in improving governance. Creating electronically supplied government services creates transparency, establishes accountability by the trails of electronic documents, and reduces civil servants' direct and unmonitored access to citizens and firms. Kyrgyzstan is now planning automation of some government services. This goal is included in the CDS plan.

Civil society

Experience has shown the importance of a country's developing a civil society. Enhancing its development occurs through including public input in decision-making; freedom of the press; freedom of information Acts; parliamentary oversight; expanding political and NGO coalitions; and integrating local communities in actions that impact them. That is, broadening checks and balances and including stakeholders in the policy formation process. The process of creating a civil society is a political one. Elites who control the government and economy have little to gain by broadening access to government.

Strengthening the civil service

The law 'On Civil Service' qualifies the legal status of governmental employees and provides for the division of political and administrative posts. The law also stipulates necessary conditions for promotion based on merit and professional standards. This began only in 2004.

Also in 2004, the Kyrgyz Republic adopted a law requiring public officials, state employees, and their close relatives to disclose their income. This is to be able to identify corruption payments. (If someone's nominal salary is \$2 500 per year and she has an income of \$10 000 per year, questions may be raised.) Honesty and compliance are needed for this law to be effective. In 2006, 10 percent of civil servants failed to hand over their income declarations (**Agency for State Services of the Republic of Kyrgyzstan, 2006**).

State positions are standardized and employees are monitored through the Agency for Civil Service Affairs (also established in 2004). The existence of this agency helps to decrease nepotism and cronyism by creating hiring rules that are competitive. It also trains government employees to improve professionalism.

Despite such steps, the civil service of Kyrgyzstan is weak because it is underfunded, politicized, and still inherently corrupt. Time and time again, poor salaries are seen as incentives that increase public corruption. The average civil servant in 2007 has a salary equivalent to 50 US dollars, which is barely adequate for living costs. Despite the creation of laws and an agency to improve the civil service, meritocracy is still weak and employees have little job security.

Demonstrating the lack of meritocracy is a study by the Civil Service Agency that observed new hires in government from January to October 2005. Nearly two-thirds (62 percent) were hired through a non-competitive process. While state codes specify employee grades, these are often abused. Little or no punishment follows such actions.

Legal reform

Laws are unpredictably executed and there is no hierarchy for legislation. The legal system is confusing, hence ripe for corruption. Causes of problems with the judicial system are similar to problems with the civil service. Salaries are low, the appointment of judges is not based solely on merit, and courts are poorly financed.

The CDS program will review and analyze the judicial system similarly as it did government agencies – job descriptions will be created and an analysis of functions in the judicial system will occur. Department size will hopefully be optimized. The law ‘On the Status of Judges’ is being adopted. It will provide for oversight of judges as well as for the selection of new appointees. The courts will be removed from the jurisdiction of the Ministry of Justice and an independent judicial branch will be created.

Conclusion

Kyrgyzstan is a good example of a transition country undergoing reforms to curb corruption. It began the transition process as an example of de-collectivization, privatization, and embracing change. Such goals were easier formed than carried out and the process derailed. Today, Kyrgyzstan has the same types of problems with its public sector as most transition economies. Nothing in this story is completely unique to Kyrgyzstan – it is a commonly shared experience across Eastern Europe and the former Soviet Union.

Like many developing countries, the dialogue about corruption thus far is limited to corruption in the public sector. Within this limited view, much is being attempted to radically upgrade government services while controlling corruption.

Nevertheless, corruption is hard to control. Those who benefit are running the government that is trying to reform itself. The elites who run the country often times arrived in their current position of advantage by engaging in corrupt practices immediately after the breakup of the Soviet Union.

With the assistance of international agencies, enough impetus for change survives that Kyrgyzstan is slowly reforming its laws and institutions, even if there is a lag between adopting such changes and their full implementation. Much hope is being pinned upon the Country Development Strategy of 2010 (CDS). Within its framework, government is being reformed, division by division. However, one must always remember that in transition economies, change on paper is a far cry from actual change. The CDS is laying the groundwork, but social evolution is needed before substantive change is effectively enabled.

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Chapter 11

An Institutional Approach to Understanding Corruption in BRIC Countries

Qiang Yan

Introduction

BRIC countries (Brazil, Russia, India, and China) have attracted the interest of business professionals and development specialists because these countries have large, transitional economies with rapid growth rates and economic opportunities for potential investors and entrepreneurs. Corruption in the BRICs is a problem that affects business activities and returns on investment.

The main objectives of this chapter are to explore alternative models to explain corruption in BRIC countries, to examine the types of corruption that affect the BRICs the most, and to examine their anti-corruption programs. This chapter is composed of three parts. It begins by introducing the economic and political background of the BRICs and explains the reason why they attracted world attention. It then investigates existing theories that explore corruption, detailing their weakness and strengths. The end of the chapter uses institutional theory to study the origins, development, and effect of corruption in the BRICs. This section also investigates anti-corruption policies implemented by BRIC country governments and their effectiveness. This chapter takes an institutional approach in analyzing corruption.

In this chapter, 'corruption' mainly refers to public corruption, i.e., government officials who use their positions of power to appropriate public resources and accept bribes at the expense of the public's interest. In other words, bureaucrats illegally use public power to pursue their personal interests. Indeed, corruption includes actors such as officials and businessmen, but it also includes any activities that are intended to enlarge individual interests at the expense of public interests. One example of corruption is that businessmen, both domestic and foreign, sometimes increase their profits by bribing officials in exchange for preferable contracts or tax breaks. In this case, officials and businessmen are corrupt and the interactions between them are corruption.

This chapter addresses the issues of corruption in BRIC countries and estimates its depth. It seeks to answer how involved businesses are in public corruption and how corruption impacts free enterprise in these countries.

Economic Success Indicators for the BRICs

The BRICS are countries that have swept the world with economic optimism. 'If things go right, in less than 40 years, the BRICs economies together could be larger than the G6 in US dollar terms' (Wilson and Purushothaman, 2003). They are rich with natural resources and each country seems capable of producing high returns to either the individual investor or the corporate, foreign direct investment investor.

The growth of physical capital, machines, factories, vehicles, etc., is an important indicator for future growth – more real capital means more productive capability. Russia is at the continued disadvantage of still recovering from the collapse of the Soviet Union, when many assets were quickly sold off or misappropriated; during transition much physical capital was allowed to deteriorate without maintenance.

The Economist Intelligence Unit (EIU) predicts growing labor forces and declining unemployment levels for each of the BRICs.

Even if the growth rate in industrial production has declined, production is still growing positively. A declining growth rate means that the rapid 'boom' that was experienced is slowing. Simple growth rates for BRIC countries are positive and predictions are optimistic.

Table 11.1 BRIC growth indicators

Growth Indicator	Country	1990	1995	2000	2005
Estimated Annual Growth of Real (physical) Capital (%)	Brazil	NA	4.00	2.70	2.00
	China	7.40	14.20	11.50	12.40
	India	7.10	8.00	6.20	8.80
	Russia	33.20	-1.50	-2.00	1.90
Annual Growth of Industrial Production (definitions vary across countries)	Brazil	NA	1.82	6.55	3.43
	China	NA	NA	11.49	15.90
	India	11.03	11.98	6.04	7.91
	Russia	NA	-3.62	11.84	4.00
Stockmarket Index	Brazil	NA	4,299	15,259	33,456
	India	1,162	3,060	3,972	9,398
	Russia	NA	NA	4,113	32,398

Source: EIU Data Services <<http://www.eiu.com>>.

Table 11.2 GDP growth rates for BRIC countries

	1996	1997	1998	1999	2000
Brazil	40.6%	16.7%	12.3%	83.4%	51.5%
China	10.0%	9.3%	7.8%	7.6%	8.4%
India	2.7%	3.3%	0.1%	0.8%	4.4%
Russia	7.8%	4.8%	6.5%	6.1%	4.4%
	2001	2002	2003	2004	2005
Brazil	22.4%	21.1%	22.3%	28.7%	26.8%
China	8.3%	9.1%	10.0%	10.1%	10.2%
India	1.3%	1.9%	0.5%	4.9%	2.3%
Russia	5.8%	3.8%	8.5%	7.5%	8.4%

Source: IMF International Financial Statistics (2007).¹

Forecasts for BRIC growth rates by Goldman Sachs (Wilson and Purushothaman, 2003) are expected to be 4.2 percent for Brazil in 2005–2010; 7.2 percent for China – after 8 percent growth rates 2000–2005; 6.1 percent for India; and 4.8 percent for Russia. India has the most favorable growth rate forecasts, with rates of 5.2–6.1 through 2050 (Wilson and Purushothaman, 2003). Russia's growth rates are predicted to slow the most – to less than 2 percent by 2050.

Growth in stock market indices is a good sign of development of the financial sector, which is necessary for continued growth and indicates improving investor confidence in these economies.

Investment and outsourcing that benefit BRICs carry over into increasing wage predictions. This will raise incomes and consumption in the BRICs. The latter should result in greater direct investment in order to sell consumer goods in these countries.

The EIU (2007) predicts climbing average real wages for China, India, and Russia, with the greatest wage increases in China – data were unavailable for Brazil. This prediction may be partially due to China's rapid growth and trends in wage rates; it may also be due to the fact that leaders are making it more difficult to invest in manufacturing. China wants to create more value-added industries, rather than rely on low-cost manufacturing for development. Generally, rises in wage rates imply more unemployment. Growth in BRICs is so optimistic that unemployment is expected to decrease (EIU, 2007).

¹ Real growth rates used for China, Brazil, and India. Growth rate constructed from production-based GDP for Russia due to the unavailability of other GDP data.

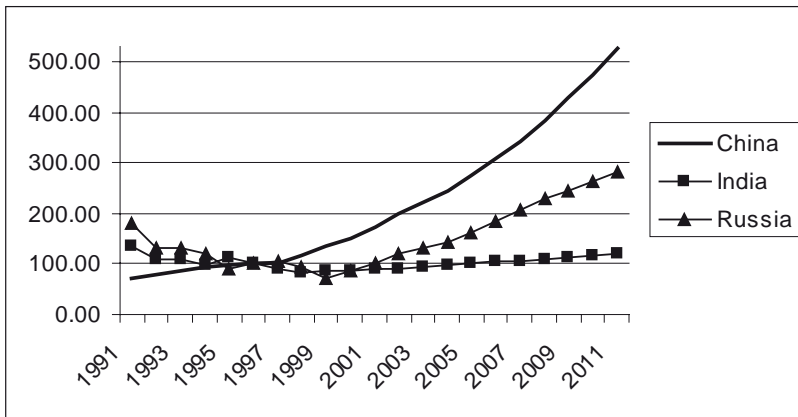


Figure 11.1 Wage predictions

Source: EIU Data Services < <http://www.eiu.com> > Brazilian forecasts were unavailable.

Growth and Corruption

Corruption and protectionism in BRICs threaten growth in Russia and Brazil the greatest (McClenahan, 2007). However, each BRIC country is challenged by corruption issues. According to the annual Bribe Payers Index (BPI) report published by Transparency International in 2006, the extent of business bribery of all the 30 major importing countries is high. Among those countries, Brazil ranks as the 23rd with Russia, China, and India each ranking 28th, 29th, and 30th respectively.

Related reports also show the severity of corruption in the four countries (See Table 11.3). In the Corruption Perceptions Index (CPI) produced annually by Transparency International (TI), surveys are created for countries based upon the way experts think these countries are performing with respect to corruption. In 10 years' time, only Brazil and China seem to be making even modest improvements. Russia and India have changed little.

Corruption is the source of many problems in the BRICs. Corruption decreases effectiveness and efficiency of public policies and elicits discontent from civilians; undermines social interests in that it obstructs the efficient redistribution and allocation of resources; and increases the transaction cost of social activities, especially business's cost. For instance, just as in many other countries, businessmen in BRICs would often find it very difficult to get official licenses if they do not bribe government officials. The transitional economy and social values in the BRICs also supplied opportunities to officials to commit corrupt crimes especially when the people increasingly accept corruption as an element of their daily life (Levine, 1997; Spiridonov, 2000; Yan, 2004; Wang, 2006).

Table 11.3 Ten years of corruption perception indices for BRIC countries

Year	Brazil	Russia	India	China
1996	3.0	2.6	2.6	2.4
1997	3.6	2.3	2.8	2.9
1998	4.0	2.4	2.9	3.5
1999	4.1	2.4	2.9	3.4
2000	3.9	2.1	2.8	3.1
2001	4.0	2.3	2.7	3.5
2002	4.0	2.7	2.7	3.5
2003	3.9	2.7	2.8	3.4
2004	3.9	2.8	2.8	3.4
2005	3.7	2.4	2.9	3.2

Source: The Transparency International. Global Corruption Reports 1997 to 2006.

Theoretical Models for Explaining Corruption

Public policy studies and some economic theories supply alternative explanations for both corruption and anti-corruption policies in the BRICs. Discussed here are the Rational Choice, Free Rider, Common Pool Resources, Transaction Cost, and the Exit and Voice Models. Each of these models is used by political scientists or economists to explain the origin or the process of corruption.

Rational Choice explanation

The Rational Choice Model assumes that a rational person acts on the basis of costs and benefits, meaning a person will pursue a goal when its expected benefits exceed its expected cost (Weimer and Vining, 1998). This model partly explains the development of corruption in any country with under-developed formal and informal institutions to prohibit corruption. Employing this model suggests that private and public officers are likely to be corrupt when the risk of being caught and censured is low and less likely to be corrupt when it is high, or when the penalty is raised or the benefit from a bribe is low.

China’s economic reform in 1979 facilitated corruption, according to the Rational Choice Model. The Chinese Communist Party (CCP) decreased its direct control of the economy, but party members still controlled most state agencies. They managed state firms without effective surveillance, allowing for rent-seeking

opportunities for officials. The possibility of being caught and censured was low for corrupt officials as there was no independent auditing and oversight system.

The main problem with this model is that each person has a different cost-benefit function. This subjectivity makes it difficult to use from a policymaking and analytical perspective.

Free Rider Model

Mancur Olson (1971) initiated the Free Rider Model by arguing that a group cannot achieve its collective goals without using coercive actions or selective incentives. Olson's argument also hints that the goals of individuals may contradict the goals of groups. This model can explain the difficulty in carrying out anti-corruption policies in many countries. Officials who are assigned by the government to discipline their corrupt peers may use oversight power as an opportunity for rent-seeking. Unfortunately, reducing corruption requires collective cooperation. If officials think anti-corruption policies as a collective goal cannot be attained unless other officials actively implement anti-corruption policies, they are less likely to conform to anti-corruption changes in law or norms.

Common Pool Resources Model

The Common Pool Resources framework demonstrates that every rational actor will extract as much as he or she can from a common pool of resources. (Ostrom, 1990) This core assumption underlying this model is that everyone is self-interested. He or she only cares about his or her personal interests without considering what is good for society. The second assumption of the model is that the supply of common resources or goods such as the pasture land, the river, and fresh air is limited and non-replenishing, so one person's consumption of resources decreases the stock available to others. This model depicts a zero-sum scenario.

This model is somewhat useful in explaining public corruption. Officials engage in corruption as self-interested agents who do not consider the public good. They will steal from the pool of public resources, especially when they think there is a low risk of being caught or punished. This model, however, is not useful in explaining the fact that in a corrupt environment, some individuals remain ethical.

Transaction Cost Model

Oliver Williamson (1985) and Janos Kornai (1992) advocate the Transaction Cost (or Soft Budget Constraint) Model. They argue that in state-owned enterprises (SOEs), decision-makers do not need to respect the profit margin, as profit-making is not the primary goal of SOEs or the criterion by which managers of SOEs are evaluated.

Williamson (1985) argues that transaction costs, referring to those costs that directly relate to human or organizational activities, are crucial in shaping economic relations. Rational individuals or organizations will have to consider probable transaction cost before they act in order to make their activities efficient. In a competitive firm, a primary goal is to minimize all transaction costs. In firms without hard budget constraints, such as in SOEs, minimizing transaction costs is not a primary goal. Kornai (1992) argues that in socialist countries there are soft budget constraints for SOEs, meaning there is no strict control to oversee investment plans in SOEs, which motivates SOE entrepreneurs to increase the economic scale of SOEs without considering much about economic efficiency.

Economic history of China and the Soviet Union supports Kornai's assertion. In China and in the former Soviet Union, where the government promoted projects on the basis of their contributions towards social development, transaction costs were not fully considered. Soft budget constraints yielded opportunities for officials to use public funds to pursue their personal interests.² While Kornai's model can explain why corruption is widespread in socialist countries, such as China or the Soviet Union, it does not explain how corruption arises in more market-based economies with limited SOEs.

Exit and Voice Model

Albert Hirschman (1970) proposes the Exit and Voice Model, arguing that the 'exit' and 'voice' of disgruntled clients serves as useful feedback to companies, forcing them to adjust their policies or risk losing clients to their rivals. That is, market competition is an enforcement mechanism for controlling all sorts of poor business practices, including engaging in corruption.

This model is useful in explaining why it is more difficult to control corruption in transitional economies. On the one hand, in such countries, the state still controls political institutions and an independent media or auditing system is lacking. This makes it more difficult for clients, or citizens in this case, to send feedback to the state agencies that control SOEs. When an economy undergoes privatization, on the other hand, government officials will not care about the exit and voice system. At the same time, as these countries begin to move from being centrally controlled economies to more free economies, new rents for governmental officials are made available.

The Exit and Voice Model is a good model to explain the way corruption increases in transitional economies that are gradually becoming more market-

2 China began to privatize in the early 1990s, which helped to solve some of the problems caused by soft budget constraints as privatized enterprise owners had to consider more about cost and benefit when making decisions. However, privatization in China also directly caused the loss of collective property rights as local leaders cheaply sold many SOEs to businessmen who offered bribes to those officials.

oriented, such as China and Russia. It is less useful for explaining why corruption is also prevalent in less controlled economies, such as India and Brazil.

One of the problems with the models above is that they are weak in explaining how corruption evolved in a society in the first place. A second weakness is that these theories are unable to satisfactorily explain differences across countries that share certain underlying conditions. These models are useful for understanding corruption, but they are less powerful than the Institutional Model. After a discussion of the Institutional Model of Corruption, this model will be applied to BRIC countries.

Institutional Model

Corruption and policies to combat corruption are both 'institutions.' North (1990) says institutions are the 'rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic.'

Institutions are classified into two subsets: informal and formal. Informal institutions are those norms and values which form organically in a society, but which may never be systematized into laws, rules, etc. Formal institutions refer to organizations, economic rules, and contracts (North, 1990). There exists an interactive mechanism between formal and informal institutions (North, 1990; Knight, 1993). Douglass North argues that formal institutions 'complement and increase the effectiveness of informal rules' by lowering transaction costs, while Jack Knight argues that 'informal conventions form the base on which a vast range of formal institutions organize and influence economic and political life.' They are closely interrelated, and while they are formed through a culture's experiences, they also shape societies.

Institutions affect human activities by defining what they can do or the way they interact with each other. Formal institutions define transaction costs as well as whether or not actions are acceptable. Informal institutions affect human behavior through the constraint of social values and norms. Ronald Coase (1960) argues that social actors must conform to the rule of institutions in order to make future interactions among them predictable. Violators are punished, through formal institutions such as laws or regulations, or they are marginalized or shunned through informal institutions. This reciprocal mechanism actually defines most actions of social members because others will react accordingly to what you have done to them or to the society.

Institutional theory supplies a comprehensive and dynamic framework with which to study corruption. First, institutions directly or indirectly define incentive systems (Becker, 1978). If a society is able to establish strong incentives against corruption, such as an effective monitoring and harsh penalty system, or if common values strongly oppose corruption, officials may not become corrupt. They will believe that the cost of corruption is prohibitively high. An effective system offers not only severe punishment but also social censure if caught.

Second, formal institutions, limit policy choices in response to corruption. If the state lacks formal rules, laws, or mechanisms for monitoring, such as independent auditing practices, anti-corruption policies are often ineffective (Manion, 2004). Informal institutions, such as religious and cultural attitudes, will affect not only the likelihood of an individual behaving unethically, but also the willingness of bureaucracies to earnestly carry out anti-corruption campaigns. If the culture of a society deems interpersonal loyalties to be more important than public obligations, policy enforcers may distort or ignore anti-corruption policies to protect friends or relatives under investigation.

Institutional Change and Anti-Corruption Battles in BRICs

Brazil

Corruption in Brazil has been hassling Brazilians for a long time. Before the 1950s, military generals and civilian officials were infamous for corruption but they would often accuse each other of corruption in order to defame their political rivals. In 1945, military leaders in Brazil launched a coup and evicted the President Getulio Vargas from power. This was done on the pretext of cleaning up the government. The Brazilian population temporarily accepted the change, as the military was perceived as being less corrupt than civilian leaders. The military government initiated projects intended to constrain the system of patronage, but immediately faced opposition from both urban and rural constituencies who thought the reform would undermine their local economy. Because the military government had to cater to patronage politicians for political support, anti-corruption policies therefore did not last long (Avritzer, 1999).

From 1951 to 1964, Brazil again staged democratic elections with military power involved in policy decisions. Although the Brazilian economy grew, corruption also developed during this period. In 1960, the new capital Brasilia was established to develop the interior area of Brazil. The high inflation and corruption helped military leaders to mobilize enough power to launch a coup to overthrow the elected president João Goulart in 1964 and established the military regime which would last for twenty-one years (Levine, 2003). In fact, the martial regime of Brazil better enabled officials to become corrupt, as Brazilians could not voice their opinions in a system where opposing parties and free press were prohibited and constitutional guarantees were suspended.

The end of military regime in 1985 in Brazil did not end public corruption. Democratically elected presidents, such as José Sarney, Fernando Collor, Itamar Franco, and Fernando Henrique Cardozo were caught between the need to suppress corruption and to launch economic reforms. In order to make economic reform more effective, local states had to get more autonomic power in dealing with local issues, but this in turn made it less likely for the federal government to oversee the behavior of local officials. If the federal government tried to centralize power,

it would also inhibit initiatives of local governments in developing economies (Avritzer, 1999). What also disturbed these leaders was that corruption remained irrespective of economic development or depression in Brazil and state intervention in the Brazilian economy only created opportunities for public officials to engage in corrupt practices (Skidmore, 1999).

Corruption in Brazil has increased since the 1990s due to rising economic inequality among different regions. Elected politicians, including the former President Fernando Collor de Mello, from the Northeastern area had strengthened the patronage system in the area to gain political support to compete with their political rivals from the developed South. Corruption was allowed as an effective means to facilitate economic development of the less developed area. Many leaders have thus been implicated in corruption scandals; a famous scandal implicated Collor de Mello (Skidmore, 1999; Goertzel, 2005). When the Workers Party (PT), which mainly won support from the South, came to power in 2002, it assured the people that the government would eliminate corruption. The PT also became mired in scandal in 2005 when confidants of President Lula were exposed for accepting bribes from business interests (Dellasoppa, 2005).

According to Geddes Barbara and Artur Ribeiro Neto (1999), corruption in modern Brazil commonly takes the following forms: overpricing, 'expediting payments,' 'facilitation contracts,' rigged public bidding for tenders, manipulating regulations, selling inside information, and unreported fund-raising. It is common for firms to bribe government officials to buy goods or services at over market prices. Officials may extract kickbacks when evaluating tender offers from contractors. Some government officials also leak inside information to businessmen in exchange for bribes. For instance, former Brazilian Central Bank head Chico Lopes was arrested for selling information on exchange rate and interest rate policies to bankers who paid him bribes before the local currency devaluation in 1999 (Davies, 2001).

In cases as bad as 'state capture,' officials may also willingly change or interpret regulations to create tax break or other fiscal advantages for firms, in exchange for bribes or political support. To attract preferential policies from the government towards their firms, especially at the local level, businessmen often contribute campaign funds (BBC, 2005).

The above examples of public corruption have institutional roots. Formal institutions affect the extent of corruption and effectiveness of anti-corruption policies in Brazil. Party systems, electoral arrangements, federalism, and presidential power are all important. For instance, the president of Brazil has the discretion to appoint 25 000 employees to well-paid jobs. This patronage system enables the president to award jobs for favors (Geddes and Neto, 1999; Osava, 2006). Some senior officials enjoy similar privileges, as they can offer jobs, preferential contracts, and access to public resources.

The federalist political system of Brazil distributes power to regional and local governments, particularly for making economic and social policy. This offers local officials opportunities for public corruption (Geddes and Neto, 1999). Businessmen

solicit tax breaks and lax inspections by maintaining good relationships with local bureaucrats, who often use their positions to extort bribes. In the federalist political system, national leaders may have to tolerate corruption among local politicians or bureaucrats, because the local leaders can significantly affect the result of future elections of national leaders. In addition, national policies also need earnest support from local governments to make them effectively implemented. The political federalism and the increasing power of the local interests thus indirectly affected the making or implementation of anti-corruption policies at the national level, which in turn made corruption difficult to be controlled throughout Brazil.

The proportional legislative system over-represents underdeveloped areas in Congress, especially the north. The poor economy in the north fosters 'pork barrel' politics, which means politicians design favorable policies to constituencies which helped them win the election. In northern Brazil, voters mainly vote for those who can directly better their daily lives regardless of values.

Federalism in Brazil led to fiscal decentralization in the 1990s as a result of the related regulations in the Constitution of 1988. Fiscal decentralization gave states more discretion in managing financial agencies or SOEs. The decentralization facilitated activities that could function outside of the Central Bank's supervision, especially when local budget constraints were soft (Alston et al., 2004).

The decentralized party system in Brazil also made it less likely for national party leaders to be able to discipline unethical party members, because local party leaders have autonomous power to resist the oversight from above. The shifting partisan alignment, which means the people can easily change their partisan support, also fosters corruption because it transforms political activities into short-term transactions among politicians (Dellasoppa, 2005).

Jeto, which means to establish good relations with the government or bureaucracy in exchange of personal favors, is an important informal institution in Brazilian society that facilitates corruption (Levine, 1997). *Jeto* is not necessarily illegal and it does not necessarily cause corruption, but it consolidates the ability that public officials have to use their discretion at will. Due to *jeto*, the occupation of *despachante* has flourished. A *despachante* is a professional facilitator who has good personal relations with government officials and can help businessmen cut through red tape and acquire licenses quickly (Levine, 1997).

Moreover, many Brazilians are quite lax about corruption as the history of corruption in modern Brazil has eroded their belief that the state could control corruption at all (Zimmermann, 2005). Cynicism in government anti-corruption policies also makes it less likely for Brazil to curb corruption in the near future.

Russia

Corruption in Russia began in the Soviet system. During the Soviet Era, the shortage economy encouraged informal market exchanges to satisfy shortages created from centralized planning and inefficiency. Among other things, this enabled public officials to seek bribes in exchange for goods that were in short supply or

permission from the government that was needed to do most everything, such as to move to another apartment or change a job position. Furthermore, corruption in the Soviet Union had internal checks in place through internal police. Soviet leaders, however, tolerated corrupt subordinates in order to mobilize loyalty from these officials (Spiridonov, 2000). Since the 1980s, when the communist party began to stage political and economic reform in the Soviet Union, Soviet officials felt their insecurity in the political domain. These officials had to increasingly 'rely on informal mechanisms and political reciprocity,' which helped them build a patronage system to circumvent the cumbersome process of Soviet bureaucracies (Karklins, 2005). These officials thus could efficiently pursue their personal interests in the given institution by mutually assisting each other. The clientelism established among Soviet officials created a system allowing cooperative cover-ups of unethical acts. (Karklins, 2005: 80–2). This mutual 'cover up' among officials stabilized working conditions, but it also undermined the effort of the central government to curb corruption.

When the Soviet Union collapsed, corruption in Russia developed so quickly that 'bribes have become almost obligatory' (Myers, 2005). Moreover, former government officials or party leaders used their power and social capital to appropriate public funds and immediately turned themselves into the new capital holders, the 'oligarchs.' Corruption has become one element of Russia's problem of 'poor governance and weak legal enforcement' which hinders Russia's rapid development (Roaf, 2000).

In the 1990s, the Russian government attempted shock therapy and rapid privatization to initiate the new market economy. This mostly failed. Living standards deteriorated while privatization supplied opportunities for elites to enrich themselves at the expense of the common Soviet citizen. Public corruption developed when ideological and institutional constraints disappeared. Government officials and former SOE managers appropriated fixed capital and public funds, thereby turning themselves into the new owners of capital and of privatized enterprises (Fang, 2006). This process was exacerbated by issues of state capture – the new business class had power to influence the redesigning of government in ways that were favorable to their interests.

Institutions affect the evolution of corruption and anti-corruption policies in Russia. After the late 1990s, the declining power of Putin's rivals weakened checks on corruption. However, during Yeltsin's era, when multiple parties were active, corruption was also rampant among government officials (Kneen, 2000). Political parties used anti-corruption as a political strategy for attacking rivals (Zhang, 2004). Accusations of corruption abounded, but no changes occurred. In this regard, the political vacuum that emerged after the collapse of the USSR exacerbated corruption.

Russian federalism undermined the effective implementation of national anti-corruption policies. In order to appease pro-secessionist sentiments in some republics, the Russian central government had to appear to be meticulous in investigating corruption scandals of leaders in these republics, but political

considerations overwhelmed the desire to curb corruption when anti-corruption polices were dubbed by local leaders as political suppression from the central Russian government. In addition, some departments in the government lack sufficient funds to properly run their operations. Rather than consolidate these departments to save money, the government allows them to be self-funded, which encourages the solicitation of rent-seeking behavior (Vadiem, 2002).

The legal and constitutional vacuum left after the collapse of the USSR weakened the authority and power of the central government to effectively check corruption. Yeltsin seemed to aim at corrupt individuals rather than to design policies to address the roots of corruption. In April 1992, Yeltsin issued Presidential Decree № 361. This required civil servants to declare their income. The Russian media accused Yeltsin of focusing on the ‘small fish’ rather than on higher-ranking officials (Virginie, 2002). Putin took a similar path during his first term, but was reluctant to remove corrupt political supporters from office.

Until November 2002, there was no official anti-corruption law in Russia. The State Duma (legislative house) had tried unsuccessfully to enact anti-corruption laws. Only through the determination of President Putin was the Anti-corruption Committee established in 2004 (Zhang, 2004). This agency was charged with policy making and oversight, although it was placed directly under the Office of the President rather than made independent.

Domestic politics, such as presidential elections, affect anti-corruption policies in Russia. On May 10, 2005, President Putin dismissed seventeen senior officials simultaneously for their convicted corruption. Putin also demanded disciplinary action for highly corrupt departments, such as customs and the Investigation Bureau in 2006 (Feng, 2006). These actions allegedly occurred to help Putin amass support for his party, United Russia, instead of curing the widespread corruption in Russia.

The Russian language and culture has its own form of *jeto – blat*. Doing something *po blatu*, ‘by means of blat,’ means that one uses informal arrangements, personal contacts, or black market contacts, for example, to accomplish the goal. Russian also has a similar occupation as that of *despachante* in Brazil. This is the *tolkach*, a ‘fixer person.’ In the post-Soviet period, the *blat* still greatly shapes people’s actions (Spiridonov, 2000). The norm *blat* hinders the eradication of corrupt bureaucrats, because it is these corrupt people who can ‘get the job done.’ Businessmen who establish personal relations with government officials, or who use fixers to accomplish the same goal, will easily acquire useful resources or information (Lovell, 2000).

The development of corruption in Russia and the weak anti-corruption policies by the Russian government had significantly contributed to the people’s apathy to (or tolerance of) corruption, which in turn fosters further corruption (Jemberga, 2003). One author observed that in Russia a lot of people perceive corruption not as a crime or immoral issue, but as ‘everyday business’ which helps them deal with slow bureaucratic processes successfully (Myers, 2005).

India

Informal and formal institutions are useful also to explain corruption in India. Cultural norms originate from many sources, one of which is historical events that shape a culture.

When Mahatma Gandhi fought for an independent India, he was also fighting for a new and pure government. The spirit of *Brahmacharya* – purity – does not have room in it for self-interest, which is required for either public or private corruption to occur. India's first Prime Minister, Jawaharlal Nehru, tried to control corruption by stressing the importance of 'official morality' and the building of some formal institutions (Gurharpal, 1997).

Following independence, self-ruling India began establishing formal institutions to combat corruption. India enacted the Prevention of Corruption Act (POCA) in 1947. The Administrative Vigilance Division (AVD) was created in 1955 (Gurharpal, 1997). The agencies of the Central Bureau of Investigation (CBI) and the Central Vigilance Committee³ (CVC) were established in 1963 and 1964 respectively, to ensure honesty and lack of corruption. The CVC website's rhetoric takes a strong anti-corruption tone: 'to provide a foolproof and corruption free system...' (CVC, 1998). Despite four decades of a CBI and CVC, India still battles corruption.

In the early 1950s, the Congress Party and Nehru saw corruption as the national enemy and strove to cleanse corruption from the government (Gurharpal, 1997). However, Indian culture and politics were clientelistic or based upon patronage and a centralized political system was an inefficient tool for investigating officials' wrongdoings (Toye, 1981).

Politics also intervened. Nehru and the government found it necessary to loosen control of local leaders to help the Congress Party win in general elections from 1948 to 1967 (Gurharpal, 1997). Nehru empowered the Congress Party to investigate and punish corrupt officials. The problem was there was no independent agency to oversee the activities of the Congress Party which could also abuse its power.

In the early 1960s, graft and rent-seeking were built into the system of political and economic management which undermined the Congress Party's goal of building clean government. For instance, in the 1940s, political parties had to report their income and fundraising openly, but in the 1960s, the lesser restrictions on political contributions led to the practice of parties' 'fundraising without official disclosure,' which supplied leeway for party leaders' corruption (Vittal, 2001). Another fundamental problem of implementing anti-corruption policies during this period was that the Constitution of India began to stipulate that police activities were under the jurisdiction power of local states. Federal agencies could

3 Today the CVC advises on legislation; reports and issues data; takes complaints; disciplines; sets guidelines for tenders; and regulates the banking sector, insurance sector, and public enterprises for fraud-prevention and anti-corruption.

not operate in states without permission from state governments. State and local patronage systems could thus strongly hinder the implementation of national anti-corruption goals.

After Indira and Rajiv Gandhi came into power in 1966 and 1984, respectively, they used the Congress Party as a tool for gaining the obedience of officials and to obtain contributions from representatives of trade and industry. They loosened corruption controls in exchange for political support (Gurharpal, 1997; Upadhyay, 2001). They removed local party leaders who did not fall in line from official positions. Rather than serving their constituency, wise local party leaders, who wished to maintain their position, met the demands of Indira and Rajiv Gandhi.

Moreover, political struggles among local leaders eroded authority of the legislative and judicial branches in dealing with corruption. Just as happened in Russia, anti-corruption policies in India in the 1960s became tools for combating political rivals.

The direct result of such institutional arrangements was that corruption in India developed and the Congress Party lost its general election in 1977 (Gurharpal, 1997). In 1989 the media exposed the Bofors Scandal and the Congress Party lost for a second time. In this case, senior officials from the Indian Defense Department asked the Swedish company, Swedish Weaponry, to bribe them in order to win the purchase bid from the Indian government. During these years when corruption flourished, most Indians began to think of corruption as part of daily life. Complacency toward corruption made anti-corruption policies even more difficult to be implemented (Quah, 2003).

Since the 1980s, the increasing power of poor people has fostered corruption. In a multi-party system, Indian political parties sought to form alliances. Government officials and party leaders catered to the demands of the poor, and in some cases deemed corruption for the poor as affirmative action in India (Wade, 1982).

To attract investment, India strengthened its anti-corruption policies beginning in the middle 1990s. The Indian government consolidated the power of agencies like the Central Vigilance Committee (CVC) and the Central Bureau of Investigation (CBI) by diminishing interventions from political leaders or parties (Vittal, 2001). Local branches of these organizations were responsible to their regional headquarters rather than to the central government.

The Indian government encouraged an active media to expose public corruption. In March 2001, ZeeNews broadcast Bangaru Laxman, Chairman of the People's Party (BJP) and also a senior official in the Defense Department, demanding bribes from a company named Tehelka (Yuan, 2006). This resulted in the resignation of officials, including George Fernandes, Minister of the Defense Department.

In 2003, India passed the Lokpal Act, which was first initiated in 1969. The Act was mainly aimed to oversee and punish corruption of senior officials but due to strong opposition the Act could not be passed until 2003 when the Indian central government finally made great effort to assist the enactment of it (Wang, 2006). To protect whistle-blowers, India also passed the Public Interest Disclosure and Protection of Informers Bill (2002), and enacted the Right of Information Act

(2005) (Zhang, 2006). Moreover, the Indian government lowered the threshold to enter the market and encourages competition among private enterprises; it simplified bureaucratic procedures, making it harder for bureaucrats to ask for bribes (Wang, 2006).

Indian's new policies are intended to curb corruption, but some institutional impediments make it difficult to curb corruption in the short term. India bases its anti-corruption policies on several assumptions (Quah, 2003):

- Top leaders are assumed not to be corrupt and above temptation to engage in corruption.
- Managers of government departments will carry out anti-corruption policies.
- Proceedings against corrupt officials will result in rapid and appropriate penalties.

Despite these assumptions, the masses do not believe that their top leaders can maintain their integrity during economic liberalization. One poll shows that more than 80 percent of Indians believed their ministers are severely corrupt (Sarre, 2005). This view is not improved by the recent case of the indictment of former Prime Minister Rao, who was convicted of corruption and sentenced to three years in jail (Gurharpal, 1997).

Low wages handicap anti-corruption efforts. Incomes are insufficient for home-ownership or quality education for one's children, but rent-seeking bonuses can cover this deficit. The weak inter-department transferability of bureaucrats also undermines the power of governmental agencies to oversee corruption, because the real implementation of anti-corruption policies will ruin working surroundings of bureaucrats. Bureaucrats do not want to oversee what their peers are doing in order to retain their personal networks in their working units. Bureaucratic red tape also increases demand for facilitation payments, or speed money. This issue of governance worsens public corruption.

China

Economic, political, and cultural institutions influence corruption in China. When speaking about corruption, the Chinese phrase '*guan xi*' usually comes up. The root of this two character word is 'relationship.' Like *jeto* and *blat*, it suggests a relationship where one prevails upon another to offer a favor or service. It is commonly used today to suggest a bribe. This system is enforced through one's personal reputation. Failing to return a favor will incur dishonor.

Even during Mao's governance (1949–76) – embodied by stoicism and the spirit of sacrifice – some forms of corruption, although not widespread, existed as officials and their relatives could easily get themselves scarce resources such as tobacco, liquor, and pork (Liu, 2005). As in the former Soviet Union, shortages motivated the development of an underground economy and bribery in China.

Guan xi during Mao’s leadership meant that those who had good relations with bureaucrats in some cases would be more likely to get decent jobs or access to limited resources.

Despite widespread *guan xi* in Chinese society, Mao and the Chinese Communist Party (CCP) still effectively inhibited the development of large-scale corruption in China before the 1980s. The CCP regarded corrupt officials as political enemies. Not only convicted officials but also their families would be punished by the law, which increased the cost of corruption.

In the post-Mao China, corruption developed. Table 11.4 shows the development of corruption in China in recent years. The number of convicted officials for corruption in 2003 was 18,515; at least 400 of them earned severe sentences of 10+ years (Supreme Court of China, 2005). Of all these 18,515 convicted officials for corruption, 93 had held been province leaders. The CCP stated concern in this report for the increase in corruption among senior officials and urged the creation of a legal structure for resolving this problem (Supreme Court of China, 2005).

Corruption undermines the legitimacy of the party and the government by transferring power out of state control. Corruption also gives the population a justified reason for criticizing the government. The CCP recognizes that corruption hinders development as well as polarizes the society. According to former party leader Jiang Zemin, ‘if we cannot stop corruption, then the CCP will die’ (Jiang, 2003). Therefore, the CCP and the Chinese government still want to control corruption.

China’s anti-corruption policies fall into either (i) disciplinary rules established by the CCP or (ii) laws and regulations. Disciplinary rules are based upon Party doctrine and ethics. The emphasis of these rules is self-discipline. The rhetoric of the Party is that leaders are made of ‘the right stuff’ and are unlikely to be tempted

Table 11.4 Public corruption convictions, 1998–2004

Year	Convicted Officials	Convicted Senior Officials
1998	35,084	1,820
1999	38,382	2,201
2000	45,113	2,680
2001	54,367	2,670
2002	51,077	4,291
2003	18,515	2,728
2004	37,001	2,915

Source: Supreme Court of China (2005).

to deviate from prescribed norms of behavior. Due to this unrealistic assumption, party disciplinary rules are weak in suppressing corruption in China.

The National People's Congress (NPC) is the main agency to design and issue laws and regulations. The CCP strongly exerts its political will on law making by deciding the constitution and operation of the NPC (Yabuki and Harner, 1999).

The Chinese Penal Code, which embodies the political will of the Chinese Communist Party, defines corruption as a felony. Those convicted officials who appropriate public funds or accept bribes exceeding 100 000 Renminbi (\$12 500) will be sentenced to more than ten years in prison. When officials embezzle or accept bribes of \$62 500, capital punishment is the maximum sentence (Supreme Court of China, 1998).

Periodically the CCP may also stage anti-corruption movements (Manion, 2004). Such anti-corruption campaigns generally resulted from formal institutions' inefficiency in controlling party members and officials. One problem with such practices is that the periods of increasing monitoring and penalty can be easily predicted by potential perpetrators, which therefore decreasing the real effectiveness of such campaigns.

The last ten years have seen a decline in the effectiveness of state anti-corruption campaigns, an increase in convicted officials, and an increase in the monetary value of corruption cases (Wedeman, 2004). The TI survey partly supports this argument (Table 11.3). The CPI has improved from 2.9 in 1996 to 3.2 in 2005, although the perception of corruption was better in 2000–2001 than it was in 2005. Table 11.4 also indicates that while corruption may have declined from its 2002 peak, it has greatly increased from its 1998 level, if convictions of public officials serve as a reliable corruption indicator.

As in other countries with corruption problems, anti-corruption campaigns may serve political interests, rather than being honest efforts to curb public corruption. The mayor of Shanghai was detained in 2006 for appropriating public funds, but it was suspected that this was the result of a political falling-out between national leader Hu Jintao and the 'Shanghai Clique,' a political rival group associated with former leader Jiang Zemin (Kahn, 2006). The Chinese government convicted more corrupt officials in 2000 than in 2002. This was because in 2000 the then Chinese leader Jiang Zemin had to build a good reputation for himself and his followers as the advocates of a clean government in order to help his election victory. In 2002, however, when power struggles in the central Politburo had almost settled, there was no urgency to punish corrupt officials to win some credit. We could also find from the figure that senior officials were rarely convicted because they had strong personal networks or *guan xi* with top leaders to protect them from being accused or convicted.

Former Chinese leader Deng Xiaoping made the argument that 'those who can catch mice are good cats; no matter if they are white or black.' The idea is that it is the economic achievement that is important, not the details. The emphasis is upon the end, not the means, and the weakening of Marxism and Maoism post-1979 has greatly impacted Chinese behavior. Today, many do not care if public corruption is

unethical or illegal. Economic development has made corruption payments more necessary.

Because the CCP is *the* institution in China, public corruption poses a particularly difficult problem. 'Fight corruption too little and destroy the country; fight it too much and destroy the party' (Chen Yun, in Manion, 2004). China's long history, much of which was feudal, still affects the mentality of many Chinese. Nepotism is part of its traditional culture; the party acknowledges that it cannot eradicate it completely at this time. The CCP is recognizing that the legal system, as a tool for fighting corruption, is weak. However, Chinese communism has enjoyed the success it has because it pursues a gradual path to change. While controlling public corruption may be a long-term goal, it is a goal for which strategic objectives must be carefully and slowly laid out. To some degree, China's institutional weakness in battling corruption is the Party's choice.

Conclusion

The rapid development of the BRICs and the large scale of their transitional economies have attracted the notice of the world. Corruption, which affects future development of these countries, develops quickly with these countries' economic growth. The economic growth supplies material resources for corruption while the transitional society may indirectly tolerate or even encourage corruption. In other words, in the BRICs, social and economic changes have increased opportunities and incentives for corruption.

While businessmen may benefit from the availability of public corruption, they may also be victimized when business transactions become more uncertain and costly. Bribery will also intensify the further development of corruption. People distrust their governments when they see their failure in controlling corruption. People may extend their disbelief to other areas of public policy.

Each of the BRICs has made and continues to make efforts to curb corruption, while informal and formal institutions in these four transitional economies greatly impact the effectiveness of their anti-corruption policies. All the countries have designed laws and agencies to solve the problem of corruption and some even staged campaigns to attack corruption. All four countries have also signed the United Nations Convention against Corruption (UNCAC) after 2003 in order to further institutionalize their anti-corruption policies.

The task of anti-corruption institutions, however, is still difficult in the near future as formal and informal institutions in these countries strongly affect the interactive mode of corruption and anti-corruption. During rapid economic change, old institutions are outgrown and new ones are still underdeveloped. This process both shapes and is shaped by values and the dominant belief system in the society, which further constrains the real effectiveness of anti-corruption policies (Shleifer and Vishny, 1993). In addition, because of weak organizations or inefficient policy implementation, anti-corruption policies do not achieve their purposes.

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Chapter 12

Private-Sector Incentives for Fighting International Corruption¹

Ethan S. Burger and Mary Holland

Introduction

This chapter focuses on the private sector's potential role in fighting international bribery. It is unrealistic to expect that national or multinational criminal prosecutions alone will effectively deter most corrupt actors so that the consequences of possible detection outweigh the benefits of corrupt behavior (Baker, 2005). The private sector is poised to take a more active role in creating meaningful deterrents against international bribery.

This chapter has four areas of discussion. First, we explore the role of international bribery in sustaining corrupt regimes and undermining the rule of law in the bribe-payer and bribe-recipient states. Although corruption exists in both the public and private sectors, this chapter focuses on the payment of bribes to government officials and political leaders, principally within the context of public tenders. Non-governmental actors who may play important roles in combating international bribery are examined. We briefly examine private corporations, multilateral development banks (MDBs), and non-governmental organizations (NGOs). Case description of successful private claims in the United States against corrupt competitors, and the legal basis for such claims in Germany, are discussed. Lastly, we conclude that the private sector's role in fighting corruption is likely to increase.

Background

Corruption exists in all countries, and its deleterious impact is clear: '[C]orruption distorts markets and competition, breeds cynicism among citizens, undermines the rule of law, damages government legitimacy, and corrodes the integrity of the private sector. It is also a major barrier to international development – systemic

¹ This chapter is an adaptation of work published by Burger and Holland (2006), 'Why the Private Sector is Likely to Lead the Next Stage in the Global Fight Against Corruption', *Fordham International Law Journal* 30: 45. They have rewritten this work with the permission of the *Fordham International Law Journal* for this book.

misappropriation by plutocratic governments harms the poor' (Heineman and Heimann, 2006). The World Bank estimates the global cost of corruption at one trillion dollars per year (World Bank 2006a). When examining such assertions, one should keep in mind that corrupt individuals do not report their actions, nor is there universal agreement on what constitutes corruption. In theory, corruption may be measured by the amount of the bribe paid or favor rendered. In practice, however, it is far more important to focus on the negative consequences of the corrupt act to states, organizations and individuals.

Raymond Baker, Daniel Kaufmann, Joseph Stilts, Martin Wolf and others have observed that there is often a relationship between high levels of corruption and lack of development. In a sense, it is not mere coincidence that the Council of Europe (COE) and OECD are the first international organizations to aggressively address the issue of international bribery with serious consequences for the wrongdoers. This is because these invitation-only organizations accept only member states that take international treaty obligations and rule of law obligations seriously. For example, the OECD requires each member to demonstrate 'its attachment to the basic values shared by all OECD members: an open market economy, democratic pluralism and respect for human rights' (OECD, 'Becoming a Member' website). OECD countries have elected governments that are responsive to their citizens.

By contrast, most of the world's countries do not have representative or responsive governments. One measure of this lack of governmental accountability is Freedom House's survey on Freedom in the World. Its list of the UN's 192 members classifies the vast majority of countries as 'Not Free' or 'Partially Free.' In many of these countries, static elites dominate the governments and do not concern themselves with the well-being of their citizens. Because many of these governments have economies based on the export of raw materials, they do not rely on their residents' income taxes. In a fundamental sense, in many countries where bribery is rife, there is no social contract between the ruling elite and the ruled. Bribes to members of these governmental elites, often de facto subsidized by international and foreign organizations, play a role in perpetuating this corrupt system.

Despite anti-corruption norms and global attention, however, corruption thrives; and globalization has created vast new opportunities for it. While global norms have set valuable benchmarks to prohibit bribery, there has been relatively little prosecution for bribery of foreign officials in any country. This is what we call the 'impunity gap' with respect to international corrupt practices. The potential financial rewards for bribes are great, while the likelihood of detection, investigation, and prosecution remains remote. Furthermore, even if the payment of a bribe is punished, the severity of the punishment may be insufficient to have a deterrent effect. Government law enforcement will always have competing priorities, whether combating terrorism, the drug trade, organized crime, or other domestic objectives; and governments are not unitary actors. They are typically divided into ministries or agencies that sometimes have inconsistent priorities.

In addition, there can be divergences among national, regional, and local governments.

Many government officials in developed countries seemingly take an attitude of 'benign neglect' towards major national corporations and campaign donors that pay foreign bribes. Mass corruption could not exist without the collusion of legitimate accountants, banks, lawyers, and government officials (Baker, 2005; Naim, 2005; Burger, 2006). Many governments lack the political will to effectively fight corruption, in part since the governments, their corporations, and citizens benefit from the present system. It is thus quite understandable that governments would have achieved enormously more progress on paper than in actual enforcement.

Scholars and specialists have expended a great deal of effort in defining corruption and examining international bribery within particular countries. Consequently, it should not be surprising that developing effective policies to combat corruption is a complex and culturally nuanced task. In some countries where civil servants cannot live on their salaries, petty corruption is essential in making the governmental system operate (Henning, 1981).

As discussed in Chapter 1, there are significant differences among states in both their official and day-to-day attitudes concerning what constitutes corruption or unlawful conduct. For example, in some countries, civil servants are permitted to accept gifts from the public, treating such 'gifts' as a component of their legal income.² These differences, however, have not impeded the development of multiple, overlapping anti-corruption legal norms. The existence of corruption in the form of large bribes or the undue use of influence to achieve particular results in 'high stake' matters can undermine the establishment of the rule of law (Sampford et al, 2006).

The difficulty in reaching agreement on what constitutes corruption made it exceedingly difficult for member states negotiating the United Nations Convention Against Corruption (UNCAC) to reach agreement on how to define the very term. Public corruption is globally prohibited, at least at the level of rhetoric and legal norms. The United Nations and the OECD have adopted conventions requiring members to enact laws prohibiting bribery and extortion. International organizations, including the Council of Europe, the Organization of American States, and the World Trade Organization have enacted additional conventions and have sought to increase public awareness of corruption and its consequences. Almost all nations have laws against corruption (Henning, 1981). Development banks and corporations have adopted internal codes of conduct and ethical guidelines.

2 Under the Russian Federation Civil Code, the giving of a 'gift' to a state or municipal official having a value of less than five times the minimum monthly wage (the equivalent of about \$150) is not considered a crime. See *Grazhdanskii Kodeks [GK] [Civil Code]* art. 575.

Non-governmental watchdog groups, such as Transparency International, monitor and report on corruption worldwide. Combating corruption is not a simple task; it cannot be resolved by adopting legislation alone. Corruption will never be entirely eradicated; its extent can be reduced, however, by multilayered policies. Generally, commentators focus on four main approaches to limiting corruption: (1) prevention; (2) enforcement; (3) state building; and (4) instilling cultural values that will reinforce prevention, enforcement, and state building (Heineman and Heimann, 2006).

While international bribes are a subset of ‘corruption,’ they represent a transnational issue that nations, international organizations, and corporate entities must address together beyond the borders of their home countries. This chapter analyzes the environment in which bribes are paid in connection with international business involving natural resources (Nick, 2005), infrastructure contracts (for example, power plants or highways), and other major purchases of services or equipment, such as weapon systems or bulk medical equipment. Since many developing countries do not have well-established laws or legal cultures for transparency and accountability, it is often difficult to determine if the State receives a fair share of the revenues or if governmental officials or private intermediaries are skimming funds. The trend in anticorruption conventions to enlarge the role for private parties to bring civil damage claims against corrupt actors is encouraging.

The legal framework for combating international bribery is based upon the US Foreign Corrupt Practices Act; the OECD Convention; the Council of Europe’s Criminal Law and Civil Law Conventions on Corruption; and the United Nations Convention Against Corruption.

The Role of Non-Governmental Actors in Curbing Corruption

Existing anti-bribery statutes and norms provide the basis for civil damage lawsuits. Private corporations that do not engage in bribery have the greatest incentives to see that their bids succeed on their merits. In addition, international organizations and MDBs have incentives to ensure that corrupt actors do not misappropriate their donor nations’ funds. NGOs monitor and advocate in the anticorruption effort. These non-state actors are likely to be increasingly important in enforcement.

Private legal entities

The private sector has recognized the need to undertake their own initiatives, for example, the Caux Business Roundtable, the Extractive Industries Transparency Initiative (EITI), and the drafting of the banking industry’s Wolfsberg Principles. Nonetheless, while some individuals and corporations act with the best of intentions, self-regulatory organizations seldom enforce strict penalties for non-compliance and often act primarily for public-relations purposes. And with respect to large

organizations there is often a divergence between declaratory policy and action. While senior management may promote global citizenship out of conviction and recognition of the consequences of illegal conduct, some employees may defy corporate policy for corrupt gain. The degree to which corporations promote the international whistleblower's hotline, Trace Inc., may prove to be a critical litmus test of how serious corporate management is in eliminating bribery of foreign officials. Unlike organizations that merely study corruption or engage in 'anti-corruption' training, Trace may provide a vehicle for a proactive policy.

Corporations that have strict policies against paying bribes or engaging in other forms of corruption have the greatest stake that large-scale international tenders be conducted without bribes. Such corporations are the principal beneficiaries of a system where winners are determined on the merits. It is these corporations that must seek civil damages when corrupt competitors harm their corporate interests (Zacharias, 2004). As countries more fully implement their obligations under the conventions, private companies are likely to be able to defend their interests more aggressively through civil lawsuits. This is particularly the case where there has been a change in the ruling government in which the corrupt activity occurred. Where the stakes are high enough, a private multinational corporation may make a decision to pursue legal action where a state prosecutor would not. Furthermore, although the legislation in some jurisdictions may preclude certain claims under the OECD Convention, such as unfair competition, antitrust, or anti-monopoly legislation, other corruption-related claims may be viable.

Conceivably some companies that lost business as a result of a competitor's bribe would not bring lawsuits (Tarullo, 2004). Perhaps potential plaintiffs have paid bribes themselves, are reluctant to take legal actions that might affect their future business opportunities in the country, or would face insurmountable difficulties in gathering evidence (Koch, 2005). While these concerns are significant, companies have incentives to sue and in fact are doing so.

Private actors are increasingly likely to sue corrupt competitors for a number of reasons. First, some government officials and employees of the tender winner leave their positions. These individuals may provide evidence or testimony, and their risks of doing so are less once they are no longer employed by the government or bribe-paying company. Second, some corporations may be willing to 'write-off' doing business in one country if they have sufficient business opportunities in other countries. In other words, they do not fear 'closing the door' on a particular country by revealing corrupt officials in that country through a lawsuit. This is particularly true of small and medium-sized companies that are incapable of accomplishing numerous projects simultaneously. They may bid on numerous tenders with the expectation of winning only a small percentage of them. For some such companies, seeking damages through a legal process arising from bribery might be quite profitable. Third, in the past, the only remedy against corrupt competitors would have to be in the country where the corruption took place and where the domestic government and courts are unlikely to overturn a tender outcome. The winning bidder's country was not likely to prosecute the case

for both legitimate and illegitimate reasons (Ouzounov, 2004). Today there are litigation options outside the country where the bribe took place.

Multilateral development banks

Multilateral development banks (MDBs) are in a position to play a key role in the fight against certain forms of corruption. They provide funds and technical assistance to the public sector and civil society to increase monitoring systems for public contracts and allocate funding through tenders held pursuant to formal procedures. Such procedures are usually better structured than domestic legislation and are more likely to achieve higher transparency and to facilitate fair evaluation of competitive bids. MDBs finance some of the largest global development projects. These banks include the Asian Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, and the World Bank (and its component parts). Increasingly, MDBs have focused on the problem of corruption, rule of law, and their impact on development. MDBs are concerned about compliance by third parties in projects they finance and anticorruption efforts within the banks themselves.

The World Bank has identified corruption as among the greatest obstacles to economic and social development. It undermines development by distorting the rule of law and weakening the institutional foundation on which economic growth depends. The harmful effects of corruption are especially severe on the poor, who are hardest hit by economic decline, are most reliant on public services, and are least capable of paying the extra costs associated with bribery, fraud, and the misappropriation of economic privileges. Corruption sabotages policies and programs that aim to reduce poverty, so attacking corruption is critical to the achievement of the bank's overarching mission of poverty reduction. The World Bank believes that an effective anticorruption strategy has five key elements: (1) political accountability; (2) civil society; (3) a competitive private sector; (4) institutional restraints on power; and (5) public sector management (World Bank, 'Anti-Corruption' website). Since 1996, the World Bank has supported more than 600 anticorruption programs and governance initiatives developed by member countries (World Bank, 'Anti-Corruption'). Despite these programs and declaratory policy, corruption problems persist at the World Bank itself (Chanda, 2004).

Despite these persistent problems at the World Bank, there are reasons to believe that MDBs will become increasingly important in combating corruption. First, MDBs do not necessarily have the same interests as the governments to which they make loans. MDBs and donor countries to MDBs have incentives to see that projects are awarded solely on the merits. And since large project financing deals are completed over many years, the institutional personnel will not remain the same throughout the relevant time frame. This turnover of personnel creates opportunities for whistleblowers. Second, the fact that MDB staffs are multinational provides a margin of protection against corruption. Given the

staff's multiple loyalties to home countries, national companies, and to the MDB, collusion among staff with particular recipient government officials or contractors for corrupt purposes is less likely than in more homogeneous environments.³

Non-governmental organizations

Non-governmental organizations (NGOs) are the principal entities that critique the government monitoring process under the OECD Convention (Bunn, 2004). NGO monitoring work provides extremely valuable background information for potential civil damage claims. NGOs provide information on country conditions and anonymous assessments of the level of corruption in particular environments. They are also able to assist whistleblowers and private corporations in the fight against corruption. Transparency International, probably the leading anti-corruption NGO, not only provides neutral information on perceptions of corruption in individual countries, but also monitors compliance with the OECD Convention. It is stating clearly that government enforcement practices are insufficient. Its work, and that of other NGOs, is invaluable in creating greater awareness of the depth and breadth of corruption.

The development of a plaintiff's bar

The plaintiff's bar is a legal institution making it possible for civil cases to be made on behalf of those alleging mistreatment or harm. The plaintiff's bar consists of attorneys who represent plaintiffs. Generally, lawyers are not permitted to fund litigation, thus the clients must pay all out-of-pocket expenses (court fees, litigation, etc.). These lawyers may be paid on an hourly basis, but many only handle contingency cases; that is, they earn their fees by winning cases.

The authors are not aware that a plaintiff's bar yet exists for bringing civil claims for bribery, but its development seems desirable and likely. Private actions against corrupt competitors in international commerce are likely to increase as the world's economy becomes ever more integrated and as anticorruption norms become more accepted. An aggressive plaintiff's bar could help deter international bribery by raising the costs of corrupt acts. If corporate actors contemplating bribery faced a credible threat of civil litigation, with its concomitant costs of bad publicity, management distraction, legal fees, and possible adverse judgment, they might think twice. A specialized plaintiff's bar would have expertise in the domestic law claims that have been most effective in winning damages and in whistleblower protection laws. Lawyers in the anti-corruption area would likely

3 Some observers of MDBs note that the MDB role in international financing is decreasing. Private banks increasingly encroach on projects that MDBs have traditionally financed in recent years. Because private sector institutions are often more entrepreneurial than inter-governmental institutions, there is reason to believe that MDBs may play a decreasing role in large international projects in the future.

have close working relationships with investigatory firms, given the extremely difficult nature of establishing causation in these cases. These lawyers would probably work on a contingency basis and be outside the major law firms that represent large corporate clients that would be potential defendants.

In situations where there are a number of losing bidders in an international tender, it might be possible for all the losing bidders to assert that they all have the right to sue the corrupt actor until such point that it is proven that a particular plaintiff had no possibility of winning the tender. This strategy would permit plaintiffs to share the costs of bringing such cases. Aggregating plaintiffs in this way is not implausible. According to the *Financial Times*, British Petroleum recently fired over 200 employees for wrongdoing, including bribery (Boxell and Harvey, 2005). One can only guess whether, but for the actions of such employees, other companies would have won certain international tender offers.

Civil Lawsuits Against Bribes Paid to Foreign Officials

The right of civil action provides a useful complement to criminal proceedings as a deterrent. US courts have recognized the legitimacy of these claims. These cases show that corporate victims of international corruption can and will sue to remedy their damages. Outlined below are several lawsuits in US courts for civil damages as a result of international bribes. Claimants have brought cases against US competitors who allegedly paid bribes in foreign transactions. It is striking that even without direct legislative support, such as a private right of action under the Foreign Corrupt Practices Act (FCPA) of the United States, plaintiffs have brought viable civil damage claims. Surely not all have been able to prove causation, that 'but for' the corrupt act, they would have won the international contract at issue. These cases, however, demonstrate the kinds of cases that are likely to become more common, resulting from changing anticorruption norms and practices.

Environmental Tectonics v. W.S. Kirkpatrick, Inc.

Environmental Tectonics Corporation, International (ETC), a Pennsylvania corporation, was a competitor against Kirkpatrick, a New Jersey corporation, for a major construction contract on a Nigerian air force base. Environmental Tectonics, the plaintiff, lost the bid but learned that a New Jersey corporation had paid bribes to Nigerian government officials and won the tender. Plaintiff brought defendant's corrupt acts to the attention of the US and Nigerian governments. The DOJ prosecuted Kirkpatrick and its chief executive officer under the FCPA; both pleaded guilty. Based on that judgment, the plaintiff sought damages under a variety of federal and state laws and the defendants moved to dismiss, claiming the Act of State doctrine in defense. The Court of Appeals for the Third Circuit wrote:

The nature of the acts alleged and the number of victims are ... important considerations in this analysis. ETC claims to have suffered direct economic injury from the appellees' scheme. By illegally influencing the decisions of appellees' public officials, however, appellees have also created an even larger class of victims, the citizens of Nigeria. Moreover, because bribery of foreign officials by American businessmen diminishes this nation's stature and influence abroad, conduct of the kind here alleged victimizes the citizens of this nation as well (Kirkpatrick, W.S. & Co. v. Environmental Tectonics Corp, 1990).

The Supreme Court accepted the case and unanimously affirmed the Third Circuit's decision that the defendants' Act of State defense had no merit because no foreign sovereign act was at issue (Kirkpatrick, W.S. & Co. v. Environmental Tectonics Corp, 1990). ETC had stated viable claims for damages against a corrupt competitor that had paid bribes abroad.

Dooley v. United Technologies Corp.

An employee of Sikorsky Aircraft, a subsidiary of United Technologies Corp. (UTC), filed an action against his employer alleging that UTC was engaged in a bribery scheme in which UTC bribed Saudi Arabian officials to win contracts for the sale of its helicopters to the Saudi Arabian government (Dooley v. United Technologies Corp, 1992). The employee alleged that the conspiracy developed through tacit agreements between high-level UTC executives and the Saudi Arabian Ambassador to the United States, Prince Bandar bin Sultan.⁴ The district court found no lack of jurisdiction over any of the corporate or individual defendants, although several were foreign entities and individuals. The plaintiff alleged violations of the Racketeer Influenced and Corrupt Organizations Act or RICO (2000), and supplemental state law claims (Dooley v. United Technologies Corp, 1992).

Rotec Industries, Inc. v. Mitsubishi Corp.

Rotec Industries, an Illinois corporation that manufactures concrete equipment, sued Mitsubishi and C.S. Johnson, a US corporation, for damages that resulted from alleged corrupt actions in an international competition in China to build the Three Gorges Dam on the Yangtze River (Rotec Industries, Inc. v. Mitsubishi Corporation, 2003). Rotec alleged that defendants had bribed certain members

4 According to the Financial Times Prince Bandar bin Sultan, the former Saudi ambassador to Washington and subsequently national security adviser to King Abdullah, allegedly received more than £1 billion from BAE Enterprises in another bribery scandal (Fidler, 2007). Both Prince Bandar and BAE deny any wrongdoing (Peele, 2007a). Indeed, Great Britain's Serious Fraud Office may reopen its investigation about the BAE-Saudi connection, Prime Minister Tony Blair cancelled the investigation (Peele, 2007b).

of the Bid Evaluation Committee and that for that reason alone, Rotec had lost the construction competition. Rotec alleged violations of federal antitrust and racketeering laws and of the Oregon tort law prohibiting intentional interference with economic relations. The US Court of Appeals for the Ninth Circuit affirmed the district court's analysis that the tort claim was a valid cause of action, but that the plaintiff had failed to allege facts that could prove that defendants' acts had caused it economic harm. The Ninth Circuit, in evaluating defendants' summary judgment motion, assumed that bribes were given, but concluded that 'too many inferences need to be drawn to establish a connection between that improper conduct and Rotec's ultimate failure to secure the two contracts won by the defendants.' Although Rotec did not prevail, its claims as a victim of international corruption were recognized as valid under state tort law.

Korea Supply Co. v. Lockheed Martin Corp.

In *Korea Supply Company v. Lockheed Martin*, the Republic of Korea solicited bids for certain military equipment (Korea Supply Co., 2003). Korea Supply Company (KSC) represented the Canadian company MacDonald Detwiler and Associates Ltd. (Serafini, 2004), KSC acted as MacDonald's agent in the bidding and negotiation process, and Loral, a California-based subsidiary of Lockheed Martin Corp., was the other party submitting a bid. Under its contract, if MacDonald had the winning bid, KSC would receive a \$30 million commission (Korea Supply Co. v. Lockheed Martin Corp., 2003). The Korean government declared Loral to be the winning bidder, even though MacDonald's bid was \$50 million lower and its equipment was superior. The Korean Ministry of Defense justified its decision to choose Loral by asserting that the US government was less likely to share intelligence information with Korea if the contract was awarded to a Canadian company. Whether true or not, the Korean Defense Intelligence Command's project management office conceded that the MacDonald equipment was less expensive than Loral's and was also technologically superior.

KSC filed suit in California, alleging that Loral had violated California's unfair competition law and the tort of interference with prospective economic advantage. KSC alleged that Loral paid \$10 million to an intermediary, Ms Kim, to arrange that persons working for the Korean Ministry of Defense would receive bribes and sexual favors (Korea Supply Co. v. Lockheed Martin Corp., 2003). Not surprisingly, the situation grew into a major public scandal. KSC alleged in its complaint that '[i]n securing the contract by wrongful means, Loral acted with full knowledge of the commission relationship between [KSC] and [MacDonald] and knowing that its interference with the award of the contract would cause [KSC] severe loss' (Korea Supply Co. v. Lockheed Martin Corp., 2003). Furthermore, KSC contended that Lockheed Martin was the beneficiary of the illegal Loral-Kim

conduct and had been unjustly enriched.⁵ The California Supreme Court's decision ultimately turned on the particular language of the California unfair competition statute that precluded KSC from obtaining damages when it did not have an ownership interest. It also rejected a restitution claim because KSC's claim could only be brought against the Korean Government, not Loral.

Nonetheless, the California Supreme Court did find that KSC was entitled to damages based on the common law claim of intentional interference with prospective economic advantage.⁶ After examining the facts and tort law, the court noted the importance of the FCPA to the present case. KSC clearly satisfied the FCPA's independent wrongfulness requirement. KSC was able to assemble the necessary evidence, perhaps through private investigators, reporters, or tips from Korean government officials or Loral employees and then proceeded to seek a legal remedy. The KSC case was possible because it could prove that its client had made the superior bid and California courts had jurisdiction. There was no doubt that, but for the illegal conduct, MacDonald would have won the tender.

German Civil Code provisions

German law provides a private right of action for parties injured by bribe-paying corporations. In its formal submission to the OECD, Germany stated that German law does not provide for specific civil sanctions against persons who paid bribes to foreign public officials. However, Germany pointed to Section 826 of the German Civil Code, which provides for damages where a person intentionally injures another in a way that breaches public morals. It stated that Section 826 does apply to intentional bribery of a foreign public official (OECD, '*Germany, Review*' document). Germany's interpretation of the OECD Convention goes beyond the US FCPA. It allows plaintiffs to sue for damages when they have been injured by bribery of foreign officials. Further, Germany's submission to the OECD clarifies that the investigation and prosecution of bribery of a foreign public official 'shall not be influenced by consideration of national economic interests, the potential effect upon relations with another state or the identity of the natural or legal person involved' (OECD, '*Germany, Review*' document). In other words, the government undertakes to treat such bribery in a criminal context, not a diplomatic one. Germany's private right of action against corrupt practices

5 KSC originally asserted three causes of action: (1) conspiracy to interfere with prospective advantage, (2) intentional interference of KSC's relationship with MacDonald Detwiler and Associates Ltd., and (3) unfair competition under California state law.

6 The court stated: [The] elements are usually stated as follows: (1) an economic relationship between the plaintiff and some third party, with the probability of future economic benefit to the plaintiff; (2) the defendant's knowledge of the relationship; (3) intentional acts on the part of the defendant designed to disrupt the relationship; (4) actual disruption of the relationship; and (5) economic harm to the plaintiff proximately caused by the acts of the defendant (Ibid).

is important in itself and as a model for other national civil law legislation within the OECD. Germany's private right of action against bribery of foreign officials is likely to lead to such a right of action in other OECD and COE nations, as required under the COE Civil Law Convention on Corruption and the OECD Convention (Lieske, 2007).

Conclusion

Generally governments are reluctant to prosecute their own companies for paying bribes; governments look out for the interests of their constituents. The recent example of the United Kingdom's Serious Fraud Unit's initial willingness to follow then Prime Minister Tony Blair's advice to drop its BAE Enterprises investigation because of Britain's foreign relations with Saudi Arabia comes to mind. Governments inevitably weigh a full range of foreign policy interests when deciding whether to prosecute the payment of bribes to foreign government officials.

Private-sector actors do not have the political constraints that governments do. If a company loses a tender due to corrupt acts, it has a significant incentive to investigate. It will undertake a cost-benefit analysis to decide whether to pursue litigation, evaluating the likelihood that it will prevail at trial, the level of damages it might win and the many costs of litigation. Our contention is that the international conventions creating civil rights of action mean that corporations will increasingly decide to sue corrupt actors in the international arena. MDBs and corporations should start to bring more civil actions when they have suffered from the corrupt acts of others. Monitoring bodies should start to devote more attention to civil law enforcement. Attorneys in private practice should start to consider this as a promising field. There is an opportunity for corporations to begin to police their own in the next stage in the global fight against corruption.

Chapter 13

Conclusion

Sharon Eicher

Corruption is a complicated behavior to define. It is rather like trying to define 'crime.' One recognizes that it is an illicit and unethical or immoral behavior, but this does not help to specifically state what is, and what is not, crime. We use laws to help us. Similarly, we understand the extreme cases of corruption to be 'corrupt,' but this is a concept with nuances that are culturally specific. Part of the struggle to combat corruption is to agree upon its definition. In this respect, perhaps the UNCAC adopted the best strategy. Rather than agreeing, or failing to agree, on a definition for corruption, representatives who signed the agreement, agreed upon specific actions not to be permitted and rights to be protected with respect to corruption in their countries.

This book has differentiated between public-sector corruption and private-sector corruption and has included both in the discussion about corruption. Both are unethical practices; both involve the misplacement and misuse of trust, thereby creating harm to one of the parties involved. Variations in how corruption is defined and categorized are explored in Chapter 1, and specific examples of public corruption and corporate corruption are explored in Chapters 2 and 3. We see that this is a difficult process that requires more dialogue.

The implications from corruption are vast. In a world where resources for public services and goods are never sufficient, corruption is wasting valuable public resources. In markets where faith in management of public corporations is necessary for investors and lenders to make sound financial decisions, corruption is eroding wealth and negatively impacting public faith in corporate management. In lieu of this trust, further legislation such as Sarbanes-Oxley has been created. Legislation serves where trust is lacking (Putnam, 2000).

Corruption is held responsible for diverting funds from international aid organizations designated for much needed development projects, such as roads, hospitals, and schools. Corruption is responsible for diverting funds from revenues from publicly owned natural resources which are extracted in exchange for fees meant for all of the nation's population, not just those who can corner these funds into their own private accounts. Corruption naturally attracts the worst professionals that a profession has to offer as those who are greedy and self-serving seek corruption rents, rather than to serve and improve society. Corruption wastes valuable resources that international aid organizations have available and make donor nations hesitant to continue their donations. Corruption involves companies that may prefer to operate honestly and embroils them in unethical and difficult

situations. Corruption may force many talented and gifted potential leaders, from both public and private spheres, into other professions. As a global society, the outcome for all of us is a less optimal world than is possible, should we succeed in curbing corruption.

Most of the countries in the world are perceived as being quite corrupt. Sixty-three percent of the countries in the world receive perception ratings of 2.00–3.99. (Figure 13.1) Only one-fifth of the world's countries are in the top half of the CPI rating system.

As one cannot directly evaluate corruption, indices such as perceptions of corruption are useful ways to approximate actual corruption levels within a country. If proxies, such as the Corruption Perception Index, are good proxies for actual corruption, most countries are highly corrupt.

We see a wide variety of methods employed for approximating corruption, producing a wide variety of reports to gauge corruption, as seen in Table AII.1 of Appendix II. These sample methods most often use a survey method of those experts with substantial experience in the region or country. Indices presented in Chapter 5 are either formed directly in this manner or are formed from other indices, so they are indirectly created from survey methods. This is the method used for forming Transparency International's Corruption Perceptions Index, the 2006 results of which are illustrated in Appendix II, Tables AII.2 and AII.3.

Some of these published indicators specialize in a particular region, such as Southeast Asia or transition economies. Others attempt to gauge every country for

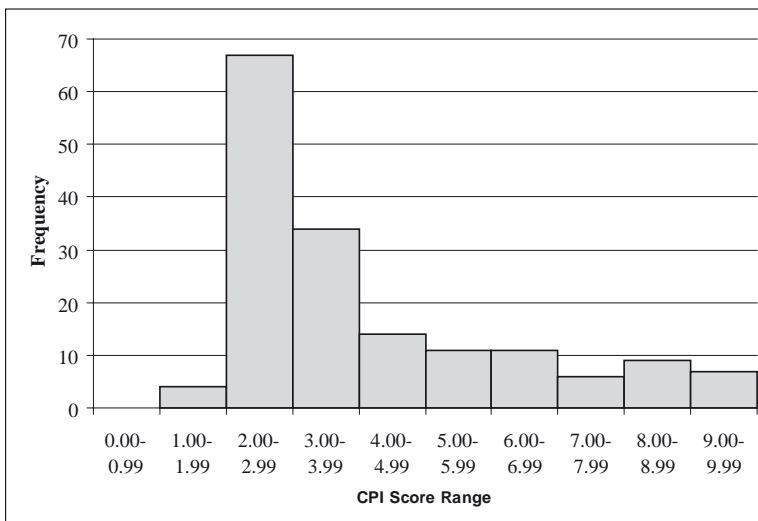


Figure 13.1 Frequency of corruption perception indices, all countries, 2006

Source: Transparency International data.

which data are available, such as the Economist Intelligence Unit and Transparency International.

Such methods do a good job in trying to quantify a concept that is essentially qualitative. What these indicators cannot do is to compare accurately across nations and time since each region has a different group of respondents and surveys naturally change over time.

Despite statistical issues that impair the reliability of these indicators, which is discussed in detail in Chapter 6, these indicators serve invaluable functions. These are used by the countries themselves as a type of score card. (How are we doing compared to the rest of the world?) Whether or not it is an accurate comparison to make, policy-makers in countries do make such comparisons. These are used by governmental, developmental, and NGO organizations to allocate their resources, which may take the form of funding, technical assistance, or merely attention. Hence, these indicators carry political and economic ramifications. Corporations making direct investment decisions or investors making financial decisions use these indicators to ascertain risk. A broad audience pays attention to the statistics discussed in Chapters 5 and 6.

These various indicators are closely correlated, as seen in Table 5.4. This could be a comfort – we are consistent in how we represent corruption – or this could be a concern – we may have statistical problems with endogeneity, discussed in Chapter 6. Chapters 5 and 6 explain how many of these indicators are created and what their respective problems or limitations may be. These are important chapters for the student of corruption as it is necessary to understand a tool's weaknesses, in order to know how best to use it. One should be hesitant at simply applying indicators across time or across countries, without considering their statistical and compositional flaws. This does not make the indicators unusable, but it should make the user aware of certain limitations in their use.

We observe a strong crossover in research and inferences made between corruption and governance. Nearly all work on corruption looks to political, legal, and economic institutions and resulting corruption levels. It is not possible to separate corruption and culture, as a nation's political, legal, and economic institutions are deeply rooted in a people's culture. For this reason, many seek to explain corruption by looking at cultural factors. Everyone seeks to control corruption through deepening institutional frameworks as well as changing the corruption-tolerant mores within the culture.

This is one way that foreign direct investors can facilitate anti-corruption campaigns. Foreign investors bring new methods of management, new ways of recording and reporting finances, new ways of hiring and promotion, and so on. These same methods which dominate most corporate cultures do so because they are efficient and they work well for large groups. They rely upon transparency and good information and communication. Merely through multinational firms' interaction in foreign cultures where business culture may be underdeveloped, these operational methods gradually become more familiar. It is not that they are necessarily better, but they are more market-oriented than corrupt methods are

and more based upon meritocracy, which corrupt systems are not. Globalization, occurring partly through foreign investment and with working with companies located abroad, facilitates the education process that should help to lesson corrupt practices.

Representatives of foreign firms who work with citizens of corrupt cultures are placed in a naturally awkward position. On the one hand, corruption payments may be expected of them or their company. Doing business without 'greasing the wheels of commerce' through 'facilitation payments,' special 'fees,' 'trucking fees,' additional 'port charges,' 'after sales service fees,' and other 'surcharges' may be difficult. It may isolate the lone ethical firm from its competitors, which may translate into lost business and higher costs of doing business. One reason that the FCPA and other national laws to abide by the OECD Convention or UNCAC may not be followed is that working in a corrupt society and not being corrupt has a financial cost. It is, however, the legal, as well as ethical, solution for decreasing corruption levels in the long run.

It is this dilemma that makes industry collaboration such as seen by the EITI Initiative and the UK Defence Industry Anti-Corruption Forum so valuable. If firms representing the majority of market share in a region's industry cooperate, collectively they may accomplish what they cannot do singly. Such actions are relatively new. Time is needed to evaluate their effectiveness, but participation by industry organizations seems quite positive. Generally, individuals, be they persons or firms, seem better able to effect change than organizations such as NGOs or governments. It is when these NGOs or governments inspire the individuals to take action that they are successful. Fundamental change requires the complicity of the grassroots actors. Action by firms, if sincere, and not done for publicity purposes, may be the best way yet to dampen corruption.

Organizations such as Publish What you Pay (PWYP), which call upon foreign companies to publicly make available information that governments are hesitant to do, are similar. These efforts try to report what revenues are flowing into a state's coffers, or *should* be flowing in, if it were not being diverted by corrupt public and private officials. Another is BRIBELine that allows firms to anonymously report corrupt behavior. TRACE supports this reporting system in order to collect better information about corruption payments. In this case, information is power, because corruption exists only so long as it can be disguised as some form of legitimate transaction or can be camouflaged altogether. We may find that such grassroots activities by the private sector are more successful than laws and attempts at institutional change in combating corruption. At the very least, such actions support these legal and institutional changes.

Chapters 7, 10, and 11 demonstrate aspects of corruption within countries or categories of emerging economies.

Koichumanov, in Chapter 10, discusses the actual policy changes and struggles with creating an anti-corruption program in Kyrgyzstan. The former Soviet Republic of Kyrgyzstan did not need to exercise autonomy before the breakup of the Soviet Union, and when this breakup occurred, the new country was left

with no institutional framework, as the country quickly attempted to undergo shock therapy and adopt western systems. This process turned out to be much more complicated than many anticipated, and Kyrgyzstan is still working on these reforms, including its anti-corruption reforms. Ranked in the 11th percentile out of 100 in the 2007 Corruption Perception Index, Kyrgyzstan has far to go.

China, though corrupt, has a completely different corruption climate and is ranked in the 57th percentile. In Chapter 7 Ostrov presents an unusual, but realistic story of corruption in China, by focusing upon the industry and politics of the quasi-state enterprise of soccer leagues and competition. It is often the everyday stories about corruption that demonstrate best the conditions that many people live in, rather than the dramatic stories involving millions or billions of pounds, euros, and dollars.

In Chapter 11 Yan compares the BRIC countries of Brazil, Russia, India, and China, exploring how corruption occurs and how it is facilitated by policies in each of these countries. He further develops the concept of weak or unenforced institutions as responsible for corruption. Yan presents various institutional and alternative viewpoints for viewing governance and corruption. Rapid economic growth and underdeveloped states is a perfect combination for fostering corruption. Opportunities abound as money flows in, while accountability systems are weak.

These three chapters represent case studies of countries and how corruption manifests itself within these societies. Another type of case study is Chapter 8 by Kobonbaev and Eicher. This chapter looks at extractive industries and specifically at oil. Fees, taxes, and royalties from natural resource extraction and export are often the only significant source of revenue for many less-developed, resource-plentiful countries. Poverty, weak institutions, and a large inflow of money create ripe opportunities for corruption by both public and private parties. This case study demonstrates the hardships encountered when trying to reform corruption in states with an industry such as the petroleum industry.

This work ends with the work of Burger and Holland in Chapter 12, who show us how the legal system is being used to combat corruption. This serves as a useful lesson to the international business practitioner who may be tempted to cross the ethical line 'just once'.¹ Despite low levels of enforcement, the laws do exist and people are prosecuted and sentenced to fines, jail time, and may be barred from engaging in their profession when their sentences are served.

This chapter also illustrates the cooperation between legal systems, government administrations, and NGOs fighting corruption. The authors highlight the initiatives and seminal legal cases involved in corruption, particularly with respect to the United States and the FCPA.

A complete reading of these chapters, which cover different aspects of corruption, different industries, and geographical areas, is that corruption is

1 It only takes once to be caught and convicted. Business ethics authors generally emphasize that crossing ethical boundaries 'just a little bit' is a slippery slope, as one's moral compass is readjusted each time. As a result, one's perspective becomes skewed.

somewhat universal in both its existence and in how it occurs. In each case, responsible parties are charged to protect the welfare of others and they fail in that charge.

How do we as a society defend ourselves against such actions? We create monitoring systems, systems of accounting and financial reporting; we require transparent disclosure² to insure that people have the information that they need. Unfortunately, this may require additional bureaucratic procedures, but open account books, which are reviewed, are the best way to prevent corrupt acts and to catch them after they have occurred.

When information is not transparently disclosed, as it usually is not in the case of corruption, there are two possible solutions: put up with a situation that is essentially exploitative to the corrupt individual's 'constituents' or employ counter-measures. Sometimes these actions are to publicize how funds are transferred, such as Svensson demonstrated in Uganda and the EITI Initiative companies are demonstrating in resource-rich countries. This may happen through mechanisms created to support the Publish What You Pay initiative, which is just being created. Newspaper and media publication may in some cases put people in positions of risk, but the Internet is a somewhat anonymous source where such information may be collected and disseminated.

Governments and NGOs have been working since the 1970s to control corruption through legislation. Laws are invaluable, but they are only one piece of the puzzle. Firstly, people have to cooperate with the laws. Laws must be supported by governments with monitoring and enforcement and punishment systems. Most countries have been lax in doing this. The laws, however, create the formal institutional attitudes concerning corruption. Informal changes must accompany legal change for laws to be effective.

This points to cultural and social changes. Rule of law, in and of itself, is a component of culture. Corruption is weakened when non-egalitarian systems of political and economic power are weakened. Corruption reinforces income inequality as the poor become poorer and the rich become richer, not only through the receipt of corruption payments that may sum up to millions of dollars in personal income, but also through the diversion of funds meant to be transfers of wealth through the creation of public goods. The poor are denied the schools, clinics, road, etc. they are due from budgetary allocations, *as well as* the good governance that they were promised.

Systems of meritocracy are at odds with systems of nepotism. Systems of special economic and business favors are at odds with market competition. This is not to say that the institutions of Western cultures are inherently better than those of other societies, but these institutions do eliminate some corruption. However, even in highly developed and prosperous countries, where no one needs to practice

2 Gitlow (2005) demonstrates how disclosure is not always transparent. Important information may be put into the public realm, but done in such a way that it is virtually unobserved. Both transparency, i.e., visibility, and disclosure are needed.

corruption to feeds one's family, for example, corruption is rife. All one needs to do to emphasize this point is to begin searching the Internet for corruption terms or cases and to begin exploring the multitude of cases that arose in recent years (as demonstrated in Table 2.1).

Corruption is a function of opportunity, motive, and institutions too weak to prevent and catch violators of formally or informally accepted norms and dominant values. This occurs in developed countries as well as in developing countries. All countries need to 'clean house', and there is much work for all to do. This is true of policy-makers and government officials, corporate executives, foreign office company representatives, and each of us who is called upon sometime in our life to make difficult ethical choices, some of which may fall into the category of 'corruption.'

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Appendix I

Table AI.1 Defining ‘corruption’

Source	Party involved	Action prohibited
Centre for Democracy and Governance	Public officials	Abuses by government officials such as embezzlement and nepotism, bribery, extortion, influence peddling, fraud
Convention against Transnational Organized Crime, Article 8	Public officials	Solicitation or acceptance of an undue advantage resulting from acting or refraining from activity according to one’s official duties
Law Library’s Lexicon	Official	Act inconsistent with one’s official duty and rights of others
National Integrity Promotion Campaign-Namibia	Persons with power	Misuse of public power for personal gain
Oxford English Dictionary	An individual	To induce to act dishonestly or unfaithfully’ to pervert the text of the law, etc.
Transparency International	Officials in the public sector	Misuse of public power, bribery, extortion or influence peddling
UN Manual on Anti-Corruption Policy	Public officials	Abuse of public power for private gain that hampers the public interest
Webster’s Unabridged Dictionary	Individuals, particularly public official	Dishonest practices, acting on mercenary motives without regard to honor
World Bank	Public and private officials	Enriching oneself through misuse of one’s position

Source: Anticorruption Website <http://www.anticorruption.info/corr_def_alt.htm>.

Table AI.2 Signatories and ratifiers of the UNCAC

Country	Signature	Ratification acceptance (A), approval (AA), accession (a), succession (d)
Afghanistan	20-Feb-04	
Albania	18-Dec-03	25-May-06
Algeria	9-Dec-03	25-Aug-04
Angola	10-Dec-03	29-Aug-06
Antigua and Barbuda		21-Jun-06 (a)
Argentina	10-Dec-03	28-Aug-06
Armenia	19-May-05	8-Mar-07
Australia	9-Dec-03	7-Dec-05
Austria	10-Dec-03	11-Jan-06
Azerbaijan	27-Feb-04	1-Nov-05
Bahrain	8-Feb-05	
Bangladesh		27-Feb-07 (a)
Barbados	10-Dec-03	
Belarus	28-Apr-04	17-Feb-05
Belgium	10-Dec-03	
Benin	10-Dec-03	14-Oct-04
Bhutan	15-Sep-05	
Bolivia	9-Dec-03	5-Dec-05
Bosnia and Herzegovina	16-Sep-05	26-Oct-06
Brazil	9-Dec-03	15-Jun-05
Brunei Darussalam	11-Dec-03	
Bulgaria	10-Dec-03	20-Sep-06
Burkina Faso	10-Dec-03	10-Oct-06
Burundi		10-Mar-06 (a)
Cambodia		5-Sep-07 (a)

Table AI.2 *Continued*

Cameroon	10-Dec-03	6-Feb-06
Canada	21-May-04	
Cape Verde	9-Dec-03	
Central African Republic	11-Feb-04	6-Oct-06
Chile	11-Dec-03	13-Sep-06
China	10-Dec-03	13-Jan-06
Colombia	10-Dec-03	27-Oct-06
Comoros	10-Dec-03	
Congo		13-Jul-06 (a)
Costa Rica	10-Dec-03	21-Mar-07
Côte D' Ivoire	10-Dec-03	
Croatia	10-Dec-03	24-Apr-05
Cuba	9-Dec-05	9-Feb-07
Cyprus	9-Dec-03	
Czech Republic	22-Apr-05	
Denmark	10-Dec-03	26-Dec-06
Djibouti	17-Jun-04	20-Apr-05
Dominican Republic	10-Dec-03	26-Oct-06
Ecuador	10-Dec-03	15-Sep-05
Egypt	9-Dec-03	25-Feb-05
El Salvador	10-Dec-03	01-Jul-04
Ethiopia	10-Dec-03	
European Community	15-Sep-05	
Finland	10-Dec-03	20-Jun-06 (A)
France	9-Dec-03	11-Jul-05
Gabon	10-Dec-03	
Germany	9-Dec-03	
Ghana	9-Dec-04	27-Jun-07

Table AI.2 *Continued*

Greece	10-Dec-03	
Guatemala	9-Dec-03	3-Nov-06
Guinea	15-Jul-05	
Guinea-Bissau		10-Sep-07 (a)
Haiti	10-Dec-03	
Honduras	17-May-04	23-May-05
Hungary	10-Dec-03	19-Apr-05
India	9-Dec-05	
Indonesia	18-Dec-03	19-Sep-06
Iran	9-Dec-03	
Ireland	9-Dec-03	
Israel	29-Nov-05	
Italy	9-Dec-03	
Jamaica	16-Sep-05	
Japan	9-Dec-03	
Jordan	9-Dec-03	24-Feb-05
Kenya	9-Dec-03	9-Dec-03
Kuwait	9-Dec-03	16-Feb-07
Kyrgyzstan	10-Dec-03	16-Sep-05
Laos	10-Dec-03	
Latvia	19-May-05	4-Jan-06
Lesotho	16-Sep-05	16-Sep-05
Liberia		16-Sep-05 (a)
Libyan Arab Jamahiriya	23-Dec-03	7-Jun-05
Liechtenstein	10-Dec-03	
Lithuania	10-Dec-03	21-Dec-06
Luxemburg	10-Dec-03	
Macedonia	18-Aug-05	13-Apr-07

Table AI.2 *Continued*

Madagascar	10-Dec-03	22-Sep-04
Malawi	21-Sep-04	
Malaysia	9-Dec-03	
Maldives		22-Mar-07 (a)
Mali	9-Dec-03	
Malta	12-May-05	
Mauritania		25-Oct-06 (a)
Mauritius	9-Dec-03	15-Dec-04
Mexico	9-Dec-03	20 Jul 2004
Moldova	28-Sep-04	
Mongolia	29-Apr-05	11-Jan-06
Montenegro		23-Oct-06 d
Morocco	9-Dec-03	09-May-07
Mozambique	25-May-04	
Myanmar	2-Dec-05	
Namibia	9-Dec-03	3-Aug-04
Nepal	10-Dec-03	
Netherlands	10-Dec-03	31-Oct-06 (A)
New Zealand	10-Dec-03	
Nicaragua	10-Dec-03	15-Feb-06
Nigeria	9-Dec-03	14-Dec-04
Norway	9-Dec-03	29-Jun-06
Pakistan	9-Dec-03	31-Aug-07
Panama	10-Dec-03	23-Sep-05
Papua New Guinea	22-Dec-04	16-Jul-07
Paraguay	9-Dec-03	1-Jun-05
Peru	10-Dec-03	16-Nov-04
Philippines	9-Dec-03	8-Nov-06

Table AI.2 *Continued*

Poland	10-Dec-03	15-Sep-06
Portugal	11-Dec-03	
Qatar	1-Dec-05	30-Jan-07
Republic of Korea	10-Dec-03	
Romania	9-Dec-03	2-Nov-04
Russian Federation	9-Dec-03	9-May-06
Rwanda	30-Nov-04	4-Oct-06
Sao Tome and Principe	8-Dec-05	12-Apr-06
Saudi Arabia	9-Jan-04	
Senegal	9-Dec-03	16-Nov-05
Serbia	11-Dec-03	20-Dec-05
Seychelles	27-Feb-04	16-Mar-06
Sierra Leone	9-Dec-03	30-Sep-04
Singapore	11-Nov-05	
Slovakia	9-Dec-03	01-June-06
South Africa	9-Dec-03	22-Nov-04
Spain	16-Sep-05	19-June-06
Sri Lanka	15-Mar-04	31-Mar-04
Sudan	14-Jan-05	
Swaziland	15-Sep-05	
Sweden	9-Dec-03	25-Sep-07
Switzerland	10-Dec-03	
Syrian Arab Republic	9-Dec-03	
Tajikistan		25-Sep-06 (a)
Tanzania	9-Dec-03	25-May-05
Thailand	9-Dec-03	
Timor-Leste	10-Dec-03	
Togo	10-Dec-03	6-Jul-05

Table AI.2 *Concluded*

Trinidad and Tobago	11-Dec-03	31-May-06
Tunisia	30-Mar-04	
Turkey	10-Dec-03	9-Nov-06
Turkmenistan		28-Mar-05 (a)
Uganda	9-Dec-03	09-Sep-04
Ukraine	11-Dec-03	
United Arab Emirates	10-Aug-05	22-Feb-06
United Kingdom	9-Dec-03	09-Feb-06
United States of America	9-Dec-03	30-Oct-06
Uruguay	9-Dec-03	10-Jan-07
Venezuela	10-Dec-03	
Viet Nam	10-Dec-03	
Yemen	11-Dec-03	07-Nov-05
Zambia	11-Dec-03	
Zimbabwe	20-Feb-04	8-Mar07

Source: United Nations Convention against Corruption website.

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Appendix II

Table AII.1 Source for governance and corruption research

Agency	Governance/corruption publication
African Development Bank (ADB)	Country Policy and Institutional Assessments
Afrobarometer	Afrobarometer
Asian Development Bank (ADB)	Country Policy and Institutional Assessments
Bertelsmann Foundation	Bertelsman Transformation Index
Brown University	Global E-Governance
Business Environment Risk Intelligence (BRI)	Business Risk Service
	Qualitative Risk Measure
Columbia University	State Capacity Project
Economist Intelligence Unit (EIU)	Country Risk Service
European Bank for Reconstruction and Development (EBRD)	Transition Report
Freedom House	Countries at the Crossroads
	Nations in Transition
	Freedom in the World
Gallup International	Voice of the People Survey
Global Insight (DRI)	Global Risk Service
	Business Conditions and Risk
Heritage Foundation	Economic Freedom Index
IJET Travel Intelligence (IJT)	Country Security Risk Assessment
Institute for Management and Development	World Competitiveness Yearbook
International Research and Exchange Board (IREX)	Media Sustainability Index

Table AII.1 *Concluded*

Latinobarometer	Latinobarometro Surveys
Merchant International Group (MIG)	Grey Area Dynamics
Political and Economic Risk Consultancy (PRC)	Corruption Survey
Political Risk Services (PRS)	Country Risk Guide
Reporters without Borders (RSF)	Reporters without Borders
Transparency International	Corruption Perceptions Index
	Bribe Payers Index
	Global Corruption Report
U.S. State Department	Trafficking in People Report
	Amnesty International Human Rights Dataset
World Bank	Business Enterprise Environment Survey
	World Business Environment Survey
	Country Policy and Institutional Assessments
World Economic Forum (WEF)	Global Competitiveness Report

Sources: Kaufmann, Kraay, and Mastruzzi (2006) and Internet resources.

Table AII.2 2007 Transparency International Corruption Perceptions Index, ranking, and percentile (high score = low corruption)

Country	2007 CPI score	Country rank	Percentile
Denmark	9.4	1	99
Finland	9.4	1	99
New Zealand	9.4	1	99
Singapore	9.3	4	98
Sweden	9.3	4	98
Iceland	9.2	6	98
Netherlands	9	7	97
Switzerland	9	7	97
Canada	8.7	9	96
Norway	8.7	9	96
Australia	8.6	11	95
Luxembourg	8.4	12	94
UK	8.4	12	94
Hong Kong	8.3	14	93
Austria	8.1	15	93
Germany	7.8	16	92
Ireland	7.5	17	91
Japan	7.5	17	91
France	7.3	19	90
USA	7.2	20	90
Belgium	7.1	21	89
Chile	7	22	89
Barbados	6.9	23	88
Saint Lucia	6.8	24	88
Spain	6.7	25	87
Uruguay	6.7	25	87

Table AII.2 *Continued*

Slovenia	6.6	27	86
Estonia	6.5	28	85
Portugal	6.5	28	85
Israel	6.1	30	84
St Vincent & Grenadines	6.1	30	84
Qatar	6	32	83
Malta	5.8	33	83
Macao	5.7	34	81
Taiwan	5.7	34	81
UAE	5.7	34	81
Dominica	5.6	37	80
Botswana	5.4	38	80
Cyprus	5.3	39	79
Hungary	5.3	39	79
Czech Republic	5.2	41	78
Italy	5.2	41	78
Malaysia	5.1	43	76
South Africa	5.1	43	76
South Korea	5.1	43	76
Bahrain	5	46	74
Bhutan	5	46	74
Costa Rica	5	46	74
Cape Verde	4.9	49	73
Slovakia	4.9	49	73
Latvia	4.8	51	72
Lithuania	4.8	51	72
Jordan	4.7	53	70
Mauritius	4.7	53	70

Table AII.2 *Continued*

Oman	4.7	53	70
Greece	4.6	56	70
Namibia	4.5	57	68
Samoa	4.5	57	68
Seychelles	4.5	57	68
Kuwait	4.3	60	67
Cuba	4.2	61	66
Poland	4.2	61	66
Tunisia	4.2	61	66
Bulgaria	4.1	64	64
Croatia	4.1	64	64
Turkey	4.1	64	64
El Salvador	4	67	63
Colombia	3.8	68	63
Ghana	3.7	69	62
Romania	3.7	69	62
Senegal	3.6	71	61
Brazil	3.5	72	57
China	3.5	72	57
India	3.5	72	57
Mexico	3.5	72	57
Morocco	3.5	72	57
Peru	3.5	72	57
Suriname	3.5	72	57
Georgia	3.4	79	54
Grenada	3.4	79	54
Saudi Arabia	3.4	79	54
Serbia	3.4	79	54

Table AII.2 *Continued*

Trinidad & Tobago	3.4	79	54
Bosnia-Herzegovina	3.3	84	49
Gabon	3.3	84	49
Jamaica	3.3	84	49
Kiribati	3.3	84	49
Lesotho	3.3	84	49
Macedonia	3.3	84	49
Maldives	3.3	84	49
Montenegro	3.3	84	49
Swaziland	3.3	84	49
Thailand	3.3	84	49
Madagascar	3.2	94	47
Panama	3.2	94	47
Sri Lanka	3.2	94	47
Tanzania	3.2	94	47
Vanuatu	3.1	98	46
Algeria	3	99	43
Armenia	3	99	43
Belize	3	99	43
Dominican Rep.	3	99	43
Lebanon	3	99	43
Mongolia	3	99	43
Albania	2.9	105	39
Argentina	2.9	105	39
Bolivia	2.9	105	39
Burkina Faso	2.9	105	39
Djibouti	2.9	105	39
Egypt	2.9	105	39

Table AII.2 *Continued*

Eritrea	2.8	111	35
Guatemala	2.8	111	35
Moldovaa	2.8	111	35
Mozambique	2.8	111	35
Rwanda	2.8	111	35
Solomon Islands	2.8	111	35
Uganda	2.8	111	35
Benin	2.7	118	33
Malawi	2.7	118	33
Mali	2.7	118	33
Sao Tome & Principe	2.7	118	33
Ukraine	2.7	118	33
Comoros	2.6	123	28
Guyana	2.6	123	28
Mauritania	2.6	123	28
Nicaragua	2.6	123	28
Niger	2.6	123	28
Timor-Leste	2.6	123	28
Viet Nam	2.6	123	28
Zambia	2.6	123	28
Burundi	2.5	131	24
Honduras	2.5	131	24
Iran	2.5	131	24
Libya	2.5	131	24
Nepal	2.5	131	24
Philippines	2.5	131	24
Yemen	2.5	131	24
Cameroon	2.4	138	21

Table AII.2 *Continued*

Ethiopia	2.4	138	21
Pakistan	2.4	138	21
Paraguay	2.4	138	21
Syria	2.4	138	21
Gambia	2.3	143	19
Indonesia	2.3	143	19
Russia	2.3	143	19
Togo	2.3	143	19
Angola	2.2	147	17
Guinea-Bissau	2.2	147	17
Nigeria	2.2	147	17
Azerbaijan	2.1	150	11
Belarus	2.1	150	11
Congo, Republic	2.1	150	11
Cote d'Ivoire	2.1	150	11
Ecuador	2.1	150	11
Kazakhstan	2.1	150	11
Kenya	2.1	150	11
Kyrgyzstan	2.1	150	11
Liberia	2.1	150	11
Sierra Leone	2.1	150	11
Tajikistan	2.1	150	11
Zimbabwe	2.1	150	11
Bangladesh	2	162	7
Cambodia	2	162	7
Central African Rep.	2	162	7
Papua New Guinea	2	162	7
Turkmenistan	2	162	7

Table AII.2 *Concluded*

Venezuela	2	162	7
Congo, Dem. Rep.	1.9	168	5
Equatorial Guinea	1.9	168	5
Guinea	1.9	168	5
Laos	1.9	168	5
Afghanistan	1.8	172	5
Chad	1.8	172	5
Sudan	1.8	172	5
Tonga	1.7	175	3
Uzbekistan	1.7	175	3
Haiti	1.6	177	2
Iraq	1.5	178	2
Myanmar	1.4	179	0
Somalia	1.4	179	0

Reference is to Transparency International 2007b.

Table AII.3 2007 Transparency International Corruption Perceptions Index, surveys used, and confidence range (high score = low corruption)

Country	2007 CPI score	Surveys used	Confidence range
Denmark	9.4	6	9.2–9.6
Finland	9.4	6	9.2–9.6
New Zealand	9.4	6	9.2–9.6
Singapore	9.3	9	9.0–9.5
Sweden	9.3	6	9.1–9.4
Iceland	9.2	6	8.3–9.6
Netherlands	9	6	8.8–9.2
Switzerland	9	6	8.8–9.2
Canada	8.7	6	8.3–9.1
Norway	8.7	6	8.0–9.2
Australia	8.6	8	8.1–9.0
Luxembourg	8.4	5	7.7–8.7
UK	8.4	6	7.9–8.9
Hong Kong	8.3	8	7.6–8.8
Austria	8.1	6	7.5–8.7
Germany	7.8	6	7.3–8.4
Ireland	7.5	6	7.3–7.7
Japan	7.5	8	7.1–8.0
France	7.3	6	6.9–7.8
USA	7.2	8	6.5–7.6
Belgium	7.1	6	7.1–7.1
Chile	7	7	6.5–7.4
Barbados	6.9	4	6.6–7.1
Saint Lucia	6.8	3	6.1–7.1
Spain	6.7	6	6.2–7.0

Table AII.3 *Continued*

Uruguay	6.7	5	6.4–7.0
Slovenia	6.6	8	6.1–6.9
Estonia	6.5	8	6.0–7.0
Portugal	6.5	6	5.8–7.2
Israel	6.1	6	5.6–6.7
St Vincent and Grenadines	6.1	3	4.0–7.1
Qatar	6	4	5.4–6.4
Malta	5.8	4	5.3–6.2
Macao	5.7	4	4.7–6.4
Taiwan	5.7	9	5.4–6.1
UAE	5.7	5	4.8–6.5
Dominica	5.6	3	4.0–6.1
Botswana	5.4	7	4.8–6.1
Cyprus	5.3	3	5.1–5.5
Hungary	5.3	8	4.9–5.5
Czech Republic	5.2	8	4.9–5.8
Italy	5.2	6	4.7–5.7
Malaysia	5.1	9	4.5–5.7
South Africa	5.1	9	4.9–5.5
South Korea	5.1	9	4.7–5.5
Bahrain	5	5	4.2–5.7
Bhutan	5	5	4.1–5.7
Costa Rica	5	5	4.7–5.3
Cape Verde	4.9	3	3.4–5.5
Slovakia	4.9	8	4.5–5.2
Latvia	4.8	6	4.4–5.1
Lithuania	4.8	7	4.4–5.3
Jordan	4.7	7	3.8–5.6

Table AII.3 *Continued*

Mauritius	4.7	6	4.1–5.7
Oman	4.7	4	3.9–5.3
Greece	4.6	6	4.3–5.0
Namibia	4.5	7	3.9–5.2
Samoa	4.5	3	3.4–5.5
Seychelles	4.5	4	2.9–5.7
Kuwait	4.3	5	3.3–5.1
Cuba	4.2	4	3.5–4.7
Poland	4.2	8	3.6–4.9
Tunisia	4.2	6	3.4–4.8
Bulgaria	4.1	8	3.6–4.8
Croatia	4.1	8	3.6–4.5
Turkey	4.1	7	3.8–4.5
El Salvador	4	5	3.2–4.6
Colombia	3.8	7	3.4–4.3
Ghana	3.7	7	3.5–3.9
Romania	3.7	8	3.4–4.1
Senegal	3.6	7	3.2–4.2
Brazil	3.5	7	3.2–4.0
China	3.5	9	3.0–4.2
India	3.5	10	3.3–3.7
Mexico	3.5	7	3.3–3.8
Morocco	3.5	7	3.0–4.2
Peru	3.5	5	3.4–3.7
Suriname	3.5	4	3.0–3.9
Georgia	3.4	6	2.9–4.3
Grenada	3.4	3	2.0–4.1
Saudi Arabia	3.4	4	2.7–3.9

Table AII.3 *Continued*

Serbia	3.4	6	3.0–4.0
Trinidad and Tobago	3.4	4	2.7–3.9
Bosnia-Herzegovina	3.3	7	2.9–3.7
Gabon	3.3	5	3.0–3.5
Jamaica	3.3	5	3.1–3.4
Kiribati	3.3	3	2.4–3.9
Lesotho	3.3	6	3.1–3.5
Macedonia	3.3	6	2.9–3.8
Maldives	3.3	4	2.3–4.3
Montenegro	3.3	4	2.4–4.0
Swaziland	3.3	5	2.6–4.2
Thailand	3.3	9	2.9–3.7
Madagascar	3.2	7	2.5–3.9
Panama	3.2	5	2.8–3.4
Sri Lanka	3.2	7	2.9–3.5
Tanzania	3.2	8	2.9–3.4
Vanuatu	3.1	3	2.4–3.7
Algeria	3	6	2.7–3.2
Armenia	3	7	2.8–3.2
Belize	3	3	2.0–3.7
Dominican Rep.	3	5	2.8–3.3
Lebanon	3	4	2.2–3.6
Mongolia	3	6	2.6–3.3
Albania	2.9	6	2.6–3.1
Argentina	2.9	7	2.6–3.2
Bolivia	2.9	6	2.7–3.2
Burkina Faso	2.9	7	2.6–3.4
Djibouti	2.9	3	2.2–3.4

Table AII.3 *Continued*

Egypt	2.9	7	2.6–3.3
Eritrea	2.8	5	2.1–3.5
Guatemala	2.8	5	2.4–3.2
Moldovaa	2.8	7	2.5–3.3
Mozambique	2.8	8	2.5–3.1
Rwanda	2.8	5	2.3–3.3
Solomon Islands	2.8	3	2.4–3.1
Uganda	2.8	8	2.5–3.0
Benin	2.7	7	2.3–3.2
Malawi	2.7	8	2.4–3.0
Mali	2.7	8	2.4–3.0
Sao Tome and Principe	2.7	3	2.4–3.0
Ukraine	2.7	7	2.4–3.0
Comoros	2.6	3	2.2 – 3.0
Guyana	2.6	4	2.3–2.7
Mauritania	2.6	6	2.0–3.3
Nicaragua	2.6	6	2.3–2.7
Niger	2.6	7	2.3–2.9
Timor-Leste	2.6	3	2.5–2.6
Viet Nam	2.6	9	2.4–2.9
Zambia	2.6	8	2.3–2.9
Burundi	2.5	7	2.0 – 3.0
Honduras	2.5	6	2.3–2.6
Iran	2.5	4	2.0–3.0
Libya	2.5	4	2.1–2.6
Nepal	2.5	7	2.3–2.7
Philippines	2.5	9	2.3–2.7
Yemen	2.5	5	2.1 – 3.0

Table AII.3 *Continued*

Cameroon	2.4	8	2.1–2.7
Ethiopia	2.4	8	2.1–2.7
Pakistan	2.4	7	2.0–2.8
Paraguay	2.4	5	2.1–2.6
Syria	2.4	4	1.7–2.9
Gambia	2.3	6	2.0–2.6
Indonesia	2.3	11	2.1–2.4
Russia	2.3	8	2.1–2.6
Togo	2.3	5	1.9–2.8
Angola	2.2	7	1.8–2.4
Guinea-Bissau	2.2	3	2.0–2.3
Nigeria	2.2	8	2.0–2.4
Azerbaijan	2.1	8	1.9–2.3
Belarus	2.1	5	1.7–2.6
Congo, Republic	2.1	6	2.0–2.2
Cote d'Ivoire	2.1	6	1.7–2.6
Ecuador	2.1	5	2.0–2.3
Kazakhstan	2.1	6	1.7–2.5
Kenya	2.1	8	1.9–2.3
Kyrgyzstan	2.1	7	2.0–2.2
Liberia	2.1	4	1.8–2.4
Sierra Leone	2.1	5	2.0–2.2
Tajikistan	2.1	8	1.9–2.3
Zimbabwe	2.1	8	1.8–2.4
Bangladesh	2	7	1.8–2.3
Cambodia	2	7	1.8–2.1
Central African Rep.	2	5	1.8–2.3
Papua New Guinea	2	6	1.7–2.3

Table AII.3 *Concluded*

Turkmenistan	2	5	1.8–2.3
Venezuela	2	7	1.9–2.1
Congo, Dem. Rep.	1.9	6	1.8–2.1
Equatorial Guinea	1.9	4	1.7–2.0
Guinea	1.9	6	1.4–2.6
Laos	1.9	6	1.7–2.2
Afghanistan	1.8	4	1.4–2.0
Chad	1.8	7	1.7–1.9
Sudan	1.8	6	1.6–1.9
Tonga	1.7	3	1.5–1.8
Uzbekistan	1.7	7	1.6–1.9
Haiti	1.6	4	1.3–1.8
Iraq	1.5	4	1.3–1.7
Myanmar	1.4	4	1.1–1.7
Somalia	1.4	4	1.1–1.7

Table AII.4 2007 Economist Intelligence Unit, level of corruption (high score = low corruption)

Country	Corruption level
Australia	5
Denmark	5
Finland	5
Netherlands	5
New Zealand	5
Norway	5
Singapore	5
Sweden	5
Switzerland	5
Austria	4
Belgium	4
Canada	4
Chile	4
France	4
Germany	4
Hong Kong	4
Ireland	4
Israel	4
Portugal	4
South Korea	4
Spain	4
United Kingdom	4
United States	4
Czech Republic	3
Greece	3
Hungary	3

Table AII.4 *Continued*

Italy	3
Japan	3
Malaysia	3
Mexico	3
Poland	3
Saudi Arabia	3
Slovakia	3
South Africa	3
Sri Lanka	3
Taiwan	3
Turkey	3
Algeria	2
Argentina	2
Brazil	2
Bulgaria	2
Colombia	2
Ecuador	2
Egypt	2
India	2
Iran	2
Pakistan	2
Romania	2
Thailand	2
Vietnam	2
Azerbaijan	1
China	1
Indonesia	1
Kazakhstan	1

Table AII.4 *Concluded*

Nigeria	1
Peru	1
Philippines	1
Russia	1
Ukraine	1
Venezuela	1

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