



CORRUPTION AND ECONOMIC ACTIVITY

VITO TANZI

Distinguished Lecture Series 26

**A PUBLICATION OF
THE EGYPTIAN CENTER FOR ECONOMIC STUDIES**

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FOREWORD

While corruption has long been associated with the abuse of public officials of their positions, recent bankruptcy cases such as Enron's in the US have brought to the forefront high-profile cases of corruption in the private sector. Moreover, the international literature dealing with this topic has shown that corruption impedes the development of markets, drives away investment, and undermines the rule of law.

In this edition of the *Distinguished Lecture Series*, Prof. Vito Tanzi, an economist of international renown, discusses various forms of corruption in economic activities, and the channels through which corruption distorts economic decisions. In addition, he highlights actions taken by some countries in their attempt to reduce corruption, stressing that the war on corruption cannot be won unless fought on all fronts. As he subtly puts it, we cannot simply rely on a single magic bullet.

The discussion that followed his rich lecture was highly relevant and the answers provided by Professor Tanzi were insightful and constructive. Both the lecture and the discussion are included in this publication.

Hanaa Kheir-El-Din,
Executive Director and Director of Research, ECES
December 2006

تقديم

على الرغم من ارتباط مفهوم الفساد منذ أمد طويل بسوء استغلال الموظفين العموميين لمناصبهم، إلا أن قضايا حديثة مثل قضية إفلاس شركة "إنرون" في الولايات المتحدة قد أبرزت حالات صارخة من الفساد في القطاع الخاص. وفي ضوء الأدبيات الكثيرة التي تعالج هذا الموضوع على الصعيد العالمي، يصعب التشكك في القول بأن الفساد يعوق تطوير الأسواق، ويترد الاستثمارات، ويحط من شأن حكم القانون.

وفي هذا العدد من سلسلة المحاضرات المتميزة، يناقش فيتو تانزي، وهو أحد الاقتصاديين ذوي الشهرة العالمية، الأشكال المختلفة للفساد في النشاط الاقتصادي، والقنوات التي من خلالها يؤدي الفساد إلى تشوه القرارات الاقتصادية. كما يلقي الضوء على الإجراءات التي اتبعتها البلدان المختلفة في محاولاتها للقضاء على هذا الفساد، مؤكداً في النهاية أن التغلب على الفساد يتطلب التعامل معه بجميع الأسلحة المتاحة وعلى كافة المستويات.

وقد تطرقت المداخلات الثرية والمفيدة التي أعقبت هذه المحاضرة إلى العديد من الملاحظات والأسئلة المتعمقة، وجاءت إجابات تانزي عن استفسارات الحضور على ذات القدر من التعمق والوضوح. ويضم هذا الإصدار كل من المحاضرة وملخص المناقشات.

أ. د. هناء خير الدين

المدير التنفيذي ومدير البحوث

المركز المصري للدراسات الاقتصادية

ديسمبر 2006

ABOUT THE SPEAKER

Vito Tanzi

Former Director

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Vito Tanzi is the former director of the Fiscal Affairs Department at the International Monetary Fund. Prior to joining the IMF in 1974, Prof. Tanzi was professor and chairman of the department of economics at the American University and was a faculty member at George Washington University. He was senior associate at the Carnegie Endowment for International Peace, and from 1990 to 1994 he was president of the International Institute of Public Finance. From May 2001 to July 2003 he served as Undersecretary for Economy and Finance in the Italian government. In addition, he has served as a consultant for the World Bank, the United Nations, the European Central Bank, the European Commission, the Organization of American States, and the Stanford Research Institute.

Prof. Tanzi has published extensively including several books and a large number of articles in leading professional journals, such as the *American Economic Review*, the *Journal of Political Economy*, the *Review of Economics and Statistics*, the *Economic Journal*, the *Journal of Public Economics*, and many others. His major interests include public finance, economic development, and macroeconomics and he is known for his research on the economic role of the state and the so-called Tanzi effect, whereby real tax proceeds are eroded during periods of high inflation. Prof. Tanzi received his Ph.D. in economics from Harvard University and has received honorary degrees from the National University of Córdoba (Argentina), the University of Liège (Belgium), the University of Torino (Italy), the University of Bari (Italy), and the University of Lisbon (Portugal).

PART I

CORRUPTION AND ECONOMIC ACTIVITY

I. HISTORICAL BACKGROUND

The Merriam Webster's Collegiate Dictionary of the English language explains that the root of the word corruption comes from the Latin word "rumpere" to break. Thus, it implies that something is broken, normally a code of conduct that is considered pure or correct. The connection with a Latin word appears appropriate because, according to some scholars, it was in the Roman Empire that corruption came to be identified as clearly inappropriate behavior and it was the Roman Empire that, other scholars argue, fell because of the corrosive impact of corruption. Corruption destroyed the moral fabric and the administrative structure of that powerful empire and eventually led to its collapse.

There have been frequent mentions of corruption in history. A very early and famous one is in the writings of Kautilya, the prime minister of an Indian Kingdom. Two thousands years ago, in a book called Arthashastra, Kautilya wrote that "as it is impossible not to taste honey placed on one's tongue, so it is impossible for a civil servant not to take advantage of his position." In the millennium after the fall of the Roman Empire, corruption came to be seen as a major sin. For example, the Koran has several references to it. Dante, the great 13th century Italian poet, who wrote The Divine Comedy, placed corrupt people in the deepest levels of Hell. The strict, negative view of corruption continued to prevail for a few centuries until relatively modern times. The American Constitution, for example, explicitly mentions two crimes that can lead to the impeachment of a President: treason and bribery (see Noonan Jr. 1984)

In the 19th century, attitudes toward corruption became more relaxed and seemingly more tolerant. There are increasing references to it in literary works and even in operas. Though not condoning corruption, these references do not seem to carry the strong moral condemnation that had characterized earlier centuries. See, for example, the references to it in books such as Henry

Adams' novel, *Democracy* and in Puccini's opera, *Manon Lescaux*. Corruption became almost a natural or expected characteristic of behavior in the new bourgeois society that accompanied the Industrial Revolution. This more relaxed attitude continued in the 20th century when corruption became prevalent and began to create serious difficulties in several countries. It reached extreme levels during the Brezhnev era in the Soviet Union when even gaining access to a morgue for a dead body required the payment of a bribe, and visitors to Brezhnev were expected to bring expensive gifts (see Remnick 1994). Until the 1990s there were few writings on corruption and they were predominantly written by political scientists. Few economists had paid attention to it, with two significant exceptions: Rose-Ackerman (1978) and Robert Klitgaard (1988).

In the 1990s, and especially in the second half of the decade, corruption suddenly became a hot topic, both academically and politically. There are several reasons for the increased attention to corruption (see Tanzi 1998), including (a) the end of the cold war; (b) increasing openness in many countries; (c) the spread of democratic regimes and the increasing role of the (free) media; (d) increasing globalization and the international contacts and contracts that it promoted; (e) the growing role of non-governmental organizations and of "civil society;" (f) the increasing attention paid to corruption on the part of international institutions and some governments; and (g) concern about the economic distortions and inefficiencies that acts of corruption could generate for market economies. In a globalized world where the economies of different countries compete against one another, economic efficiency became a more important objective than it had been in economies that were closed and not market oriented. Finally, major political scandals connected with acts of corruption in Japan, Italy, France, Germany, Brazil and other countries brought corruption to the front pages of newspapers.

Another factor that may have contributed to corruption, especially over the second half of the 20th century, was the progressively larger economic roles that governments were playing compared with previous periods. This larger role was played using various instruments including public spending, taxes, various forms of regulations, certifications, and the assumption of contingent liabilities. Each of these instruments could lend itself to abuses, either by the policymakers themselves (the "principal") or by the public bureaucracies (the "agents"). Some governmental

activities carried with them the implicit creation of monopolistic power for individuals charged with carrying out these activities. When this public power is accompanied by the power of discretion over particular decisions, unscrupulous public employees are given a tool that they can use to extract bribes or to benefit themselves in other ways.

Attempts to scale down the government role, through policies of privatization and outsourcing, especially in recent years, may also have contributed to corruption or, at least, to the perception of corruption. For example, this happened in Latin America where, following the guidelines of the so-called “Washington Consensus,” many public enterprises were privatized. The popular reaction to this privatization has been generally negative in part because it led to higher prices for higher quality services and because of widespread perception that the policymakers charged with pursuing the policies of privatization got bribes in the process. When a public enterprise is privatized there is no reference or market price that can indicate the compensation that the government should receive for selling the enterprise. This is especially true when the buyers are expected to assume some liability, such as pension obligations or the retention of unproductive workers. Thus, there is no way of refuting accusations of corruption.

II. THE DEFINITION OF CORRUPTION

Corruption can come in many shapes and forms (see Tanzi 1995). It is tempting to state that, like elephants, it may be difficult to define it but it should always be possible to recognize acts of corruption when they occur. Unfortunately, this is not always the case because the world is complicated and different individuals may interpret particular actions differently. In the 1990s several international organizations started to discuss the corruption problem in international forums in order to attempt to coordinate actions to fight corruption. Countries’ representatives and experts from international organizations spent a lot of time and effort in the search for a clear definition of corruption that would be precise and universally accepted. It did not prove to be an easy enterprise because there are forms of corruption that are difficult to identify and there are forms that may not be seen as corruption by exponents of particular cultures. Cultural backgrounds often play a large role in these attitudes especially in actions that involve exchanges of gifts or favors.

The definition of corruption has been generally associated with the absence of equal and fair treatment for all on the part of public officials; that is with the absence of what in English is defined as the “arm’s length principle.” The arm’s length principle requires that economic relationships must be characterized by the same objective treatment for everyone regardless of whether the persons involved are perfect strangers, friends, family, party members, members of the same ethnic group and so on. A public official should not take these characteristics into consideration in dealings with citizens. When the public official gives weight to non-official relationships that he has with the public, he is abandoning the arm’s length principle and may be engaging in acts of corruption.

It is easy to see how the arm’s length principle can conflict with the traditions and the norms of old cultures in which one is expected to treat particular individuals, and especially family members and members of the same clan, differently from others. This conflict between modern rules that are often imported from other countries such as the arm’s length principle, and traditional and deep-seated rules, is often at the base of disagreements between representatives of different countries. It also makes it more difficult, especially in some countries, to stamp out all forms of corruption.

There are various forms of corruption with different implications for the functioning of the economy of a country. The identification of these forms is useful in identifying the areas that need attention and protection from acts of corruption. A full discussion of these forms is beyond the scope of this paper. However, some broad classifications can be useful.

Most literature on corruption commonly assumes that it reflects “the abuse by public officials of their power or position to derive personal benefit.” This definition gives excessive but not clearly identified weight to two adjectives, namely public and personal. Before going on to the classification of various forms of corruption it may be worthwhile to elaborate briefly on the meaning of these two adjectives.

The phenomenon of corruption is usually associated with the activities of government officials so that public has been considered a synonym for government. However, modern economies have large private establishments and, especially, business corporations that are owned by thousands of

distant shareholders who often own shares (and thus own a piece of the corporations) but play no role in running the enterprises. To some extent they are in the same situation of many citizens *vis á vis* the state. These enterprises are normally run by hired professional managers and employ personnel that are unrelated to the owners of the enterprises. Thus, the employees of the enterprises, including the managers, find themselves in positions similar to those of government ministers and public employees. They often have the same capacity to abuse their public power for strictly personal advantages against the interests of the distant owners of the enterprises (the shareholders) or occasionally against the interests of the public or some other groups, such as those who have accumulated private pension rights against the corporations. This, for example, happened in Enron, the large American corporation that went bankrupt in 2001 and in several other enterprises. Corporate scandals have become frequent in recent years because market economies are creating “public” spaces where corruption is possible. Therefore, the spotlight for identifying corruption should not be limited to activities within governments but should also cover activities in particular private sector areas.

Moving to the other adjective—personal—it may be too restrictive to assume that acts of corruption are undertaken for the exclusive benefits of the individuals who engage in them. Often these acts have the objective of helping relatives, members of the same religious or ethnic group, or the political groups to which individuals belong. Thus, the benefit that the individual receives may be linked only indirectly to the acts of corruption. Surveys conducted by the Gallup Organization (for Transparency International, the leading non-governmental organization that reports on corruption) indicate that political corruption (i.e., corruption to promote political movements) is very common around the world.

The above discussion suggests that we could distinguish between public sector corruption and private sector corruption. Over the years the attention has been directed toward public sector corruption. However, in more recent years, and especially in the United States and other industrial countries, corrupt activities within the private sector have started attracting some attention. Private sector corruption can be divided into two distinct parts. Explicit and clearly illegal corruption and what could be defined as legal corruption.

Legal corruption may sound like a misnomer. It refers to private activities that may not break existing laws but, in intention or in results, are no different than explicit acts of corruption. Take, for example, tax accountants that help taxpayers avoid paying taxes by looking for ambiguities in the tax laws and exploiting them to the fullest to the taxpayer's advantage. Another example are CEOs that appoint individuals to corporate boards knowing they are likely to authorize excessively generous, often nontransparent, and complex compensation packages for corporate heads. Or, for instance, individuals who lobby politicians and regulators to get favorable decisions that may be advantageous to them but damaging to citizens, such as dangerous drugs. Or take accounting firms that become accomplices to accounting maneuvers, which allow company managers to hide the true financial position of an enterprise. Or stock analysts who release untrue and biased statements about the true financial condition of particular firms. All these examples are based on real life occurrences and all lead to results similar to those from explicit acts of corruption by public employees.

An important distinction for corruption within the public sector is that between grand (or political) corruption and bureaucratic (or administrative) corruption. The first is normally associated with the activities and the actions of political leaders or senior public officials. It involves the manipulation of the government apparatus to achieve results that economically benefit particular leaders, their parties, followers, families or similar groups. This grand corruption can take different forms including manipulating the passage of laws that help these leaders, their families or associates maintain their power and become rich. This form of "state capture" leads to questions about whether "rule of law" is always a good thing. In some cases the "rule of law" is respected but the laws are specifically designed to benefit particular individuals. This may be done while maintaining some semblance of a democratic process.

Bureaucratic or administrative corruption typically receives the most attention by both the public and those who write on the subject. It is the kind of "detail" or "small change" corruption prevalent in many countries. Government regulations and authorizations are often the major ingredient for this form of corruption. The more widespread the use of permits and authorizations is in a country, the more prevalent this kind of corruption. Public employees that engage in these

acts of corruption violate the principal-agent relationship that should exist between them (the agents) and the government (the principal). These employees use the discretion that they have over particular decisions—including the time required to get an answer to a request and whether a request will be accepted or not—to elicit bribes that may occasionally be in the form of gifts or favors. This is a very common kind of corruption that, because of its frequency and the impact on individuals, irritates private citizens. In extreme cases it may become the equivalent of “bureaucratic cholesterol” that strangles economic activities and reduces the rate of growth of a country.

Another kind of classification is that between coercive and collusive corruption, depending on whether public employees force citizens to pay bribes or whether the two parties spontaneously agree, say, to the payment of a bribe in return for a favorable decision. Of course the initiative may also start with the private citizens. This could involve tax inspectors and taxpayers, regulators and the regulated, or the provider of a public service and receiver of the service.

Other distinctions could also be introduced, as for example, that between centralized and decentralized corruption or between corruption that involves specific payments of bribes and that associated with the exchange of favors. Each of the above distinctions can lead to a different analysis of the problem and may require different corrections. However, in the remainder of the paper we will focus on the general issue of corruption, the factors that contribute to it, and the consequences of corruption for the economy.

III. FACTORS CONTRIBUTING TO CORRUPTION

Various factors contribute to a climate that makes corruption prevalent. Examining some of them may help in identifying measures or policies that can reduce corruption.

Regulations and Authorizations

Governments have several instruments for pursuing their economic objectives. Regulations and authorizations are among them. These may give some government employees monopoly power over some activities, in the sense that the employees acquire the power to approve or disapprove

particular requests. Such requests may involve getting a passport for foreign travel, getting a permit to build a house or to make modification to existing houses, to open a shop or enterprise, to keep shops open, to obtain foreign exchange or credit from banks, and so on. When the areas for which these authorizations or licenses are needed are wide, as they are in some countries, and especially when particular public employees have discretion in the decisions, corruption tends to grow and economic activity tends to diminish. The more discretion public servants have in these decisions, the more power they acquire and, in the absence of strict controls on them, the greater the likelihood of corruption.

Public employees with the power to approve or deny government permits that cannot be obtained elsewhere can, in these circumstances, elicit payments (i.e., bribes) for speeding up the process or for providing positive answers to the requests. The public employees may intentionally slow down the approval process and may end up approving requests that should be turned down while rejecting (or delaying the answer to) requests that should have been approved. It is easy to see how this kind of corruption can: increase the cost of engaging in business activities for particular individuals; distort competition; discourage new investments or activities; and even allow for activities—such as the construction of unsafe buildings or bridges, the distribution of contaminated food products or dangerous drugs—that can impose high costs on society.

Regulations do not need budgetary appropriations. Often they do not even need approval by parliaments. Thus, they are easy to introduce and, once they are introduced, they acquire an often perennial or, at least, a long life because in most countries they do not have “sunset provisions.” There is no process that periodically scrutinizes them and eliminates regulations that are no longer needed. Regulations are rarely subjected to cost-benefit evaluations. Thus, they can be damaging to economic activities just like high and random taxes (see Posner 1971 for an early discussion of this issue). It would be beneficial if regulations were subjected to a rigorous process of evaluation and, like the annual budgetary process, if the “regulatory budget” could be assessed periodically in order to eliminate damaging regulations and to simplify and make those retained more efficient. Unfortunately this does not occur.

Two aspects related to regulations and authorizations merit specific attention: discretion and complexity. Discretion in their application is the feature that contributes the most to corruption. The less discretion given to public servants who supervise the regulations, the less corruption is likely to occur. However, discretion cannot and should not be completely eliminated. When regulations are complex, they tend to leave much discretion to civil servants. This discretion can be used by the latter to favor individuals willing to pay bribes over others. The search for transparency in rules and regulations should be an important objective. Furthermore, an efficient appeals process for those who have their requests rejected should exist (a) to remove the monopoly power from the civil servants who make the decisions, and (b) to provide indirect control over them.

Another aspect of regulations that can play a role in corruption is the frequency of contact between inspectors and those inspected, or between controllers and those controlled. Frequent contact fosters familiarity. And familiarity tends to promote exchanges of favors and corrupt behavior. When, in particular activities such as tax collection, the contact between citizens and public officials become frequent, corruption rises.

Tax Systems and Tax Incentives

Taxation is one of the areas often affected by corruption and the quality of the tax system is one of the contributing factors. In some countries, the level of corruption in the tax administration became so high that at times it proved more desirable to close the existing administration (sending home all its employees and starting a new one with new employees) than to reform it. The ingredients for corruption are: (a) complexity of the tax system; (b) excessive discretion that some tax administrators may have; (c) frequent contact between taxpayers and tax inspectors; and (d) officials disposed to accept bribes or even to demand them. Low salaries for tax administrators may also contribute to corruption.

Another problem with tax systems is that governments try to achieve too many objectives with them rather than concentrate on the objective of raising revenue in a reasonably equitable fashion. As a consequence, tax systems become very complex, which creates a framework for discretionary actions on the part of both taxpayers and tax inspectors. Often the lack of clearly identifiable and

measurable tax bases gives discretionary powers to the tax inspectors who control particular taxpayers. Close controls at times breed vicinity and familiarity between taxpayers and tax administrators. This in turn can lead to favors and requests or offers of bribes in exchange for lower tax payments. When countries become more developed, it is easier to identify tax bases, because the incomes or sales originate in larger establishments (e.g., enterprises, banks) that keep better accounts. It also becomes possible to collect taxes at the source by withholding, thus eliminating physical contact between inspectors and taxpayers. The difficulty in identifying objective tax bases has been particularly significant in customs administrations where corruption is often rampant. In the absence of verifiable invoices presented by importers, import duties are calculated on the value of imports determined by customs inspectors. Inspectors can also close their eyes to goods smuggled in or can give them a classification that lowers the duties owed on them. In various ways, customs officials can reduce the tax payment in exchange for bribes.

Because of the discretion given to those who grant them, tax incentives have often been a fertile ground for corruption. An enterprise that is granted a tax incentive may be able to significantly reduce its tax liability. It will thus be willing to pay a bribe to the officials that will make the decision. When the tax liability without the incentive is high and the salary of officials is low, the probability of corruption will rise. Thus, once again transparency of laws and decisions, and the reduction of discretion for those who make these decisions can go a long way toward reducing corruption. The existence of an effective appeals process may help.

Before leaving the area of public revenue, it may be worthwhile to mention corruption related to the appropriation of revenue from the exports of government-owned mineral products (on this topic see Leite and Weidmann 2002). Often high-ranking politicians (presidents, ministers) control the earnings derived from the production and the export of natural resources such as petroleum, diamonds, copper, tin and other valuable mineral commodities. When these commodities are exported, the earnings may be difficult to precisely control, especially when there are inefficient checks on quantities exported and especially when the prices of the exports fluctuate even within short periods of time. At times these exports may be sold to foreign intermediaries at low prices and then resold at higher prices. The differences may end up in secret, foreign bank accounts of

political leaders. This is a classic example of “grand corruption” and is difficult to control in the absence of a democratic process and good systems of accounting and accountability.

Public Spending

Corruption connected with the use of public financial resources is very common and can take many forms. Some of these forms concern the activities of public servants at the low end of the bureaucratic scale, some concern higher levels of civil servants, while others involve political leaders. In all cases, the result is to increase public spending, reduce the efficiency of the public sector, and, often, reduce the growth of the economy. Corruption in public spending can range from the relatively trivial to grand misappropriation or great misuse of resources.

The “trivial” forms of corruption in public spending include public employees who: (a) receive a salary but do little work; (b) claim to be sick when in fact they are not; (c) appropriate public supplies for their private activities; (d) spend working time on private activities, and so on. These actions raise the cost of running a government and reduce its efficiency and outcome.

Beyond this form of trivial corruption, we begin to find less trivial examples such as (a) nepotism or clientelism, which may put unneeded or incompetent persons in particular and, at times, even sensitive jobs. These individuals can do damage that extends beyond the salary they receive; (b) ghost workers, who receive a salary without ever showing up for work or who may not even exist so that their wage is appropriated by someone else; (c) expenditure paid for services not performed or for supplies never received; (d) abuses in the procurement activities, by benefiting particular suppliers or, paying higher prices than necessary; and (e) diversion of funds toward extra budgetary accounts that are difficult to control and that serve non-official and non-legitimate activities.

Some of these forms of corruption are found in most countries, and a few countries experience most of them. The possibility of nepotism or clientelism in hiring has often led to policies that limit the freedom of managers to hire needed individuals. This freedom is often eliminated by bureaucratic and often ineffective civil service rules. These rules reduce the possibility of

introducing “value for money” performance criteria in public institutions. It also prevents the introduction of incentive systems for compensation or promotion.

The existence of ghost workers is often made possible by ineffective administrative controls. Often the workers are only partly “ghosts” because they may show up for brief periods and disappear for much of the time in order to pursue private activities. Ineffective administrative controls make it possible for some public officials to claim that they have made payments for supplies or services never received; or that have made payments for higher quantity or quality of services or supplies received. These problems have been reported in many countries, including advanced countries.

Public sectors need to buy supplies and services for their activities. Procurement operations provide a fertile ground for corruption because the private suppliers can inflate the prices for the goods and services provided by paying bribes to public officials. These practices can significantly increase the cost of running governments. To prevent these practices, governments at times introduce detailed rules and specifications on the characteristics of the goods to be bought. These specifications may reduce some abuses but they tend to increase the cost of the items bought. For example U.S. rules give 35 specifications of the way a mirror should break when it falls. Countries have tried to rely on open and transparent bidding on particular government contracts. However, bidding and public auctions may lead to collusion among bidders that may neutralize their positive impact. This is especially the case when participation in the bidding is restricted, for example by excluding foreigners. Procurement is an area that has been receiving considerable attention in many countries in recent years.

Public investment is an area of public spending in which corruption can and does play a major role. Public investments have many characteristics that expose them to the possibility of corruption. Each public investment has a high cost and must be approved by some public official. Many of its characteristics must be determined at some point such as size, design, location, quality of the work, and so on. The company that will execute the project must be selected; the price and timing of the work must be agreed; and the possibility of recontracting must be restricted to

prevent some bidder from winning a contract with a low bid that will be revised upward at a later time. The contract with the executor will need to include many specifications. Particular high level individuals in the government must make these decisions and must negotiate the contracts. The projects must be inspected to ascertain that their execution is living up to the agreed specifications and is not reducing the costs to the executing companies by reducing the quality of the project. All these steps may lend themselves to the payments of bribes.

There is evidence from countries that corruption has played a significant role in these choices so that money spent on public investments has given less benefit than expected. The world is full of so-called “white elephants,” projects built at high costs that have provided little or no benefits to countries (see Robinson and Torvik 2005). Often, the payment of bribes has been a determining factor in promoting these investments (see Tanzi and Davoodi 1998). In some cases, such as the building of roads or airports, the locations may have been chosen to promote the economic interests of particular high-level, political figures. Thus, in these cases bribes are not part of the act of corruption.

The budget cycle includes four stages (see Dorotinsky and Pradhan 2006). These include:

- (a) Budget formulation. At this stage it is often difficult to distinguish explicit corruption from policies that may depart from what could be called the “public interest.” Different forms of government create different opportunities for this departure. At this stage, when corruption occurs, it is likely to be “grand” or “political” and to reflect examples of “state capture.”
- (b) Budget execution. It has itself several aspects such as (i) cash management, (ii) commitments that can be formal or informal, (iii) verification; and (iv) payment authorization. In all of these phases there is scope for corruption when effective controls are not present.
- (c) Budget accounting and reporting. This phase highlights the importance of good statistical classifications to prevent, for example, the possibility that money allocated for education may end up being used for building swimming pools. This issue is important especially in countries with decentralized fiscal systems where the revenues are obtained by the central

government while some of the spending is done by sub-national or decentralized institutions. There has been a lively debate in recent years on whether fiscal decentralization and fiscal federalism reduces or increases corruption. This debate is stimulated by the fact that fiscal decentralization is a growing phenomenon (see Tanzi 1995; de Mello and Barenstein 2002; and Shah 2006).

- (d) Audits and oversight. This last phase of the budget cycle could be very important in preventing corruption but often it plays only a perfunctory function. Audits focus on legal or formal requirements rather than on the efficient use of resources. There is often little effective follow up to the formal oversight and the results obtained tend to have limited if any impact on the agencies controlled.

All four of these stages can be contaminated by corruption. Thus they must all be strengthened in order to create a “public financial management system” that prevents or reduces corruption. As with the revenue side, excessive complexity in the budgetary process, lack of transparency, lack of good classifications, and poor accountability are elements that contribute significantly to corruption. Complexity creates niches that lead to principal-agent problems. Lack of transparency reduces public scrutiny. Lack of full accountability reduces the incentive to perform in line with efficient and honest behavior.

Provision of Goods and Services at Below Market Prices

All governments provide some goods and services at prices that are below what the market would charge. In some cases (educational and health services) the prices charged may be zero. There is, thus, usually an excess demand for these goods and services and, as a consequence, the need to ration them. The task of rationing is often assigned to particular individuals who must make the decisions as to whom to provide the goods and services, when, and how much. In these circumstances, individuals will often try to get larger quantities of goods or faster access to services by attempting to bribe the public officials who make the decisions. Alternatively, the latter may request some payment for favoring particular individuals. This is an area where the need for effective controls is evident.

The areas most affected are (a) foreign exchange; (b) credit; (c) provision of electricity; (d) provision of water; (e) public housing; (f) underpriced consumption goods; (g) access to educational and health facilities; (h) access to public land. Another area in which corruption plays a role is in situations where private individuals or enterprises have performed services, for or sold goods to, the government. For these actions they are entitled to public reimbursement. Governments are often late in making these payments, because of their limited cash budget. Attempts to be put in front of the receiving line may lead individuals to offer bribes to officials charged with making these decisions; or it leads these officials to ask for bribes. In some countries this is a common situation.

Policies that control rents are a special category of this category of problems. In this case, the providers of the services (the houses that are rented) are private individuals; and the users of these services are also private individuals. Rent control policies create a special category of private sector corruption when those who have come into possession of rent-controlled apartments or houses sublet them to others at high rents. It has been said that there are two ways to destroy cities: either by bombing or rent controls. This may not be much of an exaggeration as inevitably policies of rent control lead to urban decay because the owners of the buildings have no incentives to make needed repairs. Rent control policies are not even pro poor because they tend to have a random impact on income distribution.

Other Discretionary Decisions

There are other decisions where the discretion left to particular public officials, combined with the value of these decisions to the beneficiaries of these decisions, create conditions that, in the absence of effective controls, often lead to corruption. There are many such areas in addition to those already mentioned. These include (a) decisions by public officials on the legal use of land, as with zoning laws. In this case public officials have the power to determine whether a particular piece of land can be put to low value uses, such as agriculture, or can be used for housing or even for high-rise apartments. Naturally the legal classification can change dramatically the market value of a piece of land; (b) decisions that authorize particular investments by foreign companies;

(c) decisions on the sale of public assets; (d) decisions that grant monopoly power for particular activities (such as importing medicines) to some individuals; (e) decisions that grant amnesties to particular individual or enterprises for significant legal violations; (f) decisions as to which bank will receive as deposit funds held by pension funds, public enterprises, ministries, or other public institutions. There is a lot of evidence that indicates that governments often let large deposits sit in accounts that do not pay any interest. This implies a large subsidy to the financial institutions that hold these funds. In many of these cases the value of the decisions to the private agents can be very large, while the decisions are made by public officials whose salaries are low and, because of this, may be more exposed to the temptation of bribes.

Other Factors

In addition to the factors mentioned above that may directly influence acts of corruption, there are other factors that can contribute to corruption indirectly. It is difficult to assess the quantitative importance of these factors but there is little doubt that they can be important in some countries. The following deserve to be mentioned.

Social status and traditions of public employees: When honesty and pride in belonging to a cadre of dedicated civil servants have characterized public service, and public employees command a high status in society, corruption is likely to be contained. This is especially the case when rules regarding hiring and promotions are considered fair so that the employees have been hired because of their ability and knowledge. However, when clientelism and nepotism prevail, and when the political affiliation of a public employee or his family background becomes an important consideration in hiring and promotions, this will lead to dissatisfaction that in turn will lower the morale and the ethical standards that guide public servants. These factors were stressed a long time ago by Max Weber (1947), the famous German sociologist.

Another factor mentioned in the literature, and that undoubtedly plays some role in influencing the behavior of public employees, is the level of wages that they receive compared with that received in the private sector. Populism has often forced governments to increase hiring in the public sector while reducing the real wages of those hired. In some countries public wages have

been reduced to levels that make it difficult for public employees and their families to maintain a decorous life consistent with their official positions. In these circumstances, there will be increasing pressures, on at least some public employees, to begin to do favors for citizens who repay them with other favors or with payment of bribes. Of course once some employees follow this path, others will be tempted to do the same. There are indications that public salaries tend to be high in countries where the perception of corruption is low. Some empirical evidence exists that has connected corruption to the level of public wages (see, for example, Van Rijekeghem and Weder 2002).

Another factor that has also attracted considerable attention in the literature on corruption is the penalty that is imposed on those caught in corrupt acts. There has been a tendency in this literature to apply to corruption theories developed by Gary Becker (1968) for criminal activities and by Allingham and Sandmo (1972) for tax evasion. The two theories, though applied to different areas, are similar. They both stress the trade-offs that exist between the probability of being caught, in an illegal or criminal activity, and the penalty that would be imposed in such an event. The theories argue that an increase in the probability of getting caught, or an increase in the penalty imposed once one has been caught, will make individuals less disposed to engage in illicit acts. A fall in the probability of getting caught or in the severity of the penalty will have the opposite effect. Thus, a morally neutral person that is guided solely by the expected economic benefit from an illicit activity will base his decision on these two variables.

Some economists have added interesting policy guidelines to this theoretical analysis. It has been argued that raising the probability of catching individuals engaged in illicit acts requires higher financial resources, because more policemen, comptrollers, or inspectors will be needed. Therefore, it might be cheaper to reduce administrative controls while compensating for this reduction by increasing the severity of the penalties. The assumption is that penalties can be increased without cost.

There are problems with the above analysis. First, it assumes moral neutrality. However, most individuals favor moral behavior and many would not commit illicit acts even when the probability

of being caught is low. Second, it is not true that there are no costs associated with higher penalties. Jails, or trials are costly and they are associated with higher penalties. Third, when penalties become high, they tend not to be applied. One reason is that if some people are caught while many others who are committing the same illicit acts are not, the imposition of penalties introduces a major problem of horizontal inequity. People committing the same crimes are treated differently. For this reason harsh penalties tend not to be applied. Fourth, in some undemocratic societies, when harsh penalties are possible, they may be applied selectively to political opponents. Thus, the penalties may become tools for repressive governments. Finally, in a society in which corruption is not a rare occurrence, those who must apply the penalties may themselves be corrupt. For example, surveys made by the Gallup Organization for Transparency International indicate that “judicial systems” tend to be among the most corrupt institutions. Thus, those who will apply the penalties, may be bought by those that ought to be punished especially when the latter have the financial means to pay large bribes. All this leads to the conclusion that, whenever possible, preventing illicit activities through better controls is always a better policy than relying on harsh penalties.

IV. SOME ECONOMIC CONSEQUENCES OF CORRUPTION

Market economies derive their legitimacy from the belief that the incomes that individuals receive depend broadly on what they contribute to a country’s economy. Large incomes are supposed to be the counterpart of large contributions to the economy. There are several reasons why this may not occur. The correlation between contributions to the economy and incomes received may break down because of monopolies, unearned rents, earnings from crimes, and so on. Corruption may be one of these reasons. Corruption may provide some well placed individuals with undeserved incomes. Thus, where corruption is predominant, it raises fundamental questions about the legitimacy of the existing economic system. Furthermore, there is growing evidence that countries where corruption prevails have greater difficulties to sustain growth and have more uneven income distributions.

There are now available various indices of corruption, such as the “Corruption Perception Index,” the “Global Corruption Barometer,” the “Bribe Payers Survey,” and other surveys by the World Bank, the EBRD and by other institutions. With the growing availability of indices of corruption, it can be shown that there is a negative correlation between the level of development of countries, measured by their per capita incomes, and the indices of corruption. There is also a negative correlation between indices of corruption and growth rates (see Tanzi and Davoodi 2001, 200). Naturally, these correlations, per se, are not proofs of cause and effect. In theory, the causation could go in both directions. However, lower corruption must make it easier for a country to grow and, as the country becomes richer, it might become more interested and more capable of dealing with corruption because it would have the means to build better institutions and to institute better controls. This issue has attracted some attention on the part of experts especially at the World Bank (see, for example, Kaufmann and Kraay, n.d.).

There was a time, decades ago, when some economists argued that, in very rigid economic systems, as developing countries were assumed to be, corruption could have a beneficial effect on economic activity because it could have the same effect as oil in a mechanical system. The payment of bribes could help remove obstacles to investment and to other economic initiatives, allowing the most profitable enterprises that could pay the highest bribes, to obtain needed authorizations to make particular investments or to undertake particular activities. The payment of bribes could also help to speed up procedures or decisions to obtain needed authorizations or permits. Furthermore, bribes operate as supplements to salaries and could keep the wages of public servants and, thus, taxes low. This benign view of corruption, that saw corruption as almost a growth factor is now largely discredited. Better information, more data, and deeper analyses of the effects of corruption have convinced most scholars that its impact on economic development is unquestionably negative. Many arguments have led to this conclusion. We shall mention only some of them.

Most students of corruption are now convinced that in many societies the existing rigidities, the ones that corruption is supposed to relax or remove, are not inevitable or God-given. They are in fact endogenous to the system. They are often created or hardened explicitly to create the

conditions that will make it possible for particular public employees to elicit bribes in order to remove the obstacles that they have themselves created. A good analogy would be that of an individual who blocks a road with an obstacle and then imposes the payment of a fee, to remove the obstacle, on those who want to use the road. These rigidities create veritable bureaucratic cholesterol that damages economic activities. They slow down or stop the flow of individual decisions and actions that are important for economic growth. They raise the costs of transactions, delay the taking of economic decisions, distort competitive markets, and generally reduce efficiency. In many ways they operate like inefficient and arbitrary or random taxes on economic activities.

A significant problem is that these negative effects tend to be particularly significant for small and new enterprises which, as is well known, are often the ones that provide dynamism and create employment for a country's economy. Small and new enterprises often lack the political connections and the political capital that protect the largest enterprises from the extortions that unscrupulous public employees often exert on economic agents. There are various surveys by the World Bank and the European Bank for Reconstruction and Development that indicate that, in the countries surveyed, the share of an enterprise's revenue that goes to the payment of bribes falls with the increase in the size of the enterprise. Large enterprises often have strong political connections and power that not only protects them from bureaucratic corruption but also allows them to extract rents through favorable regulations, subsidized credits, trade protection, tax incentives, and other measures. Small enterprises do not have this shield against corrupt officials. Thus, corruption operates like a tax that is regressive with respect to the size of the enterprise. When the tax is not only high and regressive but also random and capricious, the economic damage can be especially high.

A second way in which corruption may reduce economic growth is through the misallocation of talent (see Murphy, Shleifer, and Vishny 1991; and Baumol 1990). In most societies there are few individuals who have the talent to excel in almost any activity they undertake. Although talent is at times activity specific—Mozart could not be Shakespeare; Pelé or Maradona could not be Tiger Woods—often talented individuals have the capacity to excel in different fields. They choose the

field that will provide them with the highest benefits. When in a society the exploitation of political connections to get economic rents is the activity that generates the highest return to a person's talent, that person will choose this option over that of activities that could benefit a country such as managing enterprises, making valuable discoveries and so on. There is empirical evidence that in these circumstances there will be less engineers and more lawyers because the latter's skills are more useful for individuals who operate in these societies (see Tanzi and Davoodi 2001). In conclusion, the misallocation of talent toward rent-producing activities will have a negative effect on growth.

A third way in which corruption can have a negative impact on economic growth is through its effect on the quantity and quality of investment. Economic theory generally agrees that, ceteris paribus, higher investment leads to higher economic growth at least over a long, though not infinite, time period. This conclusion is backed by considerable empirical evidence. Thus, a reduction in the investment rate should lead to a reduction in the rate of growth.

A study by Mauro (1995) has shown that (a) corruption leads to a reduction in the investment rate; and (b) that the fall in investment leads to a fall in the rate of growth of countries. Over time, a lower growth rate leads to significantly lower standards of living for a country's population. A study by Wei (1997a) has shown that corruption leads to a reduction in the ratio of foreign direct investment (FDI) to GDP. Corruption tends to scare away foreign investors. Since FDI is important not only for the capital that it brings into a country but also for the new technologies that accompany it, it is evident that a reduction in FDI can reduce the growth rate. In another paper, Wei (1997b) has shown that the predictability of corruption is also important. Given the rate of corruption in a country, the more predictable is corruption; the lower will be its negative impact on growth. Thus, centralized corruption operates like a general tax that can be anticipated while decentralized corruption operates more like a random tax.

It has also been shown that corruption increases public investment but reduces the efficiency of that investment (see Tanzi and Davoodi 1998). Bad investments will be approved because some officials will get bribes from those who execute the projects or they will benefit directly from the

investments. Often less efficient companies and less optimal project designs will be chosen to carry out the investment. At the same time, expenditures for operation and maintenance (O&M) necessary to maintain the country's infrastructure in good working conditions will be reduced. There will be less money available and there are less opportunities for bribes in O&M expenditure. In conclusion, new unprofitable projects will be carried out while the existing infrastructure will be allowed to deteriorate.

There are other ways through which corruption may affect growth. These can be mentioned briefly. Corruption affects the composition of public expenditure. It also distorts the tax system. Econometric work by Mauro (1998) and by Tanzi and Davoodi (2001) has shown that corruption reduces public expenditure on education and health. Thus, it reduces the formation of human capital that is also important for economic growth. Tanzi and Davoodi (2001) have identified effects such as those on the level and the composition of the tax system. Corruption reduces the tax level, decreases the productivity of value added taxes and reduces the contribution of income taxes to tax revenue. Other authors have shown the impact of corruption on borrowing costs; on the safety of property rights; on the distribution of income, and on other variables. All these studies support the conclusion that corruption affects economic development in a negative manner.

V. COUNTRIES' ATTEMPTS TO REDUCE CORRUPTION

Naturally the attention that has been directed toward the problems created by corruption has led to attempts to reduce the scope of this problem. It is not possible in a short presentation to survey fully these attempts. They have ranged from international initiatives to promote integrity and ethics in international dealings to initiatives by specific countries.

The international initiatives have had two specific objectives. The first has been to level the global playing field so that multinational enterprises would face the same consequences, at least in theory, for acts of corruption. This levels the playing field for them so that enterprises that do not pay bribes do not lose out in their competitiveness. There was a time when American managers of enterprises could go to jail for paying a bribe to the official of a foreign country, while the managers of enterprises of other countries not only were not punished for similar acts but the

enterprises could treat the bribe as a business expense for tax purposes. International conventions have attempted to eliminate these anomalies. The second objective has been that of raising the sensitivity of those who operate in the international arenas to the problems caused by corruption. Attempts are being made to create “islands of integrity” by having corporations join virtual clubs of enterprises that make commitments not to pay bribes. It is an open question how effective these attempts are.

Perhaps, the initiatives at the country level are more interesting. A few examples will be mentioned.

Corruption has been a big issue in China. In 2006, its score on the corruption perception index (CPI) estimated by Transparency International was 3.3, on a scale in which 10 was no corruption and 1 was the worst score. It was at the 70th place among 163 countries. It had the same index and the same place as Egypt. China’s leaders have been making strong pronouncements against corruption and have been taking drastic punitive steps, including capital punishment, for some of those caught. So far these steps have had some positive but marginal results perhaps because the opportunities for, and the potential gains from, corruption remain very high. The chance of being caught also remains relatively small and there continue to be a perception among some observers that the penalties may, at times, be imposed politically, to get rid of particular individuals. It is clear that to continue with its high growth rate, China needs to do better on the question of corruption. The leadership seems to be aware of this.

Singapore is an interesting case because, within a generation, it has gone from being a normal, developing country, where corruption was common, to a country with one of the best scores on the CPI. In 2006, the CPI score for Singapore was 9.4 which placed it at the fifth place among the countries (behind, Finland, Iceland, New Zealand, and Denmark). This dramatic improvement was the result of several factors: (a) the example of the leadership; (b) the transparency of the rules and regulations that direct economic activities. This transparency has made Singapore one of the most competitive places in the world; (c) high salaries for public employees and high level officials that have reduced the “rate of temptation;” (d) zero tolerance for acts of corruption; and (e) the

existence of a powerful and politically independent anti-corruption commission that investigates any signals that it receives of possible acts of corruption and has the power to take measures without regard to political consequences and without any needed political authorization.

The role of a powerful and politically independent anti-corruption commission seems to have been very important in sharply reducing corruption in Hong Kong. The contrast between Hong Kong and China is striking. While the CPI in China, in 2006, was a low 3.3, in Hong Kong it was 8.3 placing it at the 15th place (between Canada and Germany) among the most corruption-free economies, compared with China's 70th place. The anti-corruption commission of Hong Kong is given an ample budget and wide and politically-free powers. The clarity of the rules and the limited role of the government are also factors that have helped. Hong Kong was not always a relatively corruption-free economy.

Perhaps the last example worth mentioning is that of Chile, a country that now has the best CPI score among developing countries. Its CPI score of 7.3 in 2006 places it at the 20th place among the 163 countries for which Transparency International has reported these indices. Chile's score is behind Belgium and Japan and just ahead of the United States. The Chilean achievement has much to do with the clear definition of the role of the state in the economy, with the transparency of its rules and laws, and with the attempt over the years of keeping politics out of economic decisions. For example, the tax administration of Chile has a high degree of political independence. Politics of course determines the tax laws. But these laws are not changed frequently and the tax authority administers them in a politically free environment. Chile can serve as a good example for other developing countries.

VI. CONCLUDING REMARKS

The purpose of this paper has been to survey issues related to the role of corruption in the economic activities of countries. Corruption also plays a large role in political activities. The "Global Corruption Barometer" of 2005, made available by Transparency International, lists "political parties" and "parliaments/legislatures" as the most corrupt institutions among countries.

This paper has focused on the economic and not on the political impact of corruption. Corruption delegitimizes the working of a market economy, as well as the outcomes of political processes.

This paper has highlighted ways in which corruption by distorting economic decisions and the working of the market economy inevitably reduces a country's rate of growth. The paper has also discussed some of the channels through which corruption distorts economic decisions. Finally, the paper has mentioned actions taken by some countries in their attempt to reduce corruption. It has stressed that the fight against corruption cannot rely on a magic bullet. It has to be fought on many fronts.

With a CPI score in 2006 of 3.3, Egypt is not among the most corrupt countries. However, it is a long way from being corruption free. It is evident that it would benefit by reducing corruption. That reduction could only come from major structural, political and administrative reforms, and from the elimination and simplification of many rules and regulations.

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PART II: DISCUSSION

CORRUPTION AND ECONOMIC ACTIVITY

Participants in the discussion that followed Prof. Vito Tanzi's presentation included Abdallah Shehata, Senior Economist, ECES; Abdel Aziz Hegazy, Former Prime Minister, Egypt; Ahmed Abu Shadi, Freelance Journalist; Faika El Rafeaie, Former Deputy Governor, Central Bank of Egypt; Ingy Tawakol, Journalist, Akbar El Youm; Karima Korayem, Professor of Economics, Al Azhar University; Mohsen Kandil, Arab African Publishers; Omaima Kamal Mohamed, Head of Economics Section, Akhbar El Youm; and Sultan Abou Ali, Professor of Economics, Zagazig University. The following is a summary of the discussion.

Moderator: Thank you for the comprehensive historical overview and perceptive insights on corruption, its causes, and ways to combat it. We will now open the floor for discussion.

Participant: I'd like to make three comments. You made the point that state control is linked to state corruption. I'd like to add that the spread of democracy has resulted in new forms of corruption. In poor countries bribes are paid to get votes to win the election so that those in positions of authority can make the policies they want. Similarly, in rich countries elections are financed by special interest groups to ensure that when their candidate is elected to office they will benefit from the laws (s)he passes. Therefore, the problem is not a matter of state control or democracy, but rather corruption and how it is done.

My second comment is regarding China. This country is a paradox. As you said there is corruption in China, but economically China is doing very well. It attracts FDI, especially from the west, and its exports and growth are rapidly increasing. It is a puzzle as to how it is doing so well considering that corruption should have negative effects on the economy. Economically, we can

look at corruption as a cost of production and if it is added to the very low cost in China, they can still do well and produce at a lower cost despite corruption. That is one possible explanation.

My third and final comment concerns countries, like Egypt, that are transforming into market economies and to democracy. The big challenge for these countries lies not only in overcoming corruption associated with state control or democratization but also in preventing corruption resulting from the collusion between money and authority. If I am rich and you have authority, we can trade off and become partners so that we both benefit. What are your thoughts on this?

Speaker: On the form of corruption related to democracy, Transparency International has hired the Gallup Organization to survey institutions that are corrupt in countries. They don't do it every year, but it has been done for a relatively large number of countries. One of the results of the survey is that the two institutions that are the most corrupt in most countries are parliaments and political parties. The list then goes down to include police, the health sector, education and so on. But consistently there were some countries that scored 4.5 percent in this area, in surveys in which 5 meant most corrupt, which raises a very embarrassing and difficult question. Can we say that if you eliminate parliament and political parties then you eliminate corruption? I would be very hesitant to give that interpretation. I would say that clearly democratic institutions seem to work very well in some countries including Denmark, the UK, Sweden, Canada, New Zealand and so on. But it doesn't seem to work well in other places.

One problem, and maybe this is related to that, is that political parties need money. I remember during the Italian crisis of 1992 the minister of justice in Italy made a speech at one point saying, with a straight face, that we have all these parties and I think he listed 120,000 people that were working directly for these parties. He was saying that someone has to pay their salaries, how do we get the money? If the government doesn't give them the money, as was the case in this particular instance, each party appropriated a state enterprise to transfer money to the party. So this probably leads to one question: whether the government should subsidize political parties. Once a party gets a certain proportion of votes, say more than 5 percent of the electorate, then should the government

somehow subsidize this activity to prevent the corruption that becomes an alternative to the subsidy? It is a problem. Bribes are a problem. To get elected you need a lot of money and this unfortunately is corrupting many. The Republican Party in the US conducted an examination into why they lost the recent election and two issues were important factors. One was the war in Iraq, clearly, but above that was corruption. This was probably linked to the need for candidates to finance their activities. If you want to run for president in the US you need billions of dollars and someone has to give this money to you.

On your point that China is doing very well economically despite corruption; China is clearly a challenge to all of us. Sometimes I joke that if China continues growing at this pace for the next several years we'll have to rewrite the laws of economics. One interpretation of this paradox is that there were so many inefficiencies in China in the past, that joining the market has created a tremendous possibility for productivity gains. You have a situation where you have a billion people that you can bring to the cities and pay them very low salaries. The Chinese are very hard working people and culturally very sophisticated, so it takes little time for a bright person to learn a new activity and you're paying a very low salary. We'll have to see how it works out in the long run, but China is clearly a challenge to all of us.

Participant: I think one of the great things about events like this is that they foster cultural interaction and the exchange of views in order to address the so-called clash of civilizations. In this respect, I would like to bring to your attention that the Koran 14 Centuries ago has had 38 verses condemning corruption and Muslim scholars have also condemned corruption in many writings. Perhaps you would like to elaborate on that in your paper as part of your historical overview.

You distinguish between legal and illegal corruption. I would like to draw your attention to a distinction in Egypt that may also seem contradictory, which is between good corruption and bad corruption. Bad corruption refers to the fact that the people who are corrupt enjoy it, and those who are outside the circle of corruption are just waiting for the day that they can enter that circle. On the other hand, good corruption can be seen when people on the outside are condemning it and those

inside are looking forward to a time when they will get out of the circle and the country will be rid of corruption.

One last point I have is the effect of corruption on growth. One of the mechanisms you referred to is the effect of corruption on information asymmetry, the adverse selection of projects and moral hazard. The literature says that there is an inverse relationship between corruption and growth and maybe the pass-through mechanism is adverse selection and moral hazard. I would like to think the reverse in the sense that if corruption entails the transfer of resources from public sector to private sector, and if it is true that the private sector is more efficient than the public sector then it might have a positive effect on the rate of growth. Of course it is not a one-to-one correspondence because the process of growth itself is very complex, but this is worth thinking about.

Speaker: Legal corruption is something that is starting to worry me more and more. I see elements of this and the problem is the link between complexity and legal corruption. Legal corruption can manifest itself in two different ways. It can come through state capture whereby a political group captures the state and they can promote the laws and regulations that favor their activities. This can be done completely legally using the framework of the state. Legal corruption can also come by exploiting complexity and that's one of the problems. The question asked about income distribution is really tied to this. The truth of the matter is that the tax system and legal system is very complex. What happens is that if you are rich you hire a top lawyer who is extremely smart and can argue the case, exploiting all the complexities of the law. If you are poor, you cannot hire a top lawyer. So this becomes a problem in that context between those who have a lot of money and those who do not.

On the relationship between corruption and growth, would transferring resources from the public sector to the private sector be beneficial? I'm sure one could build a model in which this happens; if you take revenues from the production of oil and these revenues would've stayed in the government that would've wasted them for military expenditure or for hiring people that will vote for the government, clearly, if you transfer these revenues to the private sector this can enhance the

situation. The closest case I can think of regarding this situation is Russia, where the oligarchs appropriated much wealth from the state, but now they are becoming more and more efficient and the Russian economy has been doing fairly well. In theory this is the case, but it depends on the kind of corruption we're talking about such as bureaucratic corruption which is simply lining the pockets of the public employees. Nobel prize-winning economist Gary Becker wrote a paper in which he argued that when you have bureaucratic corruption the state can reduce wages and thus taxes that would be one way of transferring resources to the private sector.

Participant: I appreciate the fact that we seem to be speaking very frankly and openly about the issue of corruption. Last year Egypt was ranked 74 and it has improved a bit this year to 72, but I think corruption still runs very deep. I'd like to discuss the corruption network in Egypt in that corruption is not an individual action but a complex network from the very top of a company to the bottom. I wonder if from your experience you have any suggestions for tackling this network, especially in the public sector.

My second point is related to FDI. As you correctly mentioned, corruption can deter FDI and foreign investors have to take into consideration not only the legal actions that need to be taken to get approval for investment, but must also evaluate what must be paid under the table. What is the role of foreign investors and the embassies or agencies to which they belong in disclosing such information? I'm asking because I've heard from many embassies that investors would like to invest but when they discover the corruption they withdraw. I asked why they weren't disclosing this to the government and they've said that it is a very politically-sensitive issue and they don't want to create problems. I would like you to suggest some kind of mechanism or action that will allow foreign investors to expose the problems and corruption they face in the country.

Speaker: On Egypt and the slight improvement in the ranking, I really don't know much about Egypt and it wouldn't be appropriate for me to make a judgment. However, the corruption network is clearly an interesting concept. Honestly, I've not seen it discussed in any paper so I would like to

see some literature on this. A corruption network would probably be part of the centralized corruption that I was talking about in the lecture, when operators know the exact pattern of corruption and know who to approach.

The question about foreigners not being more open to report corruption is a very good one and I don't know the answer. There may be legal reasons and challenges brought to court requiring evidence of wrongdoing. If you meet someone and they ask you for a bribe but you have no useable evidence it is your word against that person's. They could sue you and if the person is very powerful you might be prevented from working in that country in the future. So this is perhaps a reason why they don't report corruption.

Participant: There is no doubt that there is a link between power and wealth in the prevalence of corruption. One important issue that you did not address in the lecture is the link between income distribution and corruption. Could you elaborate more on this?

Another issue that is related to developing countries is how the system is managed to promote corruption. Those in power know that they can stay in power by corrupting the people around them and manipulating the system. One example of this is in the Palestinian Authority, where it has been written that the former president of the Palestinian Authority was running the system by corrupting the people around him. In fact, he had to corrupt them in order to manage the system.

The last issue I'd like to discuss is the ethical code and corruption. Laws are not enough to fight corruption. Society should abide by an ethical code so that people will fight corruption on their own.

Speaker: There is a study published by the International Monetary Fund that econometrically links corruption with income distribution; the more the corruption the worse the income distribution. See Gupta et al. (2002) This makes a lot of sense. The people who take advantage of corruption are not the people at the bottom of the ladder. If you are poor or working in the informal sector there is no

way that you can take advantage of corruption. Corruption is related to moving up the income scale. This goes back to the allocation of talent that I was discussing earlier. People who have a particular talent and who are very bright choose certain patterns of behavior that allow them to get access to higher incomes. Then you can see that there is a connection.

Regarding the Palestinian Authority managing the system through corruption, I don't know much about this issue other than what I've read in the newspapers. However, I do know the system that prevailed in Congo during Mobutu's time, where corruption was used to buy power. There was a time that the president was appropriating 6 percent of GDP from the Congolese budget for his own budget—the presidential budget. When Mobutu died there was an assumption that he had billions of dollars all over the world, but he probably had spent all of it to stay in power. So clearly there is a link between power, wealth and corruption.

I fully agree that laws are not enough to fight corruption. An ethical code is also necessary.

Participant: I'd like to discuss the idea of corruption, ethics and religion. There is a change in the social strata of communities now. With all the developments of a market-driven economy there is an increasing gap between the higher and lower classes. However, corruption is not limited to the lower level of civil servants but is also present in the upper classes, be it business or political. Is corruption related in any way to the failure in implementation of the code of ethics in religion?

Also, you talked about preventive measures. I think that the regular change of governmental/political positions is very important, because that at least brings about more transparency. However, the current structure of government organization contributes to corruption because officials stay in their positions for long periods. If a country does not have a well-established organizational structure it will lead to corruption.

Speaker: Clearly ethical codes are as valuable as people and their spiritual and political leaders make them. If there is no penalty behind the code then laws are irrelevant since some people are naturally law-abiding and some are not.

I'd like to address your point regarding the length of power. In some countries they've adopted the figure of the "prefect," which is a French institution going back to Napoleon that allows the central government to appoint people to run the regions. The prefect is the representative of the central power at the regional level. When you don't have a formal fiscal federalist system, people are appointed to these positions. In some countries there are explicit laws that prevent prefects from staying more than a certain period of time in one place. The more time passes, the more familiarity develops and the closer one gets to people; and familiarity often breeds corruption. Clearly, to have a system whereby people rotate, and no one stays as a minister for 20 years, could be helpful. Some might challenge this by saying that if one is in office for a short period of time, he may take advantage, knowing that he is not going to be there for long. I tend to agree with the first position, that when one stays in power for too long, problems begin to appear.

Participant: Could you please discuss how the share of the public sector in the economy affects the level of corruption? This is of particular importance to us in Egypt. Also, I would like your views on the level of democratization and how it affects corruption.

Speaker: One has to be careful when discussing the share of the public sector in corruption. There was a famous column in *Business Week* by Gary Becker arguing that the larger the public sector in the economy, the higher the level of corruption. This was because it gives you more access to public spending, taxes and all the reasons I mentioned earlier. At the same time, there is evidence that the countries with the largest public sectors in the world—Denmark, Sweden and so forth—also have the lowest index of corruption. So my view is that corruption is more related to regulations, authorizations and other such things that do not necessarily involve public spending. If public spending is simply for teachers, doctors and so on, and it is legislated in parliament and

subject to good accountability, then there is no reason why higher spending should lead to corruption. Democratization with transparent and full accountability should reduce corruption and especially grand or political corruption. But at times, political processes are not transparent and full accountability is missing.

Participant: My question is about the role of society in combating corruption. I don't believe it is sufficient to simplify regulations and laws; there should also be a way that allows peoples' voice to be heard. Could you please explain to us how we can create a framework to promote that role?

Speaker: Again we come to the question of whether one should establish appeals offices or politically independent anti-corruption commissions with enough power to listen to complaints and do something about them. The problem is that very often those who commit acts of corruption don't leave any trace of it. Sometimes they have a lot of political power so that if you challenge them, you open yourself up to threats or counter accusations and it becomes difficult to get much out of this channel. Clearly, there should always be an effective appeals process. In fact, I make the point strongly in the paper. In some countries if you go to have a blood test, you cannot get the results unless you bribe someone. In a survey of India done by the World Bank, they found that if your child gets ill and has to go to the hospital you are not allowed to visit the child without bribing somebody. In these cases, clearly, there must be an appeals process, but one that works. Sometimes the appeals process becomes corrupt itself or it becomes ineffective.

Participant: The Egyptian Prime Minister has announced that this year's annual growth rate has increased to 6.9 percent and the Minister of Trade and Industry announced that foreign direct investment has reached LE 6 billion, and that FDI (excluding the petroleum sector) has increased by 240 percent compared to that of last year. According to the findings of your paper, can we therefore assume that corruption in Egypt has decreased this year?

Speaker: You cannot generalize the relationship between corruption and investment by looking at one year in one country. Typically, studies take many countries and run regression analyses. The fact that one particular country's investment went up in one year, when perhaps corruption didn't change does not tell us very much. Maybe oil was discovered in that particular year; or maybe tourism was going up and foreign companies invested. So it is very difficult to answer.

Participant: Does absolute power create bribery and therefore lead to corruption?

Speaker: If you have an authoritarian government you have “grand corruption” and “state capture”—a group or political party captures the state and legislates whatever they want. This is a form of legal corruption on a grand scale. It's still corruption in my judgment, but it is no longer someone violating the law because the law may simply be designed to allow these people to do what they wish. They can change the laws to their advantage.

I'm a believer in democracy. As Churchill once said, democracy is a terrible form of government, but compared to all the others it's not so bad. Of course, it requires a lot of time and effort to make it work. You cannot simply call something a democracy and assume that problems will disappear.

Participant: Could you please elaborate on the various measures of corruption such as the World Bank's control of corruption index?

Speaker: In my view, there is no way to measure corruption. An “objective measure” of corruption does not exist and cannot exist because you don't know what you'll be measuring. If you're measuring the payment of bribes by adding all the bribes paid, sometimes bribes are not paid in cash but favors are exchanged. If you count the acts of corruption, as every time someone asks for something, you may be counting lots of little insignificant things and might be missing much larger exchanges. Therefore, this would not work as a measure.

Measuring corruption is now mostly measuring perceptions. The best known index is by Transparency International. If you go to www.transparency.org you'll find a lot of information and the latest survey covering about 170 countries and going back to 1995. These surveys are based on polls of people who are operating in the economy. They ask stockbrokers, investors and others questions about these countries and ask them to rate their answers on a scale of one to ten. They get hundreds of answers, average them out, and get an average and a standard deviation of the answers. There is another index called the Bribes Payers' Index that asks foreign investors how many times they've been asked to pay bribes.

There are other forms of measuring corruption, for example, corruption of the tax authority. In some countries they've taken towns or regions and surveyed groups of taxpayers as to how many times they've been asked to pay a bribe. Then they compare one region with another to determine the level of corruption among tax inspectors in different regions or districts.

There are also data from the World Bank. There are data from the European Bank for Reconstruction and Development about transition economies. But, to repeat, the most accessible and best known data are from Transparency International, which also reports surveys by Gallup Polls. The Gallup Polls ask people to rank, from one to five, the degree of corruption in institutions including parliaments, political parties, judiciary, schools, health sectors, police and so on. This is useful, but the results should always be taken with a grain of salt because you cannot completely trust what people are saying. Sometimes people have the impression that everything is corrupt when in fact it may not be. I was in Russia at a conference on corruption last year and there was a big discussion among Russians there. Somebody made the statement that the school system was all corrupt. There were two or three people who had been professors at universities there for many years who stated that in all that time they had never been approached by anyone for corruption. So you don't know whom to believe.

Participant: How can we combat corruption if the government itself does not punish its employees, but instead transfers them if they're proven to be corrupt? How can we combat corruption when all transactions are dealt with through bribes?

Speaker: I can only repeat what I said earlier. If I were in a country and I were going to make a list on what the country should do to fight corruption, I would start with the leadership and see if there are examples of corruption at the top because the leaders have to give the signals and lead by examples. Then I would begin to look at the elements that can lead to corruption such as regulations and authorizations. I would look deeply into that.

One time I was leading a mission in a country to advise on the issue of tax reform and we were asked to meet with representatives of the private sector. We met with a group of very distinguished-looking and articulate individuals. We soon discovered that they were not at all interested in discussing taxes, they were interested in talking about authorizations which were a bigger problem for them than the tax system. They needed authorizations for whatever they needed to do and often they would wait and wait for a reply. The implication was that if they didn't bribe somebody, they could wait for years. Authorizations may not be an issue in another country, but taxes, regulations, government spending or procurement may be problematic. In sum, you really cannot fight corruption by taking just one road. You have to do it on many fronts. A war is won on many fronts and not in a single battle.

Moderator: Thank you very much for your thoroughness in answering questions and for your insightful lecture. I would also like to thank all participants for their relevant questions on this important issue.

LIST OF ATTENDEES

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Distinguished Lecture Series

In this distinguished lecture, world-renowned economist Vito Tanzi surveys issues related to the role of corruption in *economic* activities. Besides highlighting the various factors that contribute to a climate that makes corruption prevalent, he discusses some of the channels through which corruption distorts economic decisions, and impacts negatively on the level of economic growth.

In addition, he sheds light on actions taken to reduce the scope of corruption, ranging from international initiatives to promote integrity and ethics in international dealings to initiatives by specific countries. To conclude, he stresses that the war against corruption cannot rely on a magic bullet but has to be fought on many fronts, including major restructuring, political and administrative reforms, and the elimination and simplification of many rules and regulations.

This publication is the twenty-sixth in the Distinguished Lecture Series published by the Egyptian Center for Economic Studies