

Vito Tanzi  
Former Director of the Fiscal Affairs Department  
International Monetary Fund

## Corruption and the Economy

**Abstract** *This paper focuses 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 highlights 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 also discusses some of the channels through which corruption distorts various economic decisions. Finally, the paper reports on some actions that have been taken by countries in their attempt to reduce corruption stressing that the fight against corruption cannot rely on a magic bullet but has to be fought on many fronts.*

**Keywords** *Economy, Corruption, Economic Development, Public Policy, Bureaucracy.*

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### 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* that means to break. It implies that something is broken, normally, in the case of acts of corruption, a code of conduct or a behavior considered by the relevant community as correct and proper. The connection with a Latin word is appropriate because, according to some students of corruption, it was in the Roman Empire that corruption came to be identified, perhaps for the first time, as clearly inappropriate behavior; and it was the Roman Empire that, some historians argue, disintegrated because of the corrosive impact that corruption had on its institutions and on its leaders. Corruption weakened or destroyed the moral fabric and the administrative structure of that powerful empire, eventually leading to its collapse.

There have been frequent mentions of corruption through history. A very early and often-mentioned 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 makes several references to it. Dante, the great 13<sup>th</sup> century Italian poet, author of *The Divine Comedy*, placed corrupt people in the deepest levels of Hell. The strictly negative view of corruption continued to prevail through the centuries, until relatively modern times. The American Constitution, for example, explicitly mentions two crimes that can justify the impeachment of a president. These are: treason and bribery (See Noonan Jr. 1984).

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In the 19<sup>th</sup> century, attitudes toward corruption became somewhat more relaxed and seemingly more tolerant. There are increasing references to it in literary works and even in some operas. Though these references do not condone corruption, they do not seem to carry the strong moral condemnation that had characterized the attitudes in earlier centuries. For example, there are references to it in books such as Henry Adams' novel, *Democracy*, and in Puccini's opera, *Manon Lescaux*. Corruption became almost a natural or even expected characteristic of behavior in the new bourgeois society that accompanied the Industrial Revolution when the role of the state in economic activities had started to grow. This more relaxed attitude continued in the 20<sup>th</sup> century, when, at least in some countries, corruption became prevalent and began to create serious difficulties. 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 relatively few writings on corruption and they were predominantly written by political scientists, rather than by economists. Few economists had paid attention to it, with two significant exceptions: Rose-Ackerman (Rose-Ackerman 1978) and Robert Klitgaard (Klitgaard 1988).

In the 1990s, and especially in the second half of that decade, corruption suddenly became a hot topic, both academically and politically. Several reasons can be mentioned for the increased attention paid to corruption (see Tanzi 1998), including: (a) the end of the Cold War; (b) the spread of democratic regimes and the increasing role of the (free) media; (c) increasing globalization and the international contacts that it promoted between individuals from different countries; (d) the growing role of non-governmental organizations and of "civil society;" (e) the increasing attention paid by international institutions and some governments to corruption; and (f) growing concern about the economic distortions and inefficiencies that acts of corruption can

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 especially in the economies that were closed and not market oriented. Finally, major political scandals connected with acts of corruption, in Japan, Italy, France, Germany, Brazil and some other countries, made corruption a front page story in major newspapers.

Another factor that may have contributed to both corruption and to the awareness of it, especially over the later decades of the 20th century, was the progressively larger economic roles that governments were assuming, compared with earlier periods. This larger role was played by governments through the use of various instruments, including public spending, taxes, various forms of regulations, certifications and authorizations, and through 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 the individuals who were charged with carrying out these activities or monitoring them. When this public power given to government employees is accompanied by some power of discretion, over particular decisions, unscrupulous employees are given a tool that they can use to extract bribes or to benefit themselves in other ways.

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Attempts to scale down the government role in some countries, through policies of privatization and outsourcing, may also have contributed to corruption or, at least, to the perception of corruption. This happened, for example, in Latin America where, following the guidelines of the so-called “Washington Consensus,” many public enterprises were privatized in the decade of the 1990s. The popular reaction to this privatization was generally negative in part because it led to higher prices (but often for higher quality services), and because of widespread perception that the policymakers, who were charged with pursuing the policies of privatization, got bribes in the process. When a public enterprise is privatized, there is no reference or available 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 of the enterprises’ liabilities, such as the pension obligations for retired workers, or the retention of unproductive workers. Thus, there is often no way of refuting accusations that the

enterprises have been sold at too low a price because of bribes paid to some individuals.

## II. Difficulties in Defining Corruption

Corruption comes in many shapes and forms (see Tanzi 1995). Like elephants, it may be difficult to define, but it ought to 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 or different communities may interpret particular actions differently. In the 1990s several international organizations started to discuss the corruption problem in international forums, in order to define it and to attempt to coordinate policies and 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 that would be precise and especially 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, or the treatment of particular individuals.

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The definition of corruption has been generally associated with the absence of *equal* and *fair* treatment for all individuals on the part of public officials, unless where the laws specifically require a differentiated treatment, as for example for disabled individuals. This equality of treatment implies the application 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 or religious 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 some citizens, he is abandoning the arm's length principle and he may be engaging in acts of corruption.

It is easy to see how the arm's length principle can conflict with traditions and 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 impersonal and 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. In some countries gifts are common and expected. They often become hidden bribes.

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 particular attention and protection from acts of corruption. A full discussion of these forms is beyond the scope of this paper. However, some broad classification may 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.

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The phenomenon of corruption is often 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 shareholders who own shares (and thus own a piece of the corporations) but play no role in running the enterprises. To some extent these shareholders find themselves in the same situation that many citizens find themselves *vis á vis* the state. These corporations are normally run by hired professional managers and employ workers 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 or the same space to abuse their public power (within the corporations) 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, as, for example, 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 has happened in several other enterprises. Corporate scandals have become frequent

in recent years, because the market economy has been creating “public” spaces within enterprises where acts of corruption have become possible. Therefore, the spotlight for identifying corruption should not be limited to the government activities and to the public employees, but should also cover activities in particular private sector areas. The financial market, the health sector, and professional sports have become clearly part of these sensitive areas. Major acts of corruption have been frequently reported in these sectors of the (private) market.

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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 over the years 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 parties) is very common around the world.

The above discussion suggests that we could distinguish between public sector corruption and private sector corruption. As mentioned, over the years the attention has been mostly directed toward public sector corruption. However, in more recent years, and especially in the United States and in some other industrial countries, corrupt activities in different parts of the private sector have become more frequent and have started attracting some attention.

Private sector corruption may in turn 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 or rules but that, in intention or in results, are no different than the 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 may be that of heads of corporations (CEOs) that appoint individuals to the corporate boards knowing that they are likely to authorize very generous, and often nontransparent, and complex compensation packages for the corporate heads. Or, take for instance, individuals who lobby politicians

and regulators to get favorable regulatory decisions that may be advantageous to them or to their clients, but that may be damaging to citizens. An area where this has been happening with a certain frequency is in the approval of medicines that may have significant and dangerous side effects. Or take accounting firms that become accomplices to accounting maneuvers, which allow company managers to hide the true financial position of an enterprise. Or take 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 some associates maintain their power and become rich. This form of “state capture” leads to questions about whether, following the “rule of law”, as many advocate is *always* a good thing. In some cases the “rule of law” is respected but the laws may have been specifically designed to benefit particular individuals or groups. This manipulation of the laws 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 perhaps because it is the kind of corruption encountered by most citizens. It is the kind of “detail” or “small change” corruption prevalent in many countries and that is facilitated by many bureaucratic rules. Government regulations and authorizations are often the major ingredient for this form of corruption. The more widespread is the use of permits and authorizations in a country, the more prevalent tends to become 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 for a permit,

and whether a request will be accepted or not—to elicit bribes that might 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 a “bureaucratic cholesterol” that tends to strangle economic activities and that reduces the efficiency of a country’s economy.

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 (say in the health and the educational sectors) and the receiver of the service.

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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 can contribute to a climate that makes corruption prevalent. Examining some of these factors may help in identifying measures or policies that could 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 actions or activities, because the employees acquire the power to approve or disapprove requests for particular actions by citizens and by enterprises. Such requests may involve getting a passport for foreign travel, getting a permit to build a house or to make some modification to existing houses, to open a shop or a new 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 required 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, and the more power they acquire and, in the absence of strict controls on them, the greater will be the probability that they will be tempted by and engage in acts 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. Public employees may also intentionally slow down the approval process, to encourage the offer of a bribe, 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 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.

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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 enduring or, at least, 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, 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 directly contributes the most to corruption. The less discretion is given to the 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.

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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 becomes frequent, corruption rises. The same may happen when there are revolving doors in the sense that at times the regulators switch to better paying jobs outside the tax regulating field. This has been a problem with regulatory agencies and tax administrations that occasionally lose personnel from regulating activities, only for those employees to then use the knowledge they have acquired to get around regulatory obstacles or payment of taxes.

### 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. This happened on one occasion in Peru. 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 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 fundamental 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 easily measurable tax bases gives discretionary powers to the tax inspectors, who deal with particular taxpayers. Close controls at times breed proximity and familiarity between taxpayers and tax administrators. This in turn can lead to favors, requests or offers of bribes in exchange for lower tax payments.

When countries become more developed, it becomes easier to identify tax bases, because the incomes, or the sales, originate in larger establishments (e.g., enterprises, supermarkets, banks) that keep better accounts. It also becomes possible to collect taxes at the source, by withholding them, thus eliminating the physical contact between inspectors and taxpayers. The difficulty in identifying objective tax bases has been particularly significant in the customs administrations where corruption is often rampant. In the absence of verifiable invoices presented by importers, import duties are calculated based on the value of imports determined by customs inspectors. Inspectors can close their eyes to goods smuggled in, or give them a classification that lowers the duties owed on them. In these and other ways, customs officials can reduce the tax payment in exchange for bribes.

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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 reduce its tax liability by large amounts. It may, thus, be difficult to resist offering a bribe to the officials that make certain decisions. When the tax liability, without the tax incentive, is high and the salary of the tax officials is low, the probability of corruption will rise. Thus, once again, transparency of laws and of 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 or of effective controls within the tax administration may help.

Before leaving the area of public revenue, it may be worthwhile to mention the corruption that is related to the appropriation, or better yet, the stealing of public revenue from the exports of government-owned mineral products (see Leite and Weidmann 2002). Often high-ranking politicians (presidents, ministers) have the power to 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 control precisely, 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 at low prices to foreign, controlled intermediaries, and then resold at higher market prices. This operation is at times defined as “tolling”. The differences in earning may end up in secret, foreign bank accounts of political leaders or other relevant individuals. This is often a classic example of “grand corruption”. It is difficult to control in the absence of a democratic process and good systems of accounting and accountability.

### Public Spending

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Corruption connected with the use of public financial resources (with public spending) 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, such as the stealing of pencils by government employees, 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 some 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, there are less trivial examples such as (a) nepotism and clientelism, which may in some cases put unneeded or incompetent persons in particular and, at times, even sensitive jobs. These individuals can cause damage to society, which extends well beyond the salary they receive; (b) ghost workers, who are individuals 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; (e) diversion of

funds toward extra budgetary accounts that are difficult to control and that serve non-official and non-legitimate activities; or (f) ghost pensioners, who are dead or non-existing individuals who may receive public pensions.

Some of these forms of corruption are found in most countries, and a few countries experience most of them. The possibility of hiring based on nepotism or “clientelism” has often led to policies that limit the freedom of managers to hire the most needed individuals. This freedom may be eliminated by bureaucratic and often ineffective civil service rules (for example promotions strictly based on seniority) that, in turn, reduce the possibility of introducing “value for money” performance criteria in public institutions and 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 during the time they should be working for the government. Ineffective administrative controls make it possible for some public officials to claim that they have made payments for supplies or services that were never received; or that have made payments for higher quantity or quality of services or supplies than effectively received. These problems have been reported in many countries, including advanced ones.

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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 that may in turn support political parties. Transparency international reported, for example, that after the “Tangentopoli” scandal, in Italy in the early 1990s, the cost of digging one kilometer of underground railway in Milan fell by 50 percent. These practices can significantly increase the cost of running a government. To prevent them, governments, at times, introduce detailed rules and specifications on the characteristics of the goods to be bought. These specifications may reduce the 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 bought by the government 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.

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Public investment is an area of public spending in which corruption can and does play a major role. Public investments have 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 revising the contracts to introduce modifications to the projects that the government may require must be restricted to prevent a bidder winning a contract by submitting a low bid and then requiring a more expensive payment at a later time. The contract with the executor will need to include many specifications to accommodate unexpected events. Particular, high level individuals in the government must make some of these decisions and must negotiate the contracts. The projects must be inspected to ascertain that their execution is consistent with the agreed specifications and that the executor is not profiting 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 provided 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 the payment of bribes may not be part of the act of corruption but corruption has still played a role.

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

- (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” corruption 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 has been a growing phenomenon promoted by institutions such as the World Bank. (See Tanzi 1995; de Mello and Barenstein 2002; and Shah 2006).

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(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 to the citizens at zero prices or at prices that are below what the market would charge. In some cases (educational and health services, public housing, food stamps) 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 and when to provide the goods and services, 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.

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The areas most affected are (a) foreign exchange; (b) subsidized credit; (c) provision of electricity; (d) provision of water; (e) public housing; (f) underpriced consumption goods; (g) access to education and health facilities, especially surgery; (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. However, governments are often late in making these payments, because of their limited cash budget. Attempts to be put in the 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 the rents for privately owned houses or buildings are a special type 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 the legal use of rent-controlled apartments or houses are able to sublet them to others at high rents as it often happens. It has been said that there are two ways to destroy cities: either by bombing them or by subjecting them to rent controls. This may not be much of an exaggeration as, inevitably, policies of rent control lead to urban decay, because the private owners of the buildings have no incentives to make needed repairs. Rent control policies do not even benefit the poor, because they tend to have a random impact on income distribution.

#### Other Discretionary Decisions

There are instances when discretion given to particular public officials, combined with the value of their decisions for beneficiaries, 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. The legal classification can dramatically change 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 funds as deposit held by public 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 in private banks that do not pay any interest. This amounts to 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.

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### 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 characterizes public service, and when public employees command a high status in society and decent salaries, corruption may 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 merit. However, when clientelism and nepotism prevail, and when the political affiliation of a public employee, or his/her family background, becomes an important consideration in hiring and promotions, this will lead to dissatisfaction that will in turn lower the morale and the ethical standards that should 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 a role in influencing the behavior of public employees, is the level of wages that they receive compared with that received in the private sector. Over many years there has been a lowering of the wages received by public employees, compared to those 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 is increasing pressure, on at least some public employees, to begin to do favors for citizens who repay them with other favors or with the offer of bribes. Of course once some employees follow this path, others are 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 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 acts of corruption. There has been a tendency in this literature to apply to corruption theories developed by Gary Becker (Becker 1968), for criminal activities, and by Allingham and Sandmo (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 drop in the probability of getting caught or in the severity of the penalty will have the opposite effect. Thus, a morally neutral person, one guided solely by the expected economic benefit from an illicit activity, will base his or her 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 are 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 (though not all) 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 among individuals. People committing the same crimes are treated differently. For this reason harsh penalties often tend not to be applied by judges. Fourth, in some undemocratic societies, when the application of harsh penalties is possible, the penalty 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 bribed 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.

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#### **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 correspond to large contributions to the economy. There are several reasons why this may not occur. The correlation between contributions to the economy and the 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.

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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 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). Naturally, these correlations, per se, are not proof 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, internet).

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 had more money to pay the highest bribes, to obtain necessary authorizations to make particular investments, or to undertake particular activities. The payment of bribes could also help speed up procedures or decisions to obtain needed authorizations or permits. Furthermore, bribes might operate as supplements to salaries thus keeping the wages of public servants, as well as taxes, low. This benign view of corruption, in which it is 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 make it possible for particular public employees to elicit bribes, 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 a specific activity—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 for 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 fewer 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.

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A study by Mauro (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 (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 (Wei 1997b) had shown that the predictability of corruption is also important. Given the rate of corruption in a country, the more predictable corruption is (i.e. the more centralized it is), the lower 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 that is less easy to anticipate.

Some studies have 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) that

are necessary to maintain the country's infrastructure in good working conditions will be reduced. There is less money available and there are fewer 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 (Mauro 1998) and by Tanzi and Davoodi (2001) shows 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.

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## **V. Attempts to Reduce Corruption**

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

The international initiatives have had two specific but distinct objectives. The first has been to level the global playing field in the international sphere, so that multinational enterprises would face the same consequences, at least in theory, for engaging in acts of corruption. This leveling of the playing field would allow the enterprises that do not pay bribes not to be disadvantaged in their competitiveness. There was a time when American managers of enterprises could go to jail for paying bribes to public officials of foreign countries, while the managers of enterprises of some other countries would not only not be punished for similar acts but their enterprises could treat the bribes paid as business expenses that were deductible for tax purposes. International conventions and

agreements 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 that are caused by corruption. Attempts have been 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.

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Corruption has been a big issue in China for which the score on the corruption perception index (CPI), estimated by Transparency International, has been low. China’s leaders have been making strong pronouncements against corruption and have been taking at times drastic punitive steps, including capital punishment, for some of those who get caught. So far these steps have had some positive, however marginal, results, perhaps because the opportunities for, and the potential gains from, corruption have remained very high. The chance of being caught must also have remained relatively small. The perception among observers persists to be that the penalties may, at times, be imposed for political purposes, to get rid of particular individuals. To continue to sustain its high growth rate, China will need to do better on the question of corruption. The leadership seems to have become aware of this.

Singapore is an interesting case because, within a little more than 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. This dramatic improvement was the result of several factors: (a) the example provided by the leadership; (b) the transparency of the rules and regulations that direct economic activities and that has made Singapore one of the most competitive places in the world; (c) the high salaries for public employees and high level officials that have reduced the “rate of temptation;” (d) the zero tolerance for acts of corruption; and (e) the existence of a *powerful and politically independent anti-corruption commission* that investigates any signal of possible corruption and that has the power to take corrective measures, without regard to the political consequences and without the need for 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 as well. The contrast between Hong Kong and China is striking. While the CPI in China is very low, that in Hong Kong is high.



Placing it among the countries with relatively low corruption. The commission is given an ample budget and has wide and politically-free support and powers. The clarity of the rules and the limited role of the government are also factors that have helped to achieve its present position. It was not always a relatively corruption-free economy.

Perhaps the last example worth mentioning is that of Chile, a country that in recent years it has had the best CPI score among developing countries. 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 as far out of economic decisions as possible.

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.

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## **VI. Concluding Remarks**

This paper has surveyed various issues related to the role of corruption in the economic activities of countries. Corruption also plays a role in political activities. The “Global Corruption Barometer” made available by Transparency International, has listed “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 various economic decisions. Finally, the paper has reported on some actions that have been taken by countries in their attempt to reduce corruption, stressing that the fight against corruption cannot rely on a magic bullet but has to be undertaken on many fronts.

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## Vito Tanzi

### Korupcija i ekonomija

#### Apstrakt

Ovaj rad se fokusira na ekonomske, a ne na političke posledice korupcije. Korupcija delegitimizuje funkcionisanje tržišne privrede, kao i ishode političkih procesa. Rad ukazuje na načine putem kojih korupcija – time što izobličuje ekonomske odluke i delovanje tržišne privrede – nužno smanjuje stopu privrednog rasta određene zemlje. U radu se takođe raspravlja o nekim kanalima kroz koje korupcija urušava ekonomske odluke. Naposletku, u članku se upućuje na određene postupke koje su sprovele pojedine zemlje u svom nastojanju da smanje korupciju i naglašava da se borba protiv korupcije ne može oslanjati na „magični metak“, već da se bitka mora voditi na mnogim frontovima.

**Ključne reči** ekonomija, korupcija, ekonomski razvoj, javne politike, birokratija