

ECONOMIC ANALYSIS OF CORRUPTION

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1.1. INTRODUCTION

Corruption is an emotionally charged concept that inspires in most people immediate condemnation. These reactions can be channelled into supporting anticorruption strategies to deal with the problem, but the specific strategies will depend on the definition of the phenomenon at hand. These definitions can collide with what the public and international institutions have in mind when lamenting corruption and might also misfit with the analysis of some of the detrimental effects that corruption has on social welfare and with the formulation of sensible policies to deal with the problem.

Here we will discuss the definition of corruption and the fallacies intrinsic in understandings of corruption that are based on one-sided definitions of it, focusing in particular to the questionable characterization of corruption as something that has to do only with the private sector. This specific definition is popular with economists and, in most cases covertly, it underpins the simplistic conclusion that to decrease corruption is sufficient to shrink the public sector or that there is a dilemma between market failures and corruption (e.g. Acemoglu and Verdier, 2000; for an exception see Hodgson and Jiang, 2007).

1.2. THE DEFINITION OF CORRUPTION

Corruption is a multifaceted concept that escapes monolithic characterizations. Corruption, as defined in the dictionary, epitomizes moral decay, is intrinsically bad and subject of unconditional condemnation: it is the “impairment of integrity, virtue, or moral principle”.² In search for definitions fit for the purpose of social sciences,

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² "Corruption." Meriam -Webster online, 6 Nov. 2007.

alternative – and arguably more morally neutral and less comprehensive – definitions have been developed.

A social science approach will benefit for a definition of corruption that does not have a strong moral component, because of the benefits of focusing on a set of behaviours (in this case corrupt behaviours) without being able to condemn them *a priori*. Morally charged definitions – for example – would make it very difficult to analyze the arguments of those authors that argue that corruption satisfies societal needs and ultimately has beneficial effects on social welfare (e.g. Huntington, 1968). A related issue is that the class of phenomena characterised as ‘corrupt’ should be kept at an analytically manageable size: a definition of corruption that would include phenomena that are of a very different nature would render such definition useless. In general issues that are very diverse would relate to different analytical tools in different ways and a definition of corruption that is too inclusive runs the risk of being a meaningless characterization.

Overall, the task of identifying *the* definition of corruption is not an easy undertaking because of the emotions the concept inspires and the fact that many different definitions exist. As a result of these difficulties many social scientists simply shy away from any explicit definition of corruption (see Williams, 1999; Lambsdorff, 2007:15-16) and it is often difficult to understand what exactly different authors have in mind when they discuss corruption; many times it is only from their analysis and conclusions that is possible to appreciate what characterization of corruption they are using (e.g. see the discussion below on the public sector).

The diversity of approaches to corruption underpins the diverse definitions; the earliest approach being the legalistic one (Williams, 1999). Corruption is simply defined as the breaching of legal codes – defining public duties – in order to obtain personal advantages. However, the usefulness of this definition is disputable once the prominence of power in defining the law and the indeterminacy of the legal codes is recognised. The point was forcefully made by the schools of critical legal studies and legal realism (see Hasnas, 1995).^{3,4} The first school emphasized how powerful

³ In any case, the occurrence of corruption is often sanctioned by the law; in other words, often the act of corruption is a crime. In economics, a large literature has developed starting from the seminal work of Becker (1968) on crime and punishment. The application of such literature is limited on the one hand by the fact that not all corruption is illegal. On the other hand, the case of corruption is peculiar because there is evidence that in some countries enforcement agents – the institutions in charge of punishment – are the worst offenders with respect to corruption, which limits the straight application of crime models (e.g. Pellegrini, 2007). The inclusion of corruption in models of economics of crime can produce predictions quite opposite to the standard prescription of increased punishment and monitoring to decrease crime (e.g. Kugler *et al.*, 2005).

interests can influence the development of legal codes, use them to justify the *status quo* and further pursue their welfare; in light of these considerations legal provisions are a dubious benchmark for defining corrupt acts because the fact that an act is not defined as corruption in legal codes might be better interpreted as an indicator of the influence of powerful interests rather than of lack of corruption. A telling example of similar issues is the case of the decree that the Italian government enacted in 1993 to decriminalize illicit financing of political parties (known in Italian as the ‘colpo di spugna’). The premier Giuliano Amato wanted to salvage the members of his political party from judiciary prosecution, but had eventually to back down because of the public outcry that followed the approval of the legal measure by the government.⁵ If the government were to succeed, according to Italian legal codes such acts would not be corrupt anymore, but rather than signalling the decrease in corruption they might better be classified as a display of institutionalized corruption.

Furthermore, the school of legal realism emphasized how the interpretation of legal codes plays a crucial role in sentences and there is little possible objectivity in ‘the law’ *per se*. In sum, the legal definition is seemingly clear-cut and it hides the difficulties of identifying corrupt acts according to one unambiguous standard.

Finally, a definition of corruption based on legal codes is problematic for comparative analysis when legal codes differ across countries and as a result we are comparing different phenomena. Just as an example of such differences in the legal characterization of corruption, in the USA lobbying is a legal practice and enterprises investing in it can deduct their expenditures from the taxes. In most European countries the same practices fall under the rubric of corruption and are legally sanctioned. On the other hand, in the USA it is illegal for congress’ members to hire one’s spouse to help in the congressional work, while in many European parliaments that practice is common.

We prefer to discuss and opt for other definitions of corruption that do not hide the ambiguities of the subject, but are clear enough to narrow down the classes of acts

⁴ Corruption itself can determine which and how many laws are passed and the roman historian Publius Cornelius Tacitus noted – as early as in the 1st century AD – that “now bills were passed, not only for national objects but for individual cases, and laws were most numerous when the commonwealth was most corrupt” (*Annals*, book 3, chapter 27). It is interesting to note that the current Italian prime minister – Silvio Berlusconi – has been charged of creating laws *ad personam*; i.e. he has been charged of creating specific laws to safeguard the specific interests of one individual. The beneficiaries of such legal measures include the prime minister himself and other close associates.

⁵ See Cinzia Sasso, ‘Borrelli e gli inediti di Craxi: Volevano frenare Mani pulite’ *Repubblica*, 7 December, 2007. <http://ricerca.repubblica.it/repubblica/archivio/repubblica/2007/12/07/borrelli-gli-inediti-di-craxi-volevano-frenare.html>, 25 May, 2009.

defined as corrupt if compared to the moralistic definitions that appear in the dictionaries and that are mentioned above.

A simple definition of corruption as “the misuse of entrusted power for private gain” is adopted by international institutions (e.g. by the international NGO Transparency International and by the Danish Development Agency Danida).⁶ Such definition is a useful reference point, but the benefit of simplicity comes at the cost of some vagueness. This definition suffers from the vagueness associated with the lack of examples and further classifications; we consider it as a good starting point to achieve a useful definition of corruption, but it needs to be complemented by a more articulated characterization and that is what we are turning to now.

We will complement the basic definition with a classic one from Nye that is narrower than the moralistic one, seemingly less clear-cut than the legal one, but more operational for the purposes of economic analysis: “Corruption is behavior which deviates from the formal duties of a public role because of private-regarding (personal, close family, private clique) pecuniary or status gains; or violates rules against the exercise of certain types of private regarding influence. This includes such behaviour as bribery (use of a reward to pervert the judgment of a person in a position of trust); nepotism (bestowal of patronage by reason of ascriptive relationship rather than merit); and misappropriation (illegal appropriation of public resources for private-regarding uses)” (1967: 419).⁷ This definition offers lucid classifications of corrupt behaviour, but fails to include corruption behaviour by people who are bestowed with power that derives from roles in private organizations (see the discussion in the next section). Putting together the general definition mentioned above with a corrected version of Nye’s we will use the following definition: Corruption is the misuse of entrusted power for private gain; it is behavior which deviates from the formal duties of a given role because of private-regarding (personal, close family, private clique) pecuniary or status gains; or violates rules against the exercise of certain types of private regarding influence. This includes such behaviour as bribery (use of a reward to pervert the judgment of a person in a position of trust); nepotism (bestowal of patronage by reason of ascriptive relationship rather than merit); and misappropriation (illegal appropriation of public resources for private-regarding uses).

⁶ http://www.transparency.org/news_room/faq/corruption_faq, 3rd June 2009. For Danida’s definition see <http://www.um.dk/en/menu/DevelopmentPolicy/AntiCorruption/>, 3rd June 2009.

⁷ Similar definitions are also available in the encyclopaedia: “Improper and usually unlawful conduct intended to secure a benefit for oneself or another. “Corruption”. *Britannica Concise Encyclopedia*. 2007. Encyclopædia Britannica Online, 6 Nov. 2007.

The objective of endorsing this definition is not to identify *the* right definition, but of choosing a useful one for the purpose at hand.⁸ While concepts and their definitions cannot be said to be right or wrong and can be the basis of infinite discussions, we take the more pragmatic approach of finding a working characterization and highlighting its limitations.⁹ One of the main drawbacks of this definition is that there are grey areas around the notions of misuse of power and formal duties; that is to say that concepts underpinning this definition do not have entirely univocal meanings especially when we look at different understandings that can arise because of cultural diversity. Choosing one characterization of these concepts, presumably from a model society, and casting in stone a single model of public office and moral conduct would entail an ethnocentric approach (i.e. a western stipulation) (see Philp, 1997; Roy, 1970).¹⁰ At the same time, in the converse relativistic approach, in which norms differ according to the cultural context, nothing can really be called corruption, and it is not possible to pass normative judgments on any social phenomenon (this is also referred to as the cultural approach; Bardhan, 1997). Whereas the understanding of duties and roles depends, to a certain extent on cultural norms, in most countries – where the policy framework prescribes a modern bureaucracy – norms are standardised and the concern about abuse of power for private gain is more or less universal and not confined to western societies.¹¹ In fact, in opinion polls of developing countries, corruption is often cited as the prime concern of respondents (Bardhan, 1997: 1330). We find that – while a certain degree of uncertainty is unavoidable – our definition benefits from the fact that these uncertainties are reflected in the language used (by not referring to external and seemingly clear categories such as the law) and not focusing solely in the public sector fits in a social sciences' concern with the analysis of corruption and its effects.

Additionally, we recognise that there can be extreme circumstances where the standards to discern corruption as they pertain to misuse of power, duty and public

⁸ It is also a definition that is coherent with the measures of corruption used in the empirical analysis in the rest of the thesis.

⁹ The point is made in Williams, 1999: 511.

¹⁰ In this approach, standards developed by a particular type of society (i.e. the western society) are assumed to be the ideal and are employed to set the standards against which we can measure progress of any society. In the case of corruption, the model would be the working of western rich democracies and their understanding of duty and morality.

¹¹ We highlight that the indexes of corruption that we use throughout the thesis are aggregations of indexes coming from various sources. These sources include citizens' opinion polls and international experts' surveys and the high correlation in the original indexes indicates that cultural ambiguities with respect to the concept of corruption are not a serious issue (Kaufmann and Kraay, 2007: 22).

role do not hold. For example, during revolutionary periods loyalties other than to the state are prominent and the idea of the state itself might be the object of contention. In such situations the concept of corruption – as defined here – is inadequate.

Now, we discuss some concepts related to corruption and its different forms. This discussion aims at clarifying notions used throughout the book and puts them in the context of the economic literature.

Social capital is one of the concepts associated with corruption. Social capital, as defined by Putnam, “refers to networks and the norms of reciprocity and trust that arise from them” (2000: 19). Putnam cautions us that not all forms of social capital have a positive impact and critically distinguishes between “bonding” and “bridging” social networks; the former are more likely to have negative externalities. Corruption results from bonding networks and is mentioned as a negative manifestation of social capital (Putnam, 2000: 22). The fact that corruption might arise from networks based on trust and – through repeated interactions in corrupt transactions – might increase social capital has been analysed empirically. The findings of this line of research suggest that – while corruption might bond and contribute to trust among interacting parties – it decreases trust in society in general (Seligson, 2002).

Another concept related to corruption is bribery; this is the most obvious case of corruption where inducements are used in order to convince the bribed to change her course of action. The act can be ascribed to the will of the briber or to a request of the bribed. Corruption in the case of bribery is evident because there is a direct exchange where the action of the person in power is dependent on the payment made by the briber. We will use the concept of bribery – for ease of interpretation – in exemplifying different types of corruption.¹²

Shleifer and Vishny (1993) differentiate between corruption with theft and without theft. In corruption with theft the official demands a payment in order to offer a service that the briber should not get, or offers it for a price that is a fraction of the regulated price. Custom officials letting illegal goods (or legal goods without exacting import duties) enter the country in exchange for kickbacks represent examples of corruption with theft. The final cost of the operation for the briber might well be smaller than the cost without corruption and both parties might have an interest in keeping the deal secret (i.e. they collude). The case of a custom official that requires an unofficial payment – over and above import duties – just in order to process paperwork is a case of corruption without theft. This type of transaction is

¹² Familism and patronage are other forms of corruption, where the duty is subverted not for immediate gain, but for allegiances to special networks. Of course, belonging to the network and contributing to it can ultimately lead to personal advantages.

characterised by divergent interests, because the briber would prefer to avoid the payment, hence there can be defection (i.e. the briber might denounce the bribed).

Another useful distinction, based on the status of the bribed, is between political corruption and bureaucratic corruption.¹³ In the first instance, the bribed is a policy maker that influences policies in exchange for a side payment. In the second scenario, the corrupt actor is a bureaucrat that does not implement the regulations that were set by her superiors.¹⁴ The different actors – politicians or bureaucrats – are likely to have different incentive structures (e.g. voters' perceptions can be more influential in the case of a politician than for a bureaucrat).

1.3. CORRUPTION AND THE PRIVATE SECTOR

Corruption can be either understood as a phenomenon characterizing only the public sector, where the key element is the misuse of public power, or something that might happen also in the private sector and where the power entrusted on the corrupt agent might also relate – for example – to corporations and NGOs (Hodgson and Jiang, 2007). Here we will present evidence of how the general understanding of corruption includes also the private sector, how also economists have dealt with the nature and the effects of corruption necessarily involve also the private sector, and the way a biased understanding of corruption leads to fallacies in terms of policy prescriptions.

In the first place, it is worth highlighting how corruption always involves multiple parties (typically the briber and bribee), and in most instances some of the parties will belong to the private sector; in the case of collusive corruption, the party from private sector might even play dominant role by soliciting the bribee accept a uncalled-for advantage in order to gain some undue benefit that the person in a position of power is capable of offering. These roles of the private sector do require tools to deal with these transactions, but the prominence of private sector is evident and relatively uncontested (Shleifer and Vishny, 1993). Here, by arguing for a characterization of corruption that includes also cases where none of the parties exercises a public role, we mean simply that we want to include also transactions where all the parties in the deal belong to the private sector. In other words, also cases in which the entrusted power that is being abused is of private nature should fall under the rubric corruption.

¹³ Similarly, a distinction can be made between grand and petty corruption. Grand corruption involves high level bureaucrat or politicians, for example it occurs when a sizeable payment is made to secure a large procurement contract (Rose-Ackerman, 1999: 27). Petty corruption involves small payments to people at low level of hierarchies (see Lambsdorff, 2005).

¹⁴ See also Bardhan, 2006 who has similar and additional categorizations.

Furthermore, we want to highlight how this characterization of corruption undermines the simplistic conclusion that the expansion of the private sector vis a vis the public sector (e.g. via privatization) implies a decrease of corruption. It might as well be that case that the locus and the actors involved in corruption change without changing the nature of the transactions that take place.

The public at large, international organizations and social scientists when analysing corruption reveal that their understanding is informed by the fact that corruption is something that can affect also the private sector. This perception is exemplified for the findings of the *Global Corruption Barometer 2009* (Transparency International, 2009): in a survey of the population of 69 countries – based on 73,000 interviews – it was found that the private sector is perceived in 12 countries to be the most corrupt when compared to political parties, parliament and legislature, the media, public officials, and the judiciary. This opinions, and the underlying understanding of corruption, stand in clear contrast with characterizations of corruption that focus uniquely on the public sector.

Transparency international itself – as mentioned above – endorses the operational definition of corruption as “the abuse of entrusted power for private benefit” that includes also the private sector; nevertheless its *Corruption Perception Index* uses sources that define corruption as the “the misuse of public power for private benefit”.¹⁵ Also the World Bank at times defines corruption as something pertaining only the public sector, while it also discusses the problem of “corporate corruption”.¹⁶ These inconsistencies show the tension created by the fact that often the starting point of the analysis is corruption only in the public sector, but many ramifications and issues require the inclusion of corruption in the private sector. This point is often unclear.

With respect to the way economists interpreted the problem of corruption, a long quote from Alfred Marshall is in order. Marshall already at the end of the 19th century noted that:

“Every one is aware of the tendency to an increase in the size of individual businesses, with the consequent transference of authority and responsibility from the owners of each business to its salaried managers and officials. This would have been impossible had there not been a great improvement in the morality and uprightness of the average man: for even as late as the seventeenth and eighteenth

¹⁵ Cfr. Lambsdorff, 2008 and http://www.transparency.org/news_room/faq/corruption_faq, 3rd June 2009.

¹⁶ Cfr. Kaufmann, 2004 and Kaufmann *et al.*, 2005.

centuries we find the great trading companies breaking down largely in consequence of the corruption and selfishness of their officials.” (Marshall, 1897: 130).

Marshall’s concerns for the structure of firms, their hierarchies and functioning, shows how corruption within the private sector can affect the basic unit on which economic development is based. The role of firms and the rationale for their existence was later re-emphasised by Ronald Coase who argued that to understand the nature of the firm we should look at alternative ways in which transactions could take place and compare the associated costs (Coase, 1937). Re-phrasing Marshall, it seems apparent that transactions –and the associated costs– within firms were already a concern for him and that corruption might affect these transaction to the point of limiting the size of firms in corrupt environments. This is an example of how economic analysis has shown that the abuse of power, entrusted in the private sector, can also lead to detrimental economic outcomes and that the concern with corruption in economic theory is not bound to the public sector.

Similarly, other aspects of corruption and of the way corruption has been analysed can be the base for an extension of the analysis to the private sector. One example of these instances is the explanation of the association between high corruption levels and low investment levels because corruption would act as a tax on investment (Mauro, 1995 Wei, 2000). In this framework the investor would face public officials that exact bribes in order to allow the investment to take place. The investor would discount such expenditures before taking the decision to invest and the impact of corruption would be analogous to the one of taxation. We can easily extend these considerations to the private sector; the effect on investors of corruption within their own organization would be of the same nature: the siphoning of part of the revenues of the enterprise by its employees could also be seen as a tax on investment and would have similar impacts on future revenues and on investment decisions.

Now we will present three examples of how reforms of public sector activities, namely privatization, did not achieve one of their objectives: the reduction of corruption. towards the analysis of corruption requires the private sector while we also show how basing the analysis and policy advice on definitions of corruption that focus solely on the public sector is bound to create fallacies.

The privatization process in the former USSR was marked by corruption and the sale of state assets offered an opportunity to grab and accumulate large fortunes by illegal means (e.g.Sachs, 2005), this outcome is the apparent result of the mismanagement of the whole process and of the erroneous assumptions on which it was based (Black *et al.*, 2000). The idea that substituting markets and private agents

to the state would automatically enhance efficiency and solve the problem of corruption underlies the course of action (Boycko *et al.*, 1996) and its failure. Many lasting problems were created: the whole privatization process, because of corruption, produced a class of tycoons whose fortunes are tainted by their illegal nature. To this day these entrepreneurs depend on complacency from the government to retain their possessions and this dependency has further fuelled corruption that is still pervasive. Furthermore, many of the 'new rich' have preferred to siphon their illegally-obtained funds abroad, deepening the lack of funds for investment and damaging economic development prospects of the country. Among the many negative effects of carrying out the privatization program in such a fashion, there is the detrimental impact that corrupt privatization has had on the whole democratization process in Russia because of the nexus created between the 'new rich' and the politicians and the fact that privatization and political corruption proceeded hand in hand fuelling disillusion on the changes associated with democracy.¹⁷

The second example is from the privatization of some healthcare services in Italy. The state provision of health care in Italy has been marred from corruption for a long time and the sector was at the centre of many of the judiciary cases in the anticorruption trials known as '*mani pulite*' (clean hands) at the beginning of the 1990s. The trials – among many other facts – have shown how the national health service was buying medicines at inflated prices because of the collusion of employees of the ministry of health, of the minister himself and pharmaceutical companies. Since then the presence of private health care providers has increased and many health services are now delivered by private companies that get reimbursed by the state. Unfortunately, recent cases have shown how the extension of private operations in the sector has not been able to stamp out corruption and private health care providers have been able to get compensations for services that they had never provided or, even worse, they were providing unnecessary services (including surgeries) to unknowingly patients in order to obtain compensations for them.¹⁸

The third example is the privatized electric utility of Nicaragua. The generation companies have been privatized from the mid-1990s and formerly state-owned distribution companies have been bought by a multinational company (Union Fenosa). The privatization process – as in the Russian case – has not been

¹⁷ Whole of this is not to say that privatization of state enterprises should not have taken place, on the contrary we mean that the potential benefits of the privatization process were lost because of the way the process was mismanaged (cfr. Black *et al.*, 2000).

¹⁸ For an overview of the corruption problems related to healthcare in Italy, see Paolo, 2008; for some of the most recent cases see <http://www.repubblica.it/2008/06/sezioni/cronaca/medici-arrestati/medici-arrestati/medici-arrestati.html>, 14th June 2009.

accompanied by the implementation of regulations to secure that the potential benefits of the process would be realized (CEPAL, 2003). Interestingly, one practice that is still common for employees of the distributors company is to collect bribes from consumers in order to forge consumption data and the resulting bills. Arguing that these are not cases of corruption since the company is now private, would imply some taxonomic changes (from corruption to theft, or fraud) without really addressing the problems.

The examples of privatization in Russia and Italy show how the size of the public sector might not matter for the spread of corruption and show how privatization might change the practice of corruption but not eliminate it, because privatization creates new interfaces between the public and the private sector and these interfaces remain susceptible to corruption. Overall, the examples show how the shrinking of the public sector might actually create opportunities for corruption (as in the Russian example), or change the locus of corruption interface public private (as in the Italian example), or simply, if we were to define corruption as something that can happen only in the public sector, change the name of things without changing their nature (as in the Nicaragua example).

It is worth noticing that – among social scientists – economists stand out as particularly critical of the public sector and this position is reflected by the fact that many economists agree on the fact that corruption is an issue belonging solely the public sector (Hodgson and Jiang, 2007: 57). Simplistic characterizations of corruption do simply see an alternative between state intervention and the associated corruption and a private sector that can be marked by market failures but is intrinsically not corrupt (for an example see Acemoglu and Verdier, 2000). The policy advice that derives from one-sided characterizations of corruption does not make sense in as much as it would not make sense to suggest that the way to solve problems of fraud and theft in the private sector could be solved by nationalizing private companies.

Another fallacy is the fact that corruption might be the reason why the market failures exist in the first place especially when policy formulation is influenced by political corruption. Powerful interests can unduly influence policy makers into inaction and make them unresponsive to requests to regulate a sector and deal with societal demands. One other main points of this text is that the lack of policies and regulations in the environmental sphere might actually be a result of corruption, rather than a way to deal with it. In this case there is no dichotomy, nor is there a choice between market failures and corruption: corruption actually is the source of market failures. We will transform the famous “because government intervention transfers resources from one party to another, it creates room for corruption” (Acemoglu and

Verdier, 2000: 194) into “because government intervention *and non intervention* transfers resources from one party to another, it creates room for corruption”. The point here is that in the presence of social problems inaction inevitably favour the *status quo* and transfer resources if compared to a situation where the state responds to societal needs regulating certain activities.

Finally, these considerations are backed up by the lack of any consistent econometric evidence that corruption is associated in any systematic way to the size of the public sector in the economy (e.g. Lambsdorff, 2007: 4-5; see the results in chapter 3).

To sum up, A definition of corruption that does not include corruption in the private sector (e.g. as in Nye’s original definition; Nye, 1967) leads one to the simplistic conclusion that to decrease corruption it is sufficient to decrease the size of the public sector. This conclusion is misleading in various ways: it is based only on one particular characterization that does not correspond to the interpretation of corruption that contradicts important strands of economic thought, goes against the grain of a common understanding of corruption in the public, and directs public action towards actions that would simply characterize one type of damaging behaviour (corruption) with other types of behaviours in the public sectors whose final result that is not in any way an improvement of the original state (e.g. by substituting corruption for theft or fraud).

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