INTRODUCTION

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What Is Corruption and Why Does It Matter?

The Millennium Development Goals (MDGs), established in 2000 under the auspices of the United Nations, aimed to reduce extreme poverty to half of its 1990 level, by 2015. This goal was achieved ahead of schedule, by 2010, but as impressive as this achievement is, the gains were not distributed equally across the world: 94% of the reduction in the number of people living in extreme poverty occurred in China.[1] In Paul Collier's (2007) terminology, a "bottom billion" – 1.2 billion people – still live in extreme poverty (less than \$1.25 per day) and 2.4 billion live in poverty (less than \$2 per day).[2]

Poverty, poor health, low life expectancy, and an unequal distribution of income and wealth remain endemic. Many poor countries have had very low or negative growth rates that challenge convergence models of development.[3] Others have weak economic records in spite of a well-educated labor force. Even some countries that are well endowed with natural resources have poor growth records, low per capita income, and massive inequality. The MDGs set specific global development targets, but fulfilling those goals at the country level has proven much more challenging in some countries than in others.

[1] World Bank, "Poverty Overview (Results)," http://www.worldbank.org/en/topic/poverty/overview#3 (accessed June 20, 2014).

[2] Income is measured in real purchasing power parity U.S. dollars with a base year of 2005. See World Bank, "Poverty Overview (Context)," http://www.worldbank.org/en/topic/poverty/overview#1 or http://www.un.org/millenniumgoals/pdf/Goal_1_fs.pdf (accessed June 20, 2014).

[3] Convergence models argue that, as less-developed countries tend to grow faster than more-developed countries, the former catch up with the latter. Such convergence was expected to occur in the latter half of the twentieth century, but was not realized for many countries, so that the gap between rich and poor grew rather than shrank.

The world's leaders continue to debate how to move forward. The MDGs, now called Sustainable Development Goals (SDGs), have been reformulated with the shortfalls of the first effort in mind.[4] Recognizing the remaining problems of low growth and development, the World Bank in 2013 announced the establishment of a new mission: eliminating extreme poverty by 2030.[5] Recent data suggest that this goal is overly ambitious for a variety of reasons, including the fact that a large number of people were just below the original cutoff.[6] However, one part of the explanation is dysfunctional public and private institutions that both hold back growth and restrict the flow of benefits to those at the bottom of the income distribution.[7] Neither public funds nor outside assistance are used as effectively as they could be. Low-income countries and those with weak growth records are often in difficulty because they are unable to use their human and material resources to further development and to aid the poorest.[8] These countries need institutional reform, but such reform

4 United Nations, "Sustainable Development Goals," http://www.un.org/sustainabledevelopment/sustainable-development-goals/ (accessed July 22, 2015).

5 The exact goal is for no more than 3% of the world's population to live on less than $1.25 per day measured in 2005 dollars. See, e.g., World Bank, "Poverty Overview (Strategy)," http://www.worldbank.org/en/topic/poverty/overview#2 (accessed September 3, 2015).

6 "Free Exchange: Poverty's Long Farewell," *The Economist*, February 28, 2015. http://www.economist.com/news/finance-and-economics/21645220-goal-ending-poverty-2030-worthy-increasingly-out-reach-povertys (accessed September 3, 2015). The World Bank (2015) recognizes that the goal is unrealistic and urges a focus on both overall growth and its distribution. A World Bank working paper, Yoshida, Uematsu, and Sobrado (2014), demonstrates some of the flaws in the earlier projections. Lakner, Negre, and Prydz (2014) show how a combination of policies that promote growth and provide targeted benefits to the very poor can combine to produce substantial reductions in the number in absolute poverty.

7 "Institutions are the humanly devised constraints that structure political, economic and social interaction" (North 1991: 97). These include constitutions, laws, rules, customs, and taboos. We also include entities that are commonly referred to as institutions such as bureaucracies, legislatures, courts, schools and other educational institutions, banks and other financial institutions, etc.

8 Kilby (1995) found that World Bank projects were more likely to be given an unsatisfactory rating by the Bank's Operations Evaluation Department if borrower countries ranked poorly on cross-country measures of political instability and corruption. Knack and Keefer (1995) examine the impact of government institutions on investment and growth. Their measure of government quality combines indices of corruption, expropriation risk, rule of law, risk of contract repudiation by the government, and the quality of the bureaucracy. The study examined rates of economic growth for 97 countries over the period from 1974 to 1989. The authors show that measures of the quality of government institutions do at least as well as measures of political freedoms, civil liberties, and the frequency of political violence in explaining investment and growth.

is difficult. Dams, highways, and port facilities are technically straightforward. Reforming government and nurturing a strong private sector are more subtle and difficult tasks that cannot be reduced to an engineering blueprint. The United Nations' recently proposed SDGs include fighting corruption specifically to promote equity, justice, and peace, but reducing corruption will help achieve all the goals.[9]

Until the mid-1990s, international development organizations, such as the World Bank and the International Monetary Fund (IMF), mostly took institutions as given; since then, some (most notably the World Bank) have made institutional reform and good governance priorities. Bilateral lending or aid is also often conditional on staying off "black lists" that highlight corruption, drug trafficking, and other illicit activities.[10] Several factors converged to contribute to this change in policy. The end of the Cold War reduced incentives for the more powerful countries to tolerate corruption in their allies (Theobald 1999). Transitions from centrally planned economies to market economies opened up new opportunities for both licit and illicit profit (Rose-Ackerman 1998b). Accelerated globalization and a 1977 U.S. law criminalizing overseas bribery[11] pressured governments to reduce unfair dealing and firms to reexamine their overseas practices. The founding of Transparency International (TI) and the publication of its Corruption Perceptions Index (CPI)[12] raised international concern about corruption and caused alarm (and, often, anger) in some poorly rated countries

[9] The specific goal is "Goal 16: promote just, peaceful, and inclusive societies." The subgoal reads: "Substantially reduce corruption and bribery in all its forms" and the goal also calls on countries to fight money laundering and organized crime. United Nations, "Sustainable Development Goals," http://www.un.org/sustainabledevelopment/sustainable-development-goals/ (accessed July 22, 2015). We explain the importance of combatting all three together in Chapter 9.

[10] See, e.g., FATF, "High-risk and Non-cooperative Jurisdictions: FATF Public Statement – June 26, 2015," http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/public-statement-june-2015.html (accessed September 27, 2015) for money laundering and financing terrorists; U.S. Department of State, Directorate of Defense Trade Controls, "Country Policies and Embargoes," http://www.pmddtc.state.gov/embargoed_countries/index.html (accessed September 27, 2015) for arms trade; The White House, "Presidential Determination – Major Drug Transit and Drug Producing Countries for FY 2014," http://www.whitehouse.gov/the-press-office/2013/09/13/presidential-determination-major-drug-transit-and-drug-producing-countri (accessed September 3, 2015).

[11] The law is the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494.

[12] TI was founded in 1993 as a NGO committed to exposing and combating corruption worldwide. Its Corruption Perceptions Index, a central part of that effort, is described in greater detail on their website and later in this chapter. The international role of TI is also discussed in Chapter 14. See www.transparency.org for further information.

(Johnston 2005). Finally, the intellectual underpinnings of development policy began to recognize the key role of public institutions (e.g., Olson 1996). The macropolicy prescriptions of the "Washington Consensus" proved to be insufficient to stimulate growth and to alleviate poverty.[13] Development economists began to reach out to the fields of political science and sociology and to incorporate work on the functioning of institutions into their conceptual framework; this led them to confront corruption as a particularly obvious pathology.

The tensions between the capacities of developing countries and the requirements of international aid and lending organizations arise, in part, from the diverse histories and cultures of the countries involved. To critics, the international organizations do not appreciate local customs and institutions and fail to adapt their programs to fit individual countries' special circumstances. Although this is undoubtedly true in many cases, that claim is not the end of the story. Some countries' institutions are poorly adapted even to their own stated development goals, and others manifestly neglect the interests of ordinary people or of important subgroups.

Other critics question the goals of the international community, arguing that economic growth is a narrow and incomplete measure of well-being and that international institutions tend not to take into account local conditions and traditions (e.g., Stiglitz 2003; Easterly 2013). But even if one accepts that criticism, wide differences remain across and within countries in health, education, economic opportunity, and environmental quality. Whatever one's standards of value, they vary widely around the world and are rising and falling at different rates. We do not argue here for a standard of universal value – be it per capita income, "human flourishing" in A. K. Sen's terminology (Sen 1999), ethical universalism, or impartiality. Rather we aim to show that whatever the goals of an institution or polity, corruption can undermine those goals.

We begin with a basic fact of human motivation. Differences in culture and basic values exist across the world, but there is one human trait that is both universal and central to explaining the divergent experiences of different countries. That motivating trait is self-interest. Critics call it greed.

[13] The Washington Consensus, articulated by Williamson (1990), includes standard macroeconomic prescriptions (reducing barriers to trade, establishing an independent central bank with a goal of controlling inflation, investing in human capital and infrastructure, etc.) plus privatization and deregulation. "Washington" here stands for the World Bank and the IMF, not the U.S. government. See Rodrik (2006, 2008) for a critique, a richer theoretical framework, and the incorporation of a broader range of policy options.

Economists call it utility maximization. Whatever the label, societies differ in the way they define and channel self-interest. Endemic corruption suggests a pervasive failure to tap self-interest for legitimate and productive purposes.

We can go a long way toward understanding development failures by understanding how a country's institutions manage or mismanage self-interest, and how self-interest interacts with generous and public-spirited motivations. The best case for the social value of self-interest is the archetypal competitive market where self-interest is transmuted into productive activities that lead to efficient resource use. The worst case is war – a destructive struggle over wealth that ends up destroying the resource base that motivated the fight in the first place. In between are situations in which people use resources both for productive purposes and to gain an advantage in dividing up the benefits of economic activity – called "rent seeking" by economists (e.g., Bhagwati 1974; Krueger 1974; Tullock 1993; Khan and Jomo 2000; Ngo and Wu 2009).

We explore the interaction between productive economic activity and unproductive rent seeking by focusing on the universal phenomenon of corruption in the public sector.[14] Corruption, of course, also takes place in the private sector with no government officials involved, and it often has very damaging consequences.[15] Such activities, although not the focus of our book, remain an important subject for research and policy reform that should complement our emphasis on the public sector. To us, public-sector corruption deserves special emphasis because it undermines developmental and distributional goals and conflicts with democratic and republican values.

I. What Is Corruption?

Corruption has many connotations and interpretations, varying by time and place, as well as discipline. Box 1.1 provides some examples of corrupt acts; it is an illustrative rather than a comprehensive list.[16] To encompass the

[14] Ironically, although self-interest is a basic assumption in economics, macroeconomic models typically assume a disinterested "benevolent social planner." Constructivists look more carefully at how policy decisions are made on both personal and political levels.

[15] See, e.g., Tillman (2009) and Argandoña (2003).

[16] For a more complete list of terms with definitions and examples, see Transparency International, 2009, "The Anti-Corruption Plain Language Guide," available at http://files.transparency.org/content/download/84/335/file/2009_TIPlainLanguageGuide_EN.pdf (accessed June 28, 2014).

Box 1.1. Types of Corruption

bribery	The explicit exchange of money, gifts in kind, or favors for rule breaking or as payment for benefits that should legally be costless or be allocated on terms other than willingness to pay. Includes both bribery of public officials and commercial bribery of private firm agents.
extortion	Demand of a bribe or favor by an official as a *sine qua non* for doing his or her duty or for breaking a rule. We treat extortion as a form of bribery where the bribe taker plays an active role. (Sometimes the rule is created by the extortionist in order to exact the bribe.)
exchange of favors	The exchange of one broken rule for another.
nepotism	Hiring a family member or one with close social ties, rather than a more qualified but unrelated applicant.
cronyism	Preferring members of one's group – racial/ethnic, religious, political, or social – over members of other groups in job-related decisions.
judicial fraud	A decision based on any of the preceding types of corruption, or threats to the judge, rather than the merits of the case.
accounting fraud	Intentional deception regarding sales or profits (usually in order to boost stock prices).
electoral fraud	Manipulation of election results, through vote buying or threats to the electorate, or by falsification or destruction of votes.
public service fraud	Any activity that undermines the legal requirements of public service delivery even if no bribes are paid. For example, teachers might provide students with the correct answers or change students' responses on standardized tests (usually in order to ensure funding). Health care providers might prescribe unnecessary tests or invent patients to increase reimbursements. Civil servants might neglect their jobs for private-sector work, steal supplies for resale, or simply not show up for work.

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embezzlement	Theft from the employer (firm, government, or NGO) by the employee.
kleptocracy	An autocratic state that is managed to maximize the personal wealth of the top leaders.
influence peddling	Using one's power of decision in government to extract bribes or favors from interested parties.
conflicts of interest	Having a personal stake in the effects of the policies one decides.

wide range of meanings, we start with TI's definition of corruption as: "the abuse of an entrusted power for private gain." This definition captures the principal-agent problem at the root of all types of economic and political corruption – bribery, embezzlement, nepotism, influence peddling, conflicts of interests, accounting fraud, electoral fraud, and so forth. The key term is "entrusted power," which refers to the tasks one is expected to perform – reviewing permit applications, passing laws, or hearing legal cases, for example – according to certain rules, written or otherwise. This power may be entrusted by an employer to an employee, or by the populace to a government leader. If one abuses entrusted power, the rules are broken, and the principal's stated goals are subverted. The harm takes two forms: first, in many cases the corrupt official acts inconsistently with his or her mandate, and second, even if he or she only takes acceptable actions in response to a payoff, the official has sold a benefit that was not supposed to be provided on the basis of willingness to pay.[17] Thus, corruption includes both accepting a bribe in return for certifying an unsafe building and demanding a bribe as a condition for approving a fully compliant structure. It includes embezzling contract funds so a promised infrastructure project is delayed and over budget, as well as the simple theft of public funds in a way that inflates public budgets but with little noticeable effect on the level of public services.

[17] Banerjee, Hanna, and Mullainathan (2013) and Hodgson and Jiang (2007) make rule breaking the central feature of their respective definitions. We wish to be clear, however, that the benefit provided in return for a bribe may not break any formal rules. Rule breaking might only consist of the payment of the bribe and the corresponding distortions in the distribution of the benefits and costs of public policies.

We recognize, however, that some polities may be so riddled with self-dealing that the populace cannot really be said to have "entrusted" power to politicians and officials. This can occur either because too much power is in the hands of self-interested, wealth-maximizing rulers – for example, pre-Arab Spring governments in the Middle East[18] – or because the institutional framework is so weak and chaotic that there is no power "entrusted" to anyone, as in the case of Somalia from 1991 to 2012. Some governments and institutions establish goals that most of us would abhor, but efforts to undermine them can still be corrupt in our sense, even if we would applaud those who try to subvert these goals.[19] A weak or autocratic state fuels corruption, and the level of corruption, in turn, makes reform difficult and undermines public trust in government institutions, producing a vicious cycle.

Some work on corruption starts with a strong commitment to a particular view of government legitimacy – most prominently the work of Rothstein and his colleagues (e.g., Rothstein and Teorell 2008) and of Mungiu-Pippidi (2013, 2014). Rothstein focuses on impartiality as a central normative goal for the state. Mungiu-Pippidi stresses "ethical universalism," but the concepts are similar, and they are analogous to North, Wallis, and Weingast's (2009) "open access orders" and Acemoglu and Robinson's (2012) "inclusive institutions." Government actions and institutions that violate these norms are then labeled corrupt.[20] We, instead, study a range of institutional structures that can produce incentives for payoffs and self-dealing. Analysis of the incentives for bribes, kickbacks, and other forms of self-dealing are then an input into both specific anticorruption policies and broad-based efforts at state reform. An implication of both Rothstein's and Mungiu-Pippidi's work is that if bribery undermines a ruler's effort to favor a tight elite and leads to a more impartial or universalism distribution of public benefits, then it is not corrupt. Of course, they argue that such cases are unlikely to occur, but we do not want to rule out that possibility by definition. Rather than associating clean government with a particular normative

18 See, e.g., Slackman (2011) on Egypt under Mubarak.

19 Corruption that undermines detestable laws is referred to as "noble cause corruption" (Miller 2005). One example of noble cause corruption is bribery to save Jews in Nazi Germany (Rose-Ackerman 1978: 9; Hodgson and Jiang 2007: 1049). If "noble cause corruption" is widely seen as acceptable, or when corrupt acts are interpreted as "noble," this indicates a need to change the underlying institutions, but, of course, in such cases, governments are very unlikely to want such change. They may focus on high-profile prosecutions instead.

20 Easterly (2013) includes many examples of corrupt acts in the process of exposing worldwide oppression, but he stops short of labeling the norm violations themselves as "corrupt."