7th International Scientific Conference
"Business and Management 2012"
May 10-11, 2012, Vilnius, LITHUANIA

ISSN 2029-4441 print / ISSN 2029-929X online
ISBN 978-609-457-116-9 CD
doi:10.3846/bm.2012.092
http://www.bm.vgtu.lt

GOVERNANCE POWER IMPACT ON CORRUPTION AND THE BUSINESS ENVIRONMENT-DETERMINING FACTORS

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Abstract. Corruption influences the business environment, but its impact is decreasing continuously. One of the main reasons behind this is the change in peoples' attitude and saturation to ethically questionable actions. Any realistic strategy must be based on the principle that there are always two sides in a process. It means that supply and demand also exist in the case of corruption. It can be pointed out that the war against corruption often involves reforms. Therefore, corruption will decrease only in those countries, where governments are willing to substantially reduce some of their functions.
The aim of the article is to show the different issues of corruption and analyze how they affect the business environment-determining factors; what kind of measures are used in companies to prevent corruption and how these measures affect the business opportunities; to analyze the government's role and influence on this process.

Keywords: corruption, government, business environment-determining factors, companies.

Jel classification: E26, E61, F23

1. Introduction

Corruption appears in different forms. According to the World Bank, corruption is synonymous to abusing public office for private gain. The level of corruption is defined by the amount paid for operating a certain business. For example, politicians are making decisions that appeal to the companies that fund them, not for common good. In the same way, regulations invite economic agents to find new ways, including bribing public officials, to secure favourable interpretations.This is the relationship between corruption and bureaucracy. Corrupt behaviour may ensue in countries where the line between the market and the state is not clear and is not even properly regulated.

Global companies are pursuing their own interests and countries are depending on the taxes those companies pay and the employment they provide. The business environment has changed and organizations are becoming larger than countries, they do not depend on their native countries anymore, but the countries now depend of them. In the end, corruption shakes the economical stability of a country, decreases the productivity of a country's infrastructure, reduces tax revenues and finally prevents the government from keeping public expenditures under control.

Corruption can be also seen in many other forms along with bribery. Even though not all are as clear as bribery, they have a great influence on the business environment. For example, many big organizations are co-operating with or owning a large sports team or affiliated organizations. Using that power, they make sure the affiliated organization would benefit from their business actions.

One of the features of the structural corruption is the use of your relations with someone to get what you want. But it is not that simple - structural corruption is just a method evolved from bribery.

The purpose of the article is to analyze how corruption affects the business environment-determining factors and government's influence on this process.

2. Analysis of the related literature

The literature records conflicting evidence that more economic freedom reduces corruption when it is regressed on the entire distribution of corruption, subdivided by its components, or when the relationship is tested for subsamples of countries (Lambsdorff 2007; Carden, Verdon 2010). For example, Billger and Goel (2009), Acemoglu and Verdier (2000) showed that, among the most corrupt nations, greater economic freedom does not appear to reduce corruption. It may exacerbate corruption issues indicating that nations respond differently to different levels of economic freedom because their dimension is associated with the country's developing conditions. Graeff and Mehlkop (2003), arguing against the use of an aggregate indicator of economic freedom to evaluate their effects, provided support for a counterintuitive influence of the size of government on corruption, as a specific component of economic freedom. The literature has also invoked an institutional dimension to explain some unexpected results (Billger, Goel 2009; Caballero, Hammour 2000). Lambsdorff (2007) argued that the need for government intervention may not be large enough if it is addressed to avoid market failures such as "good" government regulations may become significant in reducing corruption. This implies that the impact of economic freedom or its components on corruption may depend on the variability of government intervention efficiency across "regulated" and "freedom" countries.

3. Causes of corruption

The causes of corruption (World Bank) are varied and would have to be understood in specific contexts. The question whether a particular level or the nature of development might impact on corruption is discussed later. Meanwhile, a few general observations about the causes of corruption seem appropriate. Corruption is closely, but not solely linked to officials' discretion over rents and the degree of accountability in executing such discretion. A number of conditions may influence the extent to which the execution of such discretion becomes vulnerable to corrupt practice. In the absence of clear rules and codes of ethics, discretionary power easily becomes abused.

The less effective the government works in general, with slow budget procedures, lack of transparency, inadequate strategic vision and weak monitoring mechanisms, the more fertile the environment for corrupt practice. Low civil service salaries and poor working conditions, with few incentives and rewards for efficient and effective performance, are strong incentives for corruption.

The overall culture of governance also plays an important role. If political leaders and top bureaucrats set an example of self-enrichment or ambiguity over public ethics, lower level officials and members of the public might follow suit (Shen, Williamson 2005). If informal rules come to supersede formal ones, even the most stringent legal principles and procedures lose their authority. Hence, bribery and corruption may become the norm, even in the face of formal rules intended to support clean governance. Because of government's major role in most developing economies, opportunities for corruption are often more numerous. Furthermore, these countries have often inherited large colonial bureaucracies, where the new leadership has not had much opportunity to indigenise the machinery of government. The moral epicentre that may make for good governance has often been absent as a result. In such environments, corruption has had fertile ground to take root.

In a developing context, these features of corruption become critical to the institutional and social dimensions of development. It is in the rules and practices of governance that the foundations of sustainable development are shaped or undermined. The very basis of development becomes compromised when these rules and practices are not effectively monitored and applied. Development suffers in particular where the rules of governance allow arbitrary resource allocations and the diversion of public resources in defiance of the public good and to the exclusive benefit of corrupt officials, politicians and their collaborators (Heymans, Lipietz 1999).

4. Governance

There are different characteristics describing government functions. Government does exist for two main functions:

• Establish property rights and set the rules for income and wealth redistribution (rule and law based)

• Provide mechanism to allocate scarce resources, when market economy fails to do so. Without government interfere companies might start to produce too much of same goods and services (Parkin 2008).

Government also deals with economic problems like antitrust laws and regulations of monopolies, externalities, provision of public goods, the use of common sources and income redistribution, improvement and education of workforce etc. It is clear that all the mentioned functions are important for societies well being. Government sets preconditions for growth. For economy to work, government has to give people right incentives, government creates the space within households and firms can operate and make transactions (Gagliardi 2008). If government is not able to provides this space for reasons like weak institutions and rule of low or inappropriate economical policies or political system, the citizens of this country will be less able to create prosperity or not able to do it at all. The opinion exists that no unique political system is necessary to do the work. Liberal democracy, founded on fundamental principle of the rule of law, is the most suitable for markets to appear. Governance aspect here comes in, government has to ensure that companies can do business by free monetary exchange and rule of law is established to respect property laws and social agreement. At this point governance power enables economic growth but does not make it inevitable (Parkin 2008).

France Gagliardi (2008) in the article on institution and economic change summarizes that institutions have major effect on economic performance, especially institutions for purpose of protecting property rights and enforcing the applications of contracts. For confirmation of this relation, she discusses and provides extensive review of literature on the matter. The basic argument Gagliardi concentrates on is that individuals can capture gains from trade by cooperating, however corporation without incentives is limited due to the self interested nature of human beings and coordination costs for collective action. Therefore, institutions have to be in place to make individuals more willing to take collective action and make everyone in a society better off. Institutions are formal rules like contracts, and political and economic rules, and informal norms such as norms of behavior, codes of conduct and conventions; also organization, for example, universities, government agencies etc. (Brunetti, Kisunko, Weder 1997).

An empirical study made by Johnson D., Acemoglu (Acemoglu 2001) confirms the relation between economic performance and institutions do exist. The researcher took 75 previous colonies of European settlers with diverse set of institutions and made two hypotheses of our concern: 1) different types of colonization policies created different set of institutions; 2) colonial state and corresponding institutions have stayed even after independence. By using mortality rate of European settlers during the period the researcher argues either the colonization policy was resource exploitive or was there for the purpose of new settlements creation for living. The exploited colony policy for the most part were introduced Africa, together with to scarce protections of property rights and government abuse, while colonized lands like US, Canada and Australia were created for the purpose of living environment creation and are one of the most prosperous countries in the world. Taken as a whole, government must establish the right institutions and make sure they are working efficiently and correctly, as it accountability on economical performance is recognized by academic world.

But there are a lot of various empirical studies which show results that corruption has its adverse effects not only on static efficiency but also (and may be especially) on investment and economic growth. Here can be mentioned some classical references, wich include Shleifer and Vishny (1993), Mauro (1995, 2002), Bardhan (1997), Treisman (2000), M´eon and Sekkat (2005). According to Organization for Economic Co-operation and Development (OECD) corruption threatens good governance, sustainable development, democratic process, and fair business practices. Further the organization claims that it worsens public confidence in political institutions and leads to contempt for the rule of law, as well it alters the allocation of resources, increases spending on public sector and erodes competition. Judging from the effects, corruption has destructive force on economic growth overall, and keeping in mind the discussion on importance of institutions for developing economic setting of the country, economic growth is hard to achieve, because corruption has direct influence on quality of institutions and via versa. Therefore, corruption brings public spending towards the projects that make easier to collect on bribes instead of following priority social programs, which would make all society to live better and benefit poor people, who need the help most.

5. Impact of the governance power

The nature of many development projects often opens up opportunities for officials and service deliverers who want to enrich themselves in such ways. Development projects are particularly susceptible because they often involve vast amounts in innovative schemes where tested monitoring mechanisms are not in place. Also, the generally lower educational levels of poor people, their limited recourse to often expensive legal assistance and the frailty of old people and children make them more vulnerable to exploitation by corrupt service deliverers.

The other type of corruption is institutional corruption: both the political and bureaucratic components of government could become sources and targets of corruption. A common occurrence of such political and bureaucratic corruption is where conflicts of interest are not managed, so that potential beneficiaries of projects or resource allocations are directly able to control or influence decisions about those projects or allocations. Acemoglu and Johnson (2005) established between what they call ‘property rights institutions’ and ‘contracting institutions’ as influences on long run economic growth. Property rights institutions provide private agents protection from predation by the state or powerful elites, while contacting institution regulate contracts between private parties. Acemoglu and Johnson argue and offer evidence that property institutions exert stronger influence on long term economic outcomes than contracting institutions. The reason that they give for this is that private agents usually get around the problem of poor contracting institutions by developing informal substitutes for them albeit at a possible cost. In other words, there is little they could do to counter predatory exercise of political power and therefore withdraw entirely from activities or transactions that they would have undertaken under secure property rights. It means that, the economic outcomes of the failure of contracting institutions tend to be less extreme than those of the failure of property rights institutions.

Political outcomes could become manipulated where election rules are unfair or unfairly applied. In developing countries, where democratic regimes are often still in their infancy, much conflict and suspicion revolve around alleged election fraud. The increasing utilisation of international observers appears to be offering a way of dealing with this problem. Institutional corruption is often — perhaps most commonly — associated with cases where processes of decision-making are misused by those who have the power to waive rules. The intensity of such corruption varies from ad hoc incidents to situations where corruption becomes intrinsic to the way power is exercised. This could range from major decisions of the state to much localized project management decisions. Corruption has become systemic, formal and informal rules that are at odds with each other become interchangeable and decisions increasingly arbitrary. At its worst, this would make bribery and favouritism routine in interactions between the public sector and private interests. This may develop such a strong momentum that no one even challenges the corruption. Honorati and Mengistae (2007) have interpreted this as indication that corruption is a proxy for something more fundamental than the payments of bribes, namely, the quality of 'property rights institutions' in the sense of Acemoglu and Johnson (2005). On the other hand, the indicators of labor regulation and access to finance gauge the quality of 'contracting institutions'. If the positive association between the growth impact and power shortages exists, it can be explained by the fact that there is a property rights dimension to power shortages.

According to Acemoglu-Johnson view the quality of property rights institutions exerts more abiding influence on economic outcomes than the quality of contracting institutions. Also there might be a hierarchy among contracting institutions as influences on growth. Specifically, it looks that employment contract institutions dominate over financial institutions in as far as access to finance constrains the growth only of businesses unaffected by labor regulation. According to the contribution of Fernandes and Kraay (2006), corruption might be considered as a proxy for the quality of property rights institutions. As Fernandes and Kraay (2006) argue, corruption is ultimately the use of political authority in order to make private economic gain (in the form bribes). Its incidence should therefore be higher where property rights institutions are weaker. On the other hand we treat labor regulation, and the financial system as what Acemoglu and Johnson (2005) call 'contracting institutions'. If the Acemoglu-Johnson hypothesis of the primacy of property rights institutions over contracting institutions is correct, and we are right in using corruption as a proxy for the first type of institutions, then one would expect the growth effects of labor regulation, access to finance and power shortages all to depend on the incidence of corruption. Specifically, it can be expected weak contracting institutions to be a binding constraint on performance only where property rights institutions are not.

From the above points it should be evident that the public sector is by no means the only site of corruption. If private companies or individuals pay bribes or commit fraud, they also engage in corruption. In fact, corruption most often lies at the intersection of the public and the private sectors. Corrupt private interests wield their influence through illegal means to take advantage of opportunities for corruption and rent-seeking. Individuals in public institutions succumb to these and other sources of corruption in the absence of credible restraints. Put differently, "corruption equals monopoly plus discretion, minus accountability" (Klitgaard 1998).

Even where improper conduct, such as fraud and bribery, does not directly involve government, the public effects can be severe. For example, when financial systems become notorious for fraud, potential savers and investors might be discouraged to invest in a country, or crime syndicates may target such an environment.

The state's control of public resources and its preferential access to certain sources of information require strict rules and procedures to ensure fair practice. In the absence of such rules, and even at times when these do exist, the government is open to a number of types of corruption: bribery; fraud and theft. Let's see what the common features for these forms are.

Bribery is arguably the most common form of corruption. It entails beneficiaries using extralegal means of payment to acquire government favours and resource allocations. This can involve contracts, tax exemptions, timeframes and technical standards for complying with procurement rules and licences, public information being monopolised, or getting the government to turn a blind eye to illegal activities. The most damaging form of corruption is not always that which occurs on a large scale: the cumulative effect of many small corrupt acts and transactions often leads to gross misappropriations (Gorodnichenko and Sabirianova 2007).

Theft and fraud: Some officials steal state assets under their jurisdiction or made accessible to them as a function of their positions in government. Acquiring publicly owned assets through illegal transactions and fraud constitutes the most extensive form of such corruption. Self-enriching officials typically target taxes and fees. Ironically, while privatisation and utility reform often form useful parts of introducing more accountable governance, the asset transfers involved in such transactions, if not carefully monitored and managed, could create also opportunities for improper acquisition of payments and goods. Furthermore, like other employers, government departments suffer from some employees who simply steal, from stationary and fuel to more damaging thefts like vast sums of money, vehicles and so on (Klitgaard 1998).

6. Business environment-determining factors

Developing societies and their people are not inherently more corrupt than developed ones. Yet, the argument is sometimes made that the lack of development opportunities automatically encourages corruption. From this perspective, economic growth and development create social opportunities that are of potential benefit to people so that they tend to engage in honest activity to sustain themselves. The specific rewards for entrepreneurship and productive investment rise in relation to rent-seeking investment when there is sustained growth. A prospering economy can also afford to pay its civil servants well, reducing their motivation for corruption.

In contrast, the despair caused by inequality and pervasive poverty may encourage people to break the rules of honesty and decency. People's access to or shortages of resources often develop a self-perpetuating momentum so that the well-endowed get even more and the poor get even less. Major development-related assets in this regard are land, educational opportunities and access to capital. The distribution of land affects income distribution in most developing societies because income from land constitutes a major share of households' income in such countries. Furthermore, land is often used in such contexts as collateral for borrowing and investing. The income earning potential and productivity of capital-poor people and institutions is also lower than that of those with capital assets. Educational inequality often translates into broader income inequalities. Firstly, people's earning power is affected by their relative levels of education. Secondly, higher education levels empower some groups to lobby government more effectively to prioritise their particular needs and requirements (Hodgson 2006).

Five points could be made in this regard:

1. The internal logic of the 'more development means less corruption' argument is rather simplistic, ignoring the likelihood that many people will not necessarily benefit from growth and development initiatives
2. It generalises too much. Many poor people do not engage in corruption in the first place. In fact, even if they wanted to, they might not have the resources to do so.
3. Corruption is a global phenomenon. Both first and third world countries have experienced blatant corruption. Transparency International's ranking shows large variations in the perception of corruption among groups of countries at similar stages of development. In fact and contrary to conventional wisdom, pervasive political corruption can be an entrenched element of highly industrialised, democratic societies. It is not merely a by-product of underdevelopment or authoritarianism.
4. Corruption cuts across international borders. Many cases of corruption reported in emerging economies involved corporations from the first world. Transnational corruption, for example, is particularly rife in the arms trade.
5. Modernisation and growth are not panacea for ending corruption. In fact, these processes have been accompanied by an increase in corruption in several transitional economies (Gupta et al. 2003).

One explanation for this phenomenon is that expansion and structural changes in the economy create more opportunities and possibly rewards for corrupt transactions. Moreover, transitional economies do not change overnight. They remain on a dual-track system for some time, marked in part by obligatory delivery at controlled prices, interspersed with market transactions and market prices. This creates several new opportunities for corruption. Within the state-controlled sector, the lack of competitive pricing places extensive power in the hands of officials. Without proper rules and procedures, and in the absence of well-developed checks and balances, officials could easily abuse this power or extend favours on the basis of bribery. Often, privatisation and deregulation weaken these power bases and in that way help to reduce the scope for corruption. However, privatisation and deregulation are also not panacea for ending corruption. The process of the privatisation of state-owned enterprises in many countries has also given rise to opportunities for public officials to receive bribes from buyers of those enterprises and from contractors involved in service delivery (Bardhan 1997). Arguments have been made that corruption may not be inconsistent with development and, at times, may even foster it. The argument is often twofold: that corruption helps to streamline burdensome bureaucratic regulations and ineffective legal systems, and/or that bribery can serve as 'speed money', enhancing efficiency by cutting the considerable time needed to process permits and paperwork. A refined version of this argument is that corruption will allow supply and demand to operate, as the lowest cost firm (with the highest bribe) will win (Beck, Demirguc-Kunt, Maksimovic 2002). Corruption tends to feed on itself. The discretionary powers politicians and bureaucrats in corrupt societies provide them with discretion over the creation, proliferation and interpretation of regulations (Leff 1964, Khan 1996).

Corruption exposes development in several ways. Here can be mentioned some of them. It distorts public spending. Distortions arise in three ways: from shaping the official priorities of government, by deflecting allocated resources away from their original purpose, and by undermining the tax base of government. Tax evasion, weak tax administration and tax exemptions that favour the well-connected and wealthy limit the scope for effective development policy in a number of ways. These practices harm, curb redistribution through undermining progressive taxes and prevent public expenditure on and investment in development ventures.

Corruption undermines efficiency. Time and money wasted through corrupt activities come at the expense of productive activities. This influences both public administration and private enterprises. Public sector efficiency becomes compromised because corruption superimposes informal practices over the proper rules and procedures of government.

Corruption discourages investment and growth. While some investors might well conduct their business through bribes, the overall implication of notoriously corrupt environments is that many potential investors avoid them. In general, when there is slow growth, the returns to entrepreneurship (particularly in the production of new goods) fall relative to those of rent seeking, and the ensuing increase in the pace of rent-seeking activities further slows down growth.

Corruption intrinsically undermines the quality of governance. It does so firstly, because it creates distrust, and the uncertainties associated with arbitrary governance feed such distrust. Furthermore, corruption fundamentally runs contrary to accountability. Corrupt politicians, officials and their cohorts do not want others to know. Information about resource allocations and the basis for decisions therefore becomes deliberately obscured. In the longer run, corruption undermines governance, public trust in the state's credibility and the ethics of government and society. Corruption negatively impacts on the rule of law. The more systemic, the more difficult it becomes to be identified, dealt with.

Due to Frisch (1994) this impact on governance governance by arguing that "corruption kills the development spirit". Nothing is as destructive to a society as the rush to quick and easy money which makes fools of those who can work honestly and constructively." He continues by calling for "… a market economy built around the rule of law and a strong state that does not allow a free ride for uncivilised capitalism aimed at immediate benefit at all cost" (Frisch 1994). These are significant changes in attitude. It is no dishonestly abroad.

7. Conclusions

Corruption is still a major problem and it bends the competition in many business areas. The one dominating form of corruption is the old chap community where your own personal relations affect your decisions.

In developed countries corruption still plays a role in the business environment, though the role is not as dominating as it's been a couple of decades ago. The forms of corruption have evolved from bribery to modern structural corruption, because of the unrestrictive legislation. The contacts between less corrupt and more corrupt countries have intensified in the last decade. All indications show that the number of cases of corruption is on the rise. This may be due to the involvement of many more companies in international business or because of the larger number of countries that are now open to these companies, or more importantly, because, over the years, the reporting of corruption and monitoring of corrupt practices has improved tremendously.

Corruption has major influence on the business environment, but its impact is decreasing continuously and the main reason behind this change is the change in people's attitude and saturation to ethically questionable actions.

In order to reduce worldwide corruption that affects businesses, there has to be a concrete and well-coordinated effort on the part of all concerned. The parties that must take an active role in this effort are:

- Individual countries' governments
- International organizations
- International firms

It is quite evident that the problem of corruption is very complex. The number of entities involved, the underlying causes of it, and the territorial context under which corruption takes place makes understanding the problem quite difficult, but not impossible.

Combating corruption requires more systematic and purposeful interventions, rules and processes to secure good governance. Growth and development alone will not bring such rules: concerted institutional reform, cognisant of the multiple parties and the complex causes and manifestations of corruption, is needed to deal with this challenge.

Regardless of the differences in theoretical explanation, all seem to agree upon the effect of corrupt behavior. In general, corruption confuses the measurement of the real economical state of a nation. Any bribery on the national economical level and government efforts in trying to manipulate the supply and demand will have direct affect on the wealth of the individuals in that country. Corruption will deteriorate the wellbeing and wealth of the people, and thus negatively show on the general wealth and competitiveness of the country.

Corruption distorts the true economical state of a country as it decreases the productivity of public investments and the productivity of a country's infrastructure, reduces tax revenues, finally preventing the government to realize a proper level of public expenditures.

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