Research on Corruption and Its Control

The State of the Art

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The CSIS-Hills Program on Governance

The World Bank Institute

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Foreword

Corruption occurs in all parts of the world. More than US$ 1 trillion is paid in bribes every year, according to estimates by the World Bank Institute, and the costs of corruption in the developing world have reached approximately US$80 billion annually. Corruption significantly deters the development of markets, discourages investment, increases costs, reduces competitiveness, increases uncertainty, undermines the rule of law, and weakens the institutional foundations on which economic growth depends.

Increased global attention to the issue of corruption, and a growing concern among organizations looking for solutions to the problem, have opened up new avenues of inquiry. The sharing of knowledge, particularly experiences of what works, what doesn't, and why, can help prevent duplication of effort and repetition of mistakes.

To address this need, the CSIS-Hills Program on Governance, jointly with the World Bank Institute and the Wharton School of Business, brought together leading academics on corruption for a workshop entitled "Research on Corruption and Its Control: The State of the Art." The event took place in Philadelphia at the Wharton School of Business, University of Pennsylvania on March 3rd and 4th, 2006.

The primary objective of the workshop was to better understand existing research on corruption and to identify research gaps for the purpose of improving the quality and quantity of curricula on the subject. The event also sought to encourage researchers to contribute their expertise in support of practical efforts to reduce corruption, and highlighted the need to identify and encourage the substantial work that has already been done to understand the causes of corruption.

The day-long workshop on March 4th featured panel presentations followed by in-depth discussions, focusing on four areas of academic research:

Corruption and Economic Development; Human Behavior, Trust & Corruption; Political Corruption, and; Business & Corruption.

The edited proceedings capture the key issues as set forth in the panel presentations, and from ensuing discussions by distinguished panelists and participants.

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Introduction

On March 3rd and 4th, the CSIS-Hills Program on Governance, in partnership with the World Bank Institute and Wharton School of Business, brought together leading academics on corruption for a comprehensive workshop entitled: "Research on Corruption and its Control: The State of the Art." The principal objective of the workshop was to highlight cutting edge research on corruption and to identify needed areas of research for reducing corruption and improving curricula on the subject.

The workshop dealt with corruption in practical terms, recognizing that free markets are distorted by corruption and that the rule of law is rendered ineffective when bribes are paid to police, prosecutors, and law enforcement officials. A survey of developing economies suggests that firms in countries with high levels of corruption achieved half the output growth of firms in countries with far lower levels of corruption.

At the workshop's opening dinner on March 3rd, His Excellency Ernesto Zedillo, former President of Mexico, stressed that enforcing the rule of law with an impartial judiciary is the most important weapon in the war against corruption. Without the rule of law, corruption flourishes and policies for economic development and reform are undermined.

The day-long workshop on March 4th was held at the Jon M. Huntsman Hall at the Wharton School of Business, University of Pennsylvania. The panels featured presentations followed by an in-depth discussion in four areas of academic research: corruption and economic development; human behavior, trust and corruption; political corruption; and business development and corruption.

William Laufer, Director of the Carol and Lawrence Zicklin Center for Business Ethics in the Wharton School, Roderick M. Hills, Chairman and Founder of the CSIS-Hills Program on Governance, and Djordjija Petkoski, Head of the Business, Competitiveness and Development team at the World Bank Institute

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opened the conference. Paul Wolfowitz, President of the World Bank, offered remarks by video, emphasizing the World Bank's shared mission with the Hills Program to address corruption as a major obstacle to development around the world.

President Wolfowitz noted that the World Bank estimates that corruption costs the developing world about $80 billion a year[1] – an amount approximately equal to the total of all development assistance. Notice was made of the enormous loss to corruption from the administration of the $64 billion oil-for-food program in Iraq between 1996 and 2003, as well as the estimated $80 billion spent in reconstruction efforts in Iraq, which cannot be accounted for to date. Fighting corruption is now a priority for the World Bank, and it plans to do its part by imposing heavy sanctions on fraud connected to World Bank projects.

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1. All dollars are in U.S. dollars unless otherwise indicated.

Panel 1
Corruption and Economic Development

CHAIR
- Susan Rose-Ackerman, Henry R. Luce Professor of Jurisprudence, Yale University Law School

PANEL
- Francisco Rodriguez, Assistant Professor of Economics and Latin American Studies, Wesleyan University
- Raymond Fisman, Associate Professor of Finance and Economics, Columbia University
- Benjamin Olken, Junior Fellow, Harvard Society of Fellows
- Dean Yang, Assistant Professor of Economics, University of Michigan

A number of themes emerged in the workshop, ranging from sources of political corruption to an analysis of the psychological causes of corruption, and the accuracy of corruption perceptions indices. The first panel, "Corruption and Economic Development," chaired by Susan Rose-Ackerman, Professor of Jurisprudence, Yale University Law School, brought together leading scholars to discuss empirical research on corruption and its policy implications. Corruption indices have raised the profile and brought media attention to the corruption problem. Rose-Ackerman suggested that the next step in research should be toward microeconomic studies of corruption, in particular, the various forms corruption takes in the public and private sectors, and the policies that tend to give rise to each type of corruption. The broad-based perception indices, although useful in capturing the general atmosphere in a particular country, fail to offer specific steps and solutions, such as where to concentrate policy resources.

Panel 1

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Critique of Corruption Perception Indices (CPIs)

Corruption perception indices (CPIs) rank countries according to the preva-lence of corruption perceived by in-country experts. However, corruption perception indices do not measure real instances of corruption, nor do they distinguish types and causes of corruption in a country. Because corruption manifests itself differently in each country, Rose-Ackerman stressed the need for micro level studies of corruption in specific public and private sectors. Detailed studies of corruption in a single country and sector would offer policy makers more concrete evidence of steps that must be taken to root out corruption.

Francisco Rodriguez, Assistant Professor of Economics and Latin Ameri-can Studies at Wesleyan University, warned that corruption is not caused by any single political or economic factor. Consequently, future corruption research must seek to identify the factors that facilitate an environment of cor-ruption. Although corruption may reduce the amount of development dollars that reach their intended recipient, growth can occur in a corrupt environ-ment, creating difficulties for researchers intent on measuring the detrimental effects of corruption. Corruption is different in every nation-state and must be treated as a nonlinear problem.

Rodriguez discussed Paolo Mauro's seminal research paper on cross-country corruption. Mauro analyzed country-specific data on subjective per-ceptions of corruption in institutions, the amount of red tape, the efficiency of the judicial system, and various categories of political stability. Mauro found an inverse relationship between corruption and foreign investment. Countries with high corruption had low foreign investment and vice versa. Likewise, high corruption was associated with low growth. Mauro found a direct cor-relation between corruption and bureaucratic red tape. Jacob Benson's article

in the *Journal of Economic Perspectives* replicated Mauro's calculations and came to similar conclusions, noting that the statistical correlation between low growth and corruption was not robust.

Corruption perception indices, similar to corruption data used by Mauro, are assembled by surveying country experts and international investors. Perceptions of corruption do not measure actual corruption. In fact, perception measurements deviate significantly from actual corruption. A study that asked survey participants how many times the participant had paid a bribe, or been asked for a bribe, showed that the incidence of bribery could be higher than perceptions of corruption indicate. Perceptions of corruption may be a result of popularity, or lack of popularity of a political party or government agency, reducing the accuracy of perception surveys to measure corruption.

A further criticism of CPIs is that cross-country analyses of CPI may be misleading because corruption arises for different reasons in each country. Corruption in one country may be the result of rapid growth combined with weak public governance, causing the appearance of a correlation between corruption and growth, whereas another country may show increased corruption during a period of economic decline. For example, President Juan Vincent Gomez governed Venezuela from 1908 to 1935, and was arguably one of the most corrupt dictators in Latin American history. But during Gomez's rule, Venezuela experienced the highest rate of growth in Latin American history, with an average annual growth rate of more than 5 percent. After his death, the Venezuelan government appropriated $400 million of illegally obtained capital. Gomez apparently accumulated his fortune by giving oil concessions to family members who resold the concessions to oil companies.

Investigating corruption using cross-country macroeconomic indicators may show broad trends that diverge from circumstances on the ground. Microstudies of corruption within a country are better suited to identify the causes and effects of corruption. Accumulating microdata in each country can be analyzed with macroeconomic growth data to achieve better understanding of the causes and effects of corruption. Microdata also allow economists to study the correlation between corruption and growth as a nonlinear relationship.

Although treating corruption as a nonlinear problem risks disrupting the consensus that corruption is a singularly negative phenomenon, it will ultimately lead to better understanding. Although collecting microdata on corruption is attractive and useful, researchers must be wary of combining microdata with macrogrowth data in a way that gives a false sense of linear causation. Both corruption and growth are the result of many political, economic, and

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institutional factors. Rodriguez suggested researchers integrate micro level corruption data into macroeconomic growth models country by country.

Capital Markets as Corruption Indicators

Raymond Fisman, Associate Professor of Finance and Economics at Columbia University, discussed his use of capital markets to measure corruption. Fisman investigated whether the market price of politically connected firms shifts with changes in the health of the relevant politician. If the market believes a company's profitability is the result of political connections rather than operational ability, the market should reduce a firm's value when its political connection is jeopardized. A market that responds to the personal health of individual politicians suggests that those politicians use their position to benefit the patron companies in a manner that detracts from a level competitive playing field.

Fisman studied firms in Indonesia under Suharto and found that firms with strong connections to Suharto declined in value whenever Suharto fell ill. A similar phenomenon was observed in Brazil and Thailand, where crony capitalism is prevalent. Informed investors place substantial importance on political connections in markets where political connectedness affects profit-

<figure>

Average share price returns (y-axis, from −4 to 2)
Suharto dependency index (x-axis: 0, 1, 2, 3, 4)

Legend:
- Jan 30–Feb 1, 1995
- Apr 27, 1995
- Apr 29, 1996
- July 4–9, 1996
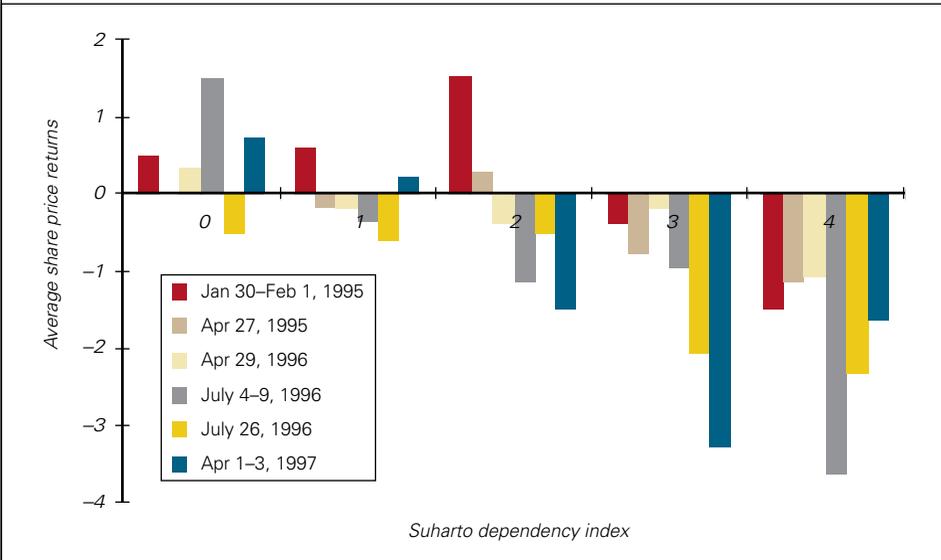- July 26, 1996
- Apr 1–3, 1997

Figure 1: Well-connected firms have lower returns when Suharto gets sick
</figure>
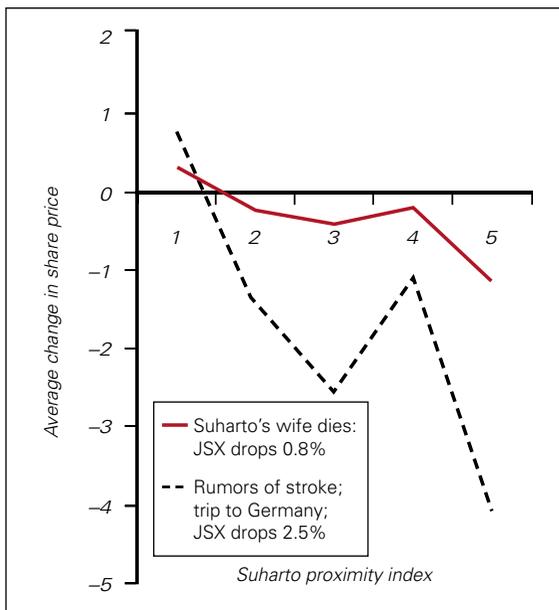
Figure 2: Well-connected firms suffer (relatively) more during more severe episodes

Chart axis: *Average change in share price* (vertical, from 2 to −5); horizontal axis labeled 1, 2, 3, 4, 5 with *Suharto proximity index*.

Legend:
— Suharto's wife dies: JSX drops 0.8%
- - Rumors of stroke; trip to Germany; JSX drops 2.5%

ability. To measure the effect of political connections on a company's profitability, Fisman rated the political connectedness of firms and relied on current market price to value expected future cash flows. A prime minister or cabinet member on the board of a firm is a strong political connection. Personal relationships with politicians, consulting relationships with former congressmen, and financial support of politicians through lobbying are popular methods of gaining political influence in the United States.

Fisman tracked the share price of Indonesian companies connected to Suharto and found declines in market price whenever Suharto fell ill (refer to figure 1). As Suharto's health deteriorated, share price declines intensified (refer to figure 2). This suggests that the companies would not have been competitive without their political influence, or that the companies derived a substantial portion of profits from their connection to Suharto. Either way, informed investors place importance on political connections in markets where political connectedness affects profitability. Fisman notes that Halliburton's share price did not decline in response to Cheney's heart attacks or political troubles. A well-diversified company such as Halliburton may be less reliant on any single political connection. Other researchers have tracked share price before and after close elections or an election upset.

Fisman's study focused on short-term share price fluctuations in response to news about a relevant politician, but long-term trends might demonstrate that a company is actually capable of surviving without a prominent politician on the board. For a connected firm to have long-term profits day after day, investors have to realize that one firm is more profitable than another. Economists should avoid measuring these long-run events, and instead focus more on where and how to isolate a specific shift in a firm's valuation.

This phenomenon has been observed in countries (including Brazil) during political scandals, and in Thailand, where crony capitalism is equally prevalent. Vice President Dick Cheney's involvement in Halliburton is contrary to assertions of the susceptibility of well-connected firms to a politician's health, as share price was not affected by Cheney's heart problems. This may be due to the different political and economic systems in Indonesia compared with those of the United States. In an open and transparent democracy, corporate competitors have equal ability to seek political influence, whereas public scrutiny impedes anticompetitive favoritism.

In conclusion, markets value political connections. Indonesia developed relational capitalism, which many consider to be detrimental to growth. Dependency of firms on political connections may have contributed to the crash of Southeast Asian economies in 1998. However, Southeast Asia has managed to retain significant growth over a sustained period. Fisman notes the International Monetary Fund has been studying whether well-connected firms were preferentially bailed out during the Asian financial crisis in 1998. Research is also being conducted on whether these firms actually made countries vulnerable to crisis in the first place.

Evaluating Anticorruption Strategies

Benjamin Olken, Junior Fellow at Harvard University, described his research on the effectiveness of different anticorruption measures. Olken's "Randomized Field Experiments" produced empirical data on the extent to which various anticorruption measures reduce corruption in a development project. Olken studied a World Bank village-level road building project in Java, Indonesia. He examined budgets for similar road construction projects submitted by villages that had been told they would be subject to a monitoring regime randomly assigned by Olken. Olken then compared the villagers' reported expenditures to the amount estimated by independent engineers for building the road. Next, Olken compared the deviation from expected cost demonstrated by villages subject to the different monitoring schemes.

The four anticorruption measures Olken tested were (1) a 4 percent chance of being audited, which represented the control—that is, the typically weak oversight of government monitors; (2) a 100 percent chance of being audited; (3) grassroots monitoring, where the budget was decided at a village-wide meeting, intended to address budget manipulation by village elites; and (4) facilitating whistleblowers, by sending anonymous comment cards to households with instructions to report budget irregularities. The second

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treatment, a 100 percent chance of audit, demonstrated the least deviation from estimated costs. The other treatments produced expenditures 8 percent higher than fully audited villages. Grassroots monitoring limited the inflation of labor costs, but not the inflation of materials costs. Olken believed village-wide meetings did not provide an opportunity to monitor suppliers though they did facilitate peer monitoring of wages. Thus, strict auditing was the most effective anticorruption measure.

To carry out this type of experiment in other areas, researchers must have (1) the cooperation of the target institution; (2) anticorruption strategies to test; (3) an outcome measurement such as a budget supplied by the subject (for a study of police effectiveness, a record of citations, or for tax compliance, a record of tax revenue); and (4) a control treatment randomly allocated to groups. Applying different anticorruption treatments to a single group over time while measuring the same corruption indicator is an alternative to Olken's approach of randomly assigning anticorruption measures to a number of groups.

This methodology should become more prevalent in studies of diverse sectors, including education, microfinance, and governance. The effectiveness of media exposure as an anticorruption measure could be quantified by randomly choosing regions in which to publicize the problem of corruption and measure an indicator of corruption. The ability of transparency to reduce corruption could be investigated by measuring the effect of different disclosure rules on diversion of funds from discrete projects. Bureaucratic structures could be studied to find the optimal configuration to reduce corruption. Also, the effect of civil servant wage levels on corruption could be studied using this experimental methodology.

Olken's approach uses real-world settings with real actors. Researchers observe villages involved in a single development project under randomly assigned anticorruption and control treatments. Corruption is measured by comparing the budget and productivity of different villages to expert estimates of funds and time needed to complete the project. These experiments are the gold standard of empirical research, because they directly measure the effect of various anticorruption initiatives on the dollar amount of funds diverted from a project. Such studies provide tangible answers to policy makers on the effectiveness of different anticorruption strategies.

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Minimizing Corruption in Customs

Dean Yang, Assistant Professor of Economics at the University of Michigan, presented his investigation of pre-shipment inspection (PSI) as an anticorrup-

tion measure in customs agencies. Pre-shipment inspection firms are multinational companies that inspect goods before shipment, then send information on value, quantity, and tariff classification of the shipment to the client, typically the government of the recipient country. For example, Nigeria may hire a PSI firm to inspect shipments leaving the United States for Nigeria. The PSI firm sends information it collects in the United States on each shipment to high-ranking Nigerian customs officials and government auditors. When the shipment arrives in Nigeria, Nigerian monitors compare customs invoices to the PSI information. The PSI information allows monitors to hold customs officials accountable for inconsistencies.

Pre-shipment inspection programs on average have been extremely effective at reducing corruption in customs agencies. Yang's research examining 19 different countries over 20 years showed that implementation of PSI programs increased import duty revenue by 15 to 30 percent within 5 years after implementation. Furthermore, PSI programs have proven to be cost effective – the increases in import duties because of a PSI program exceed the cost of PSI inspections. Governments should hire only local branches of internationally recognized PSI firms; these have a vested interest in maintaining their reputation for integrity, assuring that they eschew corruption within their ranks.

Combating corruption in customs is important because customs operations generate substantial government revenues in many developing countries in which up to a quarter of revenue may come from customs duties. Customs revenue is particularly important in countries where tax collection is limited. Contrary to popular opinion, PSI programs do not replace a country's customs officials, but rather provide government officials with an information advantage over corrupt parties. PSI firms essentially provide extra information to client governments to alleviate constraints on high-level enforcers. Yang has also documented circumstances in which PSI programs fail to reduce corruption, merely diverting it to other channels. In particular, two programs in the Philippines and Colombia demonstrated displacement of corruption in customs duties to other channels when reforms were not sufficiently broad. Therefore, customs monitoring must be broad to be effective.

As a suggestion for further research, Yang suggested using mystery shopping, a tactic employed by firms to monitor customer service. Mystery shopping could be used to monitor provision of public services in sectors like public health and business licensing, which frequently suffer from inefficiency and graft.

A question-and-answer session revisited some questions about the methodologies and experiments carried out by the panelists.

Addressing the legalities involved in proving corruption, a participant inquired to what extent research on political connectedness is admissible as evidence in court. Raymond Fisman responded that research aims to inform policy makers, not support prosecutors. Furthermore, most information collected would be considered circumstantial. Ultimately, questions of admissibility would be decided by a presiding judge.

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Panel 2
Human Behavior, Trust, and Corruption

CHAIR
- Lynn Paine, John G. McLean Professor of Business Administration, Harvard Business School

PANEL
- Arthur P. Brief, Lawrence Martin Chair of Business, Tulane University
- Thomas S. Murphy, Distinguished Research Fellow, Harvard Business School
- Maurice Schweitzer, Associate Professor, Operations and Information Management Department, Wharton School
- Cristina Bicchieri, Professor of Philosophy and Legal Studies, University of Pennsylvania
- Eric Uslaner, Professor, Department of Government and Politics, University of Maryland

The second panel brought together experts from a range of disciplines, including business behavior, political science, philosophy, legal studies, and operations and information management, to examine "Human Behavior, Trust and Corruption." Panel chair, Lynn Paine, John G. McLean Professor of Business Administration, Harvard Business School, underlined the need to understand the motives behind corruption to identify why corruption occurs. Research on moral development suggests that few people are natural-born miscreants; instead individuals are drawn into corruption because of social, political, and economic environment. People may participate in corrupt behavior as individuals, as businesses, or as societies. Understanding the basic phenomena will facilitate more effective remedies.

Panel 2

Psychology of Corruption

Paine questioned whether there are recurrent patterns and pathologies of corruption, whether researchers can discover the turning points where intervention has the most impact, and how corruption can be reversed.

Arthur Brief, Lawrence Martin Chair of Business at Tulane University, discussed research on pressure within firms to act unethically to meet performance expectations. Firms often approve corrupt activity for the sake of gaining business. Until Enron and other corporate fraud cases were scrutinized in the media, few organizational behaviorists studied corporate culture from an ethical standpoint. Furthermore, collective corruption has been the focus of limited attention because organizational successes and failures are typically over attributed to leadership, rather than attributed to firm culture as a whole.

Brief gave two examples of collective corruption in the 1990s. First, in the early 1990s, Sears Automotive created a goal-setting and incentive system for its service advisors. The system caused widespread sale of unnecessary repairs and parts to unsuspecting customers. Low-level management condoned the practice because it increased sales. Once the practice came to light, approximately 18 class action lawsuits were brought against Sears, including suits by New Jersey and California joined by officials in 44 states.

Second, in the early 1990s, the CEO of Shoney's, a nationwide restaurant chain, instituted discriminatory hiring practices by seeking to match service personnel with customer race. The CEO stated that if a restaurant was underperforming, managers should consider whether the race of the service personnel matched the race of the customers. One restaurant manager interpreted this to mean, "Hire pretty white girls." Shoney's franchises located in white neighborhoods translated the marketing tactic into discrimination against black applicants for service positions. As a result, discrimination was

pervasive at the operational level of the organization. Shoney's paid $132.5 million in penalties for race discrimination.

Brief discussed his studies of fraudulent financial reporting at low levels of an organization. In one test, top management was provided the opportunity to lie to the public accounting firm about assets and sales. Brief attempted to identify the personal values, both express and implicit, of the people who committed fraud. He concluded that values do not predict behavior in such cases.

According to Brief, pay rate does not determine propensity for fraud. One study showed 76 percent of MBA graduates committed fraud. A test involving top-level executives undergoing simulation found that the fraud rate of MBA graduates dropped to 47 percent, while 40 percent of corporate controllers committed fraud. The research indicates that the nature of hierarchical organizations compels such behavior. The desire to report positive results to a superior may lead to wrongdoing that becomes commonplace if not addressed.

Prominent behavioral scientists have asserted that pressure to perform causes unethical behavior. Hebert Simon, the Nobel Prize economist, believes that when an employee takes a job, he or she signs a blank check in terms of behavior. Stanley Milgram argued that humans evolved to be obedient to orders. Recent research suggests that the effects of a corporate hierarchy are compounded by personal motives.

Maurice Schweitzer, Associate Professor at Wharton School, studied ethical decision making by individuals. He found that individuals overstate productivity when pay was tied to productivity

Without oversight. Although more challenging goals increase productivity, monitoring is necessary to assure accurate reporting.

Schweitzer found that individuals are more productive when given specific performance goals than with less rigorous goals or vague expectations. High goals led to steady productivity and higher scores. Schweitzer used anagram tests, a classic goal setting experiment, to study causes of unethical conduct. Test subjects completed a word-jumble exercise and rated their own productivity. Self-scored results were compared to actual performance in relation to the group as a whole. Three separate conditions were given. The first group was told to do their best and received $10. The second group received $10 for participating but had a goal of nine words per round. The third group was given an envelope with 14 $1 bills and told to pay themselves $2 for each round in which they achieved a goal set by themselves.

In the first set, the difference between actual performance and stated performance was not significant. The second set overstated somewhat but less so than the third set. The third set overstated significantly. Participants

in the third set falsified performance, then paid themselves according to their report. The group had the opportunity to report actual performance and take extra payment, which would have been open theft. Schweitzer interpreted this result to indicate that participants justified the fraud to themselves as, "I am a liar but I am not a thief." Also, the study showed how fraudulent actors seek to take advantage of insufficient oversight to perpetrate fraud. Furthermore, participants were more likely to overstate performance when given a high goal than when not given a goal. The goal motivated corruption although it increased productivity.

Schweitzer raised several questions for future research: how people shift moral codes between home and work, or across cultural boundaries; which factors about a group or type of monitoring induce unethical behavior; and how ethical behavioral norms can be restored.

Social Expectations and Corruption

Cristina Bicchieri, Professor of Philosophy and Legal Studies at the University of Pennsylvania, discussed the effect of social expectations on corrupt practices. If an individual believes corrupt activity is the norm, he or she is more likely to participate in corrupt activity when given the opportunity. Yet research shows that promoting ethics in the workplace reduces corrupt practices.

Social norms include what people know from experience is to be expected in a situation, as well as what people believe to be expected in a situation. Research on ambiguous situations, where the ethically correct path is not clear, shows that individuals act ethically if reminded of ethical norms before making a decision. People tend to transgress if there is a conflict of two ethical norms, or if a single ethical principle could be applied to the situation in different ways. Those facing an ambiguous situation without ethical guidance are more likely to transgress. Thus, in an institutional setting, individuals are more likely to act ethically if opportunities for corruption are minimized and ethical norms are publicized.

Unethical behavior can flourish when there is a lack of communication between similarly situated individuals, because each may believe unethical behavior is acceptable. For example, the accused in a corruption trial in Italy assumed other business leaders were involved in similar corrupt behavior, presumably negating its illegality. This perception was enough to induce and justify corrupt practices in the mind of the accused. Bicchieri believes that the availability of information about acceptable practices is important.

Eric Uslaner, Professor for Government and Politics, University of Maryland, argued corruption may persist in any government institution. Every ethnic group has been guilty of corruption at some time. Corruption is not just an ethnic issue.

Uslaner theorizes in his book, *The Ethical Foundations of Trust*, that individuals develop their sense of trust in others at an early age. This trust is learned from observing parental trust of strangers. Uslaner argues that corruption flourishes where trust is low between strangers in a society. Where trust between strangers is high, corruption is low. An individual who believes others are acting unlawfully without repercussions is more likely to bend the rules. Therefore, distrust among members of a society lays the groundwork for corruption: economic inequality and perceived inequity create distrust that breeds corruption.

A World Bank survey in Romania demonstrated that the public believes economic inequality is the single greatest consequence of corruption. Surveys of public perception in developing countries show that many believe success comes from corruption, not from merit. In an Estonian case study, 85 percent of the general public recognized corruption to be endemic, whereas only 5 percent of government officials and business owners saw corruption as a major problem.

Uslaner noted that reducing corruption will not necessarily make a government more democratic. Instances of corruption arose in Romania after it embraced democracy. An Indian journalist aptly wrote, "India may have the hardware for democracy, but lacks the software, and the software is impossible to import."

"Software" aspects, like a fair legal system, are essential for a functional democracy. Uslaner's research on inequality and corruption suggests that corruption-free government reduces economic inequality because its market policies foster a level playing field, as opposed to favoritism that stifles competition.

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Lunch Panel Session
Anticorruption Research and Multilateral Banks

CO-CHAIRS
- William Laufer, Associate Professor of Legal Studies and Business Ethics and Sociology; Director, Carol and Lawrence Zicklin Center for Business Ethics, Wharton School, University of Pennsylvania
- Djordjija Petkoski, Lead Specialist, World Bank, Head of the Business, Competitiveness and Development Team, World Bank Institute

PANEL
- Glenn T. Ware, Managing Director, Diligence Inc.; former Senior Institutional Integrity Officer, World Bank

- Stephen Zimmermann, Chief, Office of Institutional Integrity, Inter-American Development Bank (IADB)

- Jonathan Shapiro, Department of Institutional Integrity, World Bank

The working lunch discussion focused on anticorruption research undertaken by multilateral development banks (MDBs), including the World Bank, Inter-American Development Bank, and the International Financial Corporation, as well as on the internal and external challenges MDBs face, such as enforcing transparent engagement with stakeholders and corruption prevention within MDBs.

Intra-Institutional Monitoring of Multilateral Development Banks

The first speaker, Glenn Ware, recalled World Bank President James Wolfensohn, who created a fraud and corruption investigation unit in response to corruption cases emerging from World Bank projects. Before Wolfensohn, cor-

Lunch Panel

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ruption was rarely mentioned in an official setting. Through the Institutional Integrity Unit, Wolfensohn launched a series of initiatives to curb corruption, including an investigative department and a corruption reporting mechanism. Hundreds of cases have been identified and investigated. However, questions remain concerning the initiation and structure of investigations, the regulatory framework surrounding the cases, and the designation of authorities to lead such investigations, especially investigations involving member countries.

Approximately 2,000 cases were investigated in the five years since formation of the unit. Ware, formerly with the Institutional Integrity Unit of the World Bank, and his colleagues wrote an article, "Anatomy of Transnational Corruption," exposing the common anatomy of this type of corruption. The various schemes repeatedly employed by corrupt actors worldwide include bribery, kickback brokers, front companies, bid rigging, official-owned enterprises, theft from government accounts, and abuse of public assets. Ware did not find forms of corruption unique to any specific culture.

Procurement mechanisms initially implemented by the World Bank and later replicated by member states offer little if any protection from corrupt activities. Many governments create the illusion of having controlled corruption while allowing it to flourish. Governments, companies, and individuals can manipulate anticorruption rules with ease to withstand external audits and reviews. Ware therefore argued for less reliance on local government systems to curb corruption, and for use of MDBs to expose fraud and implement random external audits.

Stephen Zimmermann noted that successful assertion of anticorruption principles may not benefit all involved. A major World Bank hydroelectric project was halted when plans of local officials to divert funds and manipulate electricity prices came to light. The decision to take a hard line against corruption deprived the region of electricity.

The scandalous United Nations oil-for-food program was successfully investigated, yet the final impact of the investigation remains uncertain. The UN's Independent Inquiry Commission provided an extensive audit, but did not make specific recommendations to prevent such occurrences in the future.

Zimmermann questioned self-regulation of MDBs, which are not bound by laws of any country or international legal body. Multilateral development banks are owned by member countries. How should MDBs address corruption from within? The World Bank's Institutional Integrity Unit (INT) investigated 30 staff members in FY04, resulting in nine terminations for fraud or corruption.[2] The Inter-American Development Bank (IDB) has an Office of Institutional Integrity (OII) that pooled corruption data from more than 400 projects. Zimmermann called for publication of the data to facilitate anticorruption research. The IDB OII does not yet meet the level of transparency achieved by the World Bank's INT, which publishes a list of parties that INT investigations have found guilty of fraud or corruption. Inter-Development Bank, the World Bank, the African Development Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development issued a joint statement in 2004 committing to fight corruption, but only the World Bank makes its findings public. The other MDBs should follow the World Bank's lead.

Jonathan Shapiro expanded on the World Bank's anticorruption program. Initially, most anticorruption work was based on a reactive model, but under Wolfensohn's initiative has shifted to a blend of reactive and proactive. The Bank now conducts more due diligence at the front end of projects to ensure that funds go only to designated recipients and are spent according to plan. Also, the Bank is addressing how to make loan processing more transparent.

The panel discussed how MDBs should change lending practices to avoid corruption. Should MDBs avoid lending altogether if the recipient countries are corrupt? Multilateral development banks cannot afford to lose the impact of lending and development. Ideally, corruption can be reduced without reducing lending. Multilateral development banks should discuss tainted projects and subsequent investigations more openly, to facilitate problem solving. Historically, institutions have been reluctant to analyze internal problems openly. Investigative findings should function as a preventative tool through public disclosure.

On the issue of enforcement, a participant asked how investigations involving high-level foreign government officials can lead to prosecutions. Multilateral development banks should not attack corruption on a bottom-line

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2. See World Bank, Insitutional Integrity homepage/about us/FAQ, viewed 7/5/06.

basis, investigating only the largest cases, because most low-income countries with rampant small-scale corruption would escape scrutiny. Shapiro suggested that many small cases can be easily prosecuted and publicized with the desired effect of public debate and condemnation. The goal should be to prosecute as many cases as possible.

As the World Bank and other MDBs increase anticorruption measures, corrupt parties who resist World Bank scrutiny seek loans from commercial lenders, which are less concerned with how loaned funds are spent. For example, the World Bank halted its projects in Chad, but oil companies with massive lending capacities may fund the project instead. This calls into question the effectiveness of MDB sanctions.

Commenting on the use of the vast databases owned by MDBs, Susan Rose-Ackerman suggested identifying vulnerable loans, such as loans involving projects that typically attract corrupt practices or certain geographic areas. The World Bank's INT conducts due diligence on loans from particular sectors to ensure better safeguards in the expenditure process.

Panelists agreed that analyzing the World Bank's database would be valuable. If MDBs can measure the impact of money lent and the discount due to corruption, MDBs will be able to determine the cost effectiveness of loans, allowing them to better manage resources.

Opening the MDB's database to outside research would allow external monitoring, which if conducted independently of the World Bank would pressure other MDBs and member countries to be more transparent about their own experience with corruption. This would allow private investors to benefit from MDB experience.

The costs and benefits of loans versus grants is another point of debate. Kenneth Dam asserted that large construction projects often lend themselves to corruption. When a corrupt government receives funds in the form of a loan, not only are the funds used inefficiently, but the project often fails to produce income as initially calculated. This leaves the government unable to repay the loan, further damaging the country's economy and ability to raise funds. If funds were issued as grants, at least part of the damage would be avoided.

Barry Metzger, former general counsel of the Asian Development Bank, commented that anticorruption has been on the agenda for more than 10 years with little real progress. The movement toward more effective dispersal of funds is part of a broader effort to stem member countries' traditional sense of entitlement and ensure resources are allocated to countries most in need. Most disappointing during this period has been the failure to change project design in response to the threat of corruption and lack of response to

corruption case studies. Metzger argued that insufficient support has been given to nongovernmental monitoring of projects as part of the auditing process.

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Panel 3
Political Corruption

CHAIR
- Michael Johnston, Professor of Political Science, Director, Division of Social Sciences, Colgate University

PANEL
- Mark Warren, Harold and Dorrie Merilees Chair in the Study of Democracy, Department of Political Science, The University of British Columbia
- Philip Nichols, Associate Professor of Legal Studies and Business Ethics, Wharton School
- Luigi Manzetti, Associate Professor, Department of Political Science, Southern Methodist University
- Jon Quah, Professor of Political Science, National University of Singapore; Visiting Scholar, Asia-Pacific Research Center, Stanford University

A New Definition of Political Corruption

Political corruption is typically defined as the use of political office for private gain. But this definition is deficient, especially in countries where the norms of public office include personal gain. Where societal norms do not include the concept of public servants working in the public interest, strong institutions in the democratic model cannot be built.

The second difficulty with the conventional definition of corruption is that elected officials face a paradox of advocating the interests of their constituents, while governance norms would have them be impartial. Third, the common definition is rule-based. It does not incorporate the flexibility needed

in political spheres nor the different manifestations of integrity that an official may display, such as living up to campaign promises even though the promise may be induced by special interests.

Mark Warren, Professor of Political Science at The University of British Columbia, stressed the element of deceit involved in political corruption. Warren called for a new definition of corruption in the political sphere: holding out democratic norms to the public, but in actuality acting on undisclosed pecuniary motives.

Political corruption excludes citizen stakeholders from decisions that affect them. Political corruption is usually achieved when politicians or officials uphold democratic norms in public but violate them in private. This definition of political corruption demonstrates logically the inverse relationship between political corruption and normatively functional democracy. Increased political corruption decreases functional democracy.

Participatory democracy combats political corruption because the decision-making process is more transparent and inclusive of popular interests. Citywide meetings and local democracy are solutions to political corruption at the local level. They increase transparency, accountability, and inclusive decision making, thereby reducing politically corrupt exclusivity.

Westphalian Sovereignty and Anticorruption Agreements

Philip Nichols, Associate Professor of Legal Studies and Business Ethics at The Wharton School of Business, hopes more research will be done on the politics of corruption to complement the extensive economic research on the subject. Nichols discussed three levels of political corruption:

the local level, the bilateral level, and the multilateral level. At the local level, charges of corruption against politicians are as disruptive to democratic elections as actual corruption. In emerging democracies such as Kazakhstan and Belarus, political competitors are eliminated from elections by charges of corruption. Charges of corruption at the bilateral level may be based on foreign policy interests rather than ethical norms. For example, the United States may find a foreign government corrupt whereas the United Kingdom does not. Such equivocation may undermine the rule of law by condoning certain types of political corruption but not others. Nichols suggests the effect of bilateral perceptions of corruption on the rule of law is an area ripe for research.

At the multilateral level, the forum for action on corruption is primarily the Doha Round of the World Trade Organization (WTO) negotiations, where corruption is addressed under the guise of "government procurement." Political corruption is closely tied to a country's system of government; consequently, efforts to root out corruption in binding multilateral negotiations have been accused of threatening Westphalian notions of national sovereignty and self-determination. In fact, the issue of "government procurement" was sidelined in the Doha Round. Nichols argued that anticorruption need not be viewed in terms of Westphalian concepts. Rather, Doha decisions on corruption will influence countries in terms of social constructionism; that is, binding agreements on government procurement influence how institutions develop at the local level.

Effective Anticorruption Agencies

Nations with disruptive corruption problems have a mixed track record of creating effective anticorruption agencies. Jon Quah, Professor of Political Science at National University of Singapore, found that the first best practice rule for building a functional anticorruption agency is not to place police in charge of the new institution. For example, the Philippines government staffed a new anticorruption agency with personnel from their corrupt police force, dooming it to failure. In contrast, Singapore and Hong Kong have successful anticorruption agencies. Both began by assigning anticorruption enforcement to the police force, but the police failed severely in both countries, prompting the establishment of independent anticorruption agencies administered by officials with proven integrity. These new autonomous institutions have since been successful in their mission to reduce corruption.

Creating anticorruption measures involves the government, political parties, and administrative agencies. The role these elements play in anticorruption has a substantial effect on success. In Singapore, the police force was corrupt before it was assigned to fight corruption. Police officers stole a shipment of opium, creating such an uproar that an independent anticorruption agency was formed. In Hong Kong, a scandal involving a corrupt police officer who escaped to England was the impetus for creation of an independent anticorruption agency.

The two principal components of anticorruption measures are laws and agencies. The government must enact laws to criminalize corruption and to establish enforcement agencies. For both laws and agencies to be effective, they must be reviewed and altered periodically to keep pace with the evolution of corrupt practices that constantly seek to circumvent the law. Implementation must scrutinize exceptions to anticorruption rules and tailor the penalties for different types of violations from civil penalties to criminal. Furthermore, implementation requires political will to provide new agencies with enforcement power, funding, and autonomy. Political will can be gauged by the percent of budget allocated to anticorruption, the establishment of well-funded agencies, and the existence of competent, well-trained personnel. An agency must demonstrate accountability within its ranks and should fire employees found to be corrupt. Agencies should enforce anticorruption laws at all levels, prosecuting the big fish as well as the small fry.

Professor Luigi Manzetti of Southern Methodist University noted that measuring accountability is inherently difficult. However, World Bank statistics on accountability and financial health of a country display a direct correlation between the two. Decreasing accountability decreases financial stability. Measurement and publication in the media of the amount of money stolen or illicitly acquired by a corrupt official can create sufficient public outcry to force a corrupt official's resignation. In Italy in 1992, Craxi and Andreotti were found to have stolen public funds. Once the judicial investigation published the exact amount that was stolen, the public outcry was enormous and led to the *Mani pulite* reforms. Thus, effective measurement of dollar value of corruption and subsequent public disclosure increases accountability. Manzetti suggested that corrupt governments stay in power because they are efficient at distributing benefits of their government to a broad base.

Panel 4
Business and Corruption

CHAIR
• Ronald Goldstock, Professor of Law, New York University School of Law

PANEL
• Frank Anechiarico, Maynard-Knox Professor of Government and Law, Hamilton College
• Ronald Berenbeim, Principal Researcher and Director, Working Group on Global Business Ethics Principles, The Conference Board
• G. Robert Blakey, The William and Dorothy O'Neill Professor of Law, Notre Dame Law School

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The final panel, entitled "Business and Corruption," conducted a role-playing exercise as board members of a publicly traded United States corporation seeking to secure a government contract in a developing country. The chair of the panel, Ronald Goldstock, Professor of Law, New York University School of Law, led the exercise by explicating challenging choices that United States companies face when investing in countries where many business practices fall within a "gray area." Goldstock assumed the position of an assistant to the CEO of a U.S. company establishing operations in an Asian country. In the process, he consulted with his Board of Directors (the panelists) on business and investment strategies, as well as legal and ethical risks.

First, the board had to decide whether to hire a local consultant who guaranteed the ability to land the desired contract for a 2 percent finder's fee, equivalent to $10 million. Participants in the role of board members were suspicious of the consultant's ties to the government and the risk that part of the consulting fee would be paid to government officials as bribes. If the

Panel 4

money were used for bribery, the company risked prosecution by the Justice Department under the Foreign Corrupt Practices Act (FCPA). Turning a blind eye to the destination of the consulting fee would invite prosecution under the FCPA and possible blacklisting by the World Bank if World Bank funds are involved.

To reduce the risk of prosecution, board members requested due diligence on the consultant: information about his or her ties to local government; why he or she could assure landing the contract; information about his or her past contracts; whether he or she had ever been accused of bribery; and information about his or her financial history. Participants suggested requiring the consultant to sign a contract promising not to use the fee to pay government officials and disclosing the consulting contract to the local government and the U.S. State Department through the local embassy to pre-empt perceptions of impropriety. Board members suggested spreading payment of the consultancy fee over 2 to 3 years to reduce the consultant's ability to pay bribes up front. Moreover, the board had to decide how to account for the consulting fee to shareholders, and whether the consultant would perform any services or merely "facilitate" the deal. The consultancy must not run afoul of any local laws or procurement regulations. All the while, other companies were competing for the contract and the company did not want to lose the opportunity to expand operations in the country.

Assuming the company went forward with the project, in the second scenario a port official refused to move essential company equipment, demanding $5,000. The board had minimal information about the situation, but had to decide whether to pay or not pay and hold up the equipment. The demand could be defined as extortion rather than bribery; however, payment would give rise to legal and ethical consequences the board should investigate. The FCPA may permit $1,000 facilitation payments, but $5,000 U.S. risks violating

U.S. and perhaps local law; consequently, legal guidance from the Justice Department may be in order.

The final scenario involved overtures of violence against local operations unless the company hired certain "security consultants." The board had to decide whether to acquiesce to the payments or terminate operations in the country because of the threat violence to local employees. Payment could violate U.S. law if the group were considered a terrorist organization by international authorities.

In sum, anticorruption researchers have made substantial progress in collecting accurate data on corruption and developing new methods for studying anticorruption measures. More work must be done to investigate the causes of corruption and corrupting influences in different political-economic environments. Anticorruption research would benefit from microlevel studies that identify the variables that facilitate corruption in different sectors. Weaknesses exist in macrocorruption perceptions indices as well as in microcase studies, but both are useful. Further research on the effectiveness of different anticorruption programs using Olken's randomized field experiments would provide policy makers with hard evidence of successful strategies. Where persons in power have a stake in corrupt government, the international community must promote media exposure of corruption and unilaterally penalize parties that take part in foreign corrupt practices. The many manifestations of corruption preclude a silver bullet. Instead, governance weaknesses must be addressed, using tailored approaches that include strong and streamlined institutions, frequent audits, transparency, accountability, and judicial enforcement.

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