Corruption and Public Finance

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600 Water Street, SW, Washington, DC 20024 USA
Authored by: Michael Schaeffer

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Abstract

The phenomenon of corruption should not be viewed in isolation, but as part of the broader issue of governance and public management. The international community's recognition in the late 1990s of the corrosive effect of corruption is a logical extension of the link between governance and development created earlier in the decade. Corruption has occurred from the earliest of time and in all societies. Virtually every aspect of public administration, and public finance, can be a source of corruption – large procurements and major public works projects, tax administration, debt management, customs and ill-designed privatization of state owned enterprises.

Definitions of corruption can be extremely complex. The simplest definition is, "Corruption is the misuse of public or private office for personal gain."[1] In particular, it is widely believed that weaknesses in information and control systems in developing country bureaucracies, and lack of transparency and accountability within the legal and political systems have given rise to cost padding, service diversions and corruption. Aside from the moral and legal considerations, there is now solid evidence that corruption harms operational effectiveness, distorts resource allocation, and invariably hurts the poor the most.

In contrast to just a few years ago, corruption is increasingly seen as neither beneficial ('grease for the machine'), nor inevitable ('it's always worked this way'), nor respectable ('everybody does it').[2] The emerging consensus with respect to corruption is being translated into actual policies of international organizations and governments around the world. This desk study will address the above topics through a selective review of some of the issues dealing with corruption in public finance and service delivery. Specifically, this note will review factors that are likely to influence, or corrupt, public finances and assess their impact on resource allocation and public good finance. This desk study will also provide some recommendations with respect to improving governance and public financial management.

[1] OECD. "Managing Public Expenditure: A Reference Book For Transition Countries". Pg. 447.
[2] ADB. 2001 "Improving Public Administration in a Competitive World". Pg 14.

I. Introduction

Good governance and effective public finance are the two most important vehicles for establishing a country's economic and social priorities within the scarce resources that are available to government. Good governance is an essential part of a framework for economic and financial management including: macroeconomic stability, promotion of efficient institutions responsive to the public interest, and social and economic equity. Poor governance and inefficient, or inadequate, public financial management may result from a number of factors including: civil service incompetence, lack of efficient institutions, and pervasive institutional corruption. Corruption, itself, is not identical to poor governance. Poor governance includes issues that extend well beyond corruption. Nevertheless, poor governance often fails to prevent corruption.

Two simple relationships emerge from international experience: corruption is generally less frequent in richer countries; and, there is a negative correlation between the rate of growth and corruption.[3] In effect, more corrupt countries tend to be poorer and grow at a rate that is significantly lower than less corrupt countries. This desk study will address the issues of governance and corruption issues vis-à-vis public revenue and expenditures. Specifically, this note will review factors that are likely to influence, or corrupt, public finances and assess their impact on resource allocation and public good finance. This desk study proceeds as follows. Factors that are likely to influence public good finance and investment are discussed in Sections 2 and 3. Sections 4 and 5 briefly provide some policy considerations and opportunities for formulating or enhancing additional anti-corruption polices with respect to finance of public goods and briefly look at a few of USAID's anti-corruption projects.

[3] ADB. 1999 "Governance, Corruption and Public Financial Management". Page2.

II. Corruption and Public Finance

The past few years have seen growing public recognition and discussion of the problem of corruption in public finance. The World Bank, OECD, USAID, and UNDP have all established internal task forces on corruption. Equally telling is the willingness of many public officials in emerging economies to discuss the challenges of corruption in their respective countries. In a recent survey of more than 150 ranking public officials and key members of civil society from more the 60 developing countries, the respondents ranked public sector corruption as the most severe impediment to development.[4]

What is corruption as applied to public finance? There are many different definitions of this concept. The simplest, and broadest, definition of corruption is "the misuse of public or private position for direct or indirect personal gain."[5] Various factors contribute to corruption (see Tanzi 1998). Some of these factors have a direct impact while others only an indirect impact. The factors which have a direct impact include: regulations and authorizations; complex tax systems; government spending decisions; public provision of goods and services at below market prices[6]; and situations in which public employees have discretionary power over economic decisions.[7] Among the indirect causes of corruption must be included: the professionalism of the civil service, the level of public wages, institutional controls, the transparency of rules, laws, and process, and the severity of the penalty system if caught.[8] The following sections will discuss in some detail the relationship between public revenue and public expenditure and governance in general and corruption in particular.

[4] See Cheryl Grey and and Daniel Kaufman. 2000. "Corruption and Development". The World Bank.
[5] OECD. Pg. 447.
[6] In addition, some state protected monopolies may provide goods and services at exploitative prices. Or, these protected state monopolies may provide shoddy or poor quality goods.
[7] ADB. 1999. Page 6.
[8] Ibid. Pg. 6.

The Fiscal Dimension

In order to perform the roles assigned to it by its citizens, the government (national and subnational) needs to collect resources from the economy in an efficient and appropriate manner, and allocate those resources responsively, and efficiently. An important dimension in assessing the extent and efficiency of public good finance is how the authority to tax and spend is distributed between the central (national) and local government. This raises a complicated set of issues because there are many different types of taxes, different types of expenditures, and many different ways in which (economic) jurisdictions can be defined. In addition, tax expenditure assignments can be divided among different jurisdictions.

Particular types of governmental activities often create fertile ground for corruption. In this section, the fiscal aspects of governmental function are reviewed, specifically: incentive effects of fiscal decentralization, taxation, public expenditures and the general provision of goods and services.

1. Incentive Effects of Fiscal Decentralization

The governance outcomes of decentralization efforts largely depend on the design of the fiscal transfers from the central government. These fiscal transfers take many forms, including: block, conditional and matching grants; and the assignment of shares of taxes collected by the central government (revenue sharing taxes). The variety of central government transfers and tax sharing schemes brings with it an equally wide array of incentive effects. Discretionary transfers frequently may depend on the loyalty of lower-level government officials. As a result, discretionary transfers may tend to strengthen the patronage networks of national political systems.

In many developing countries, grants and political mandates arise from centrally (or nationally) determined policy priorities. The centrally determined priorities may advance national priorities equally across the country. Sometimes these centrally driven priorities may deviate from, conflict with, or distort the political and fiscal initiatives that are being driven at the local level. Fiscal policy distortions between central and locally driven priorities usually create incentives for corruption.

2. Taxation

Good governance and public financial management requires taxes that are based on clearly written laws and do not require frequent contacts between taxpayers and tax administrators. The decentralization of fiscal responsibilities may create coordination problems with respect to tax rates and overlapping tax bases. One problem with respect to overlapping tax bases is that the tax rate set by each layer of government creates vertical externalities by reducing the tax base of the other layer.[9] Competition between the two layers may lead to tax rates that are too high. In this instance, the vertical externality may lead to increases in tax avoidance schemes.[10]

[9] Roger Gordan, "An Optimal Tax Approach to Fiscal Federalism". Quarterly Journal of Economics. Pg 321.

[10] A simple remedy for reducing tax avoidance schemes in the instance(s) where tax rates are considered to be too high (i.e., Russia in the mid-1990s, India) is to reduce overall tax levels (rates). Reducing tax rates has proved effective in increasing government tax revenues. However, steps to improve overall tax compliance by reducing tax rates should be undertaken in conjunction with increasing tax enforcement and compliance measures (penalties, etc.,).

a. Tax Assignment: Revenue Sharing

It is generally recognized that assigning all or most taxing powers to subnational governments with upward revenue sharing is not advisable, since such an arrangement does not allow the central government to perform its redistributive and macroeconomic roles. This arrangement however is carried out in a few countries, such as China. Upward revenue sharing is considered viable in loose confederations where stabilization and redistribution policies lie with the member states, as well as in countries where subnational jurisdictions have homogenous economic conditions and close tax policy coordination and harmonization (i.e., Germany).

On the other hand, assigning all taxing powers to the central government and relying entirely on downward transfers to local governments is equally undesirable. The arrangement inhibits local governments from matching spending authority with revenue-raising power, hence reducing their fiscal accountability. Some countries completely separate the tax bases for each level of subnational governments, while others allow certain overlaps. Tiers of government in Australia and India have separate tax bases, while Canada and the U.S. have a certain degree of overlap.

b. Criteria for Tax Assignment

In decentralized tax systems, tax policies must be coordinated between jurisdictions to avoid distortion in the free movement of economic resources from one region to another. Such migration would cause jurisdictions to compete with one another through lower taxes or other inducements, and thus create an inefficient (possibly corrupt) fiscal system.

There should be rules for allocating tax revenues among jurisdictions to avoid double taxation or no taxation at all. Where tax bases are relatively mobile, decentralized tax assignment opens opportunities for tax avoidance and evasion. Taxes assigned to central government should cover mobile tax bases, be sensitive to changes in income, and cover tax bases that are unevenly distributed across regions. Correspondingly, local taxes require a relatively immobile tax base, a stable and predictable tax yield, relatively easy administration, and an adequate tax yield to meet local needs and the buoyancy to grow at the same rate as expenditures.

- Value Added Tax

Local administration of value added tax is problematic, as each local government could set its own standard tax rates and methods of administration. There are also opportunities for local protectionism. Even if the VAT rate and base structure are determined by the central government, VAT proceeds should not be shared between levels of government; otherwise, some resource rich areas would benefit great, while others would collect little or no revenues. Nonetheless, the VAT is a subnational tax in Brazil (and, in China) where central and provincial governments share VAT proceeds on a derivation basis. Still, protectionist measures have been taken in some Chinese provinces (with the potential for increase in corruption). In Brazil, the decision to allow VAT as a subnational tax has lead to administrative problems and economic distortions. Overall, one useful way to funnel VAT proceeds to subnational governments is for the central government to administer and collect VAT and earmark a share of it for a distributable pool.

- Corporate Income Tax

The corporate income tax must be levied by the central government since it fails all the tests of a good local tax; it imposes high compliance costs, generates incentives for tax avoidance and offers the opportunity to export the tax burden to other regions. Corporate income taxes are still levied at the subnational government level in many developing and transitional economies. Problems have not arisen because many businesses tend to operate in a single province, but problems (corruption) will become more apparent once businesses begin to operate in more than one province.

c. Primary Areas of Tax Corruption

Taxes based on clear laws and not requiring contacts between taxpayers and tax inspectors are less likely to lead to acts of corruption.[11] Tanzi (1998) writes that corruption is likely to be a major problem in tax and customs administration, when laws are difficult to understand and can be interpreted differently so that taxpayers need assistance in complying with them. In addition, when the administrative procedures (e.g., the criteria for the selection of taxpayer audits) lack transparency and are not closely monitored within the tax or customs administrations the potential for corruption is likely to increase. Most importantly, public sector corruption will be pervasive when acts of fraud on the part of the tax administrators are ignored, not easily discovered, or when discovered – penalized only mildly.

d. Tax and Customs Administrations

Tax and customs departments are often the locus of major fraud and corruption and thus are potential candidates for inclusion in national strategies to control corruption. Malfeasance in the tax and customs department can be addressed by potentially providing greater managerial freedom to the revenue agency (hiring and firing of personnel) and to establish decent pay levels while at the same time subjecting the agency's performance to close scrutiny. By controlling theft, good financial management systems change the economics of bribery.[12]

Organizational restructuring of tax departments[13] and staff rotation can also help reduce the opportunities for corruption. Furthermore, supervisory

[11] Vito Tanzi. 1998 "Corruption Around the World". IMF Staff Papers. Vol. 45. No. 4. Page 567.
[12] Businesses' may no longer have the incentive to collude with corrupt officials to avoid taxes. The incentive maybe changed, such that businesses may now have the incentive to report corruption.
[13] For example, separating the tax assessment function from the collection function.

oversight, and control, within the tax administration should be increased.[14] In other words, tax management supervisors should attest that they have scrutinized the work of their subordinates.

3. Computerization of Tax and Customs Administration

According to World Bank analysis (WB Prem Note 44, 2000) computerization of tax and customs administration is an important element of capacity building and revenue administration. The most obvious benefit of computerization is more effective revenue collection due to better audit selection, easier detection of non-filers, and faster payment and refund processing. Information technology can also increase the transparency of tax and customs administration, and thereby reduce corruption.

Tax computerization projects are effectively tax administration projects. Their timing depends on the status of legal and administrative reforms of the tax system. As a result, tax policy reforms during the installation of an information technology system could negatively affect the potential positive impacts of developing a computerized system. Ideally, tax computerization should follow and support tax policy reform.[15]

a. Tax Avoidance

The impact of corruption and of tax evasion on tax collection is not new in the public finance literature. In a series of papers, Tanzi and Davoodi (1997) have provided evidence that countries with high levels of corruption tend to have lower collection of tax revenues in relation to GDP. The implication is that some of the taxes paid by taxpayers are diverted (to tax administrators). Tanzi

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[14] For a more detailed discussion of tax administration reform see David Meyer and R. Hester. 2001. "Combating Corruption in Economic Growth Activities: The Case of Tax Administration Reform".

[15] The computerization of the tax and customs administration systems could (possibly) allow for on-line filing of tax and customs forms in the most advanced countries. This would potentially eliminate many opportunities for corruption. Further, computerizing the tax system would enhance the adequacy of administrative procedures including: compliance, tax audit, taxpayer services, sanctions and appeals, customs clearance procedures, pre-shipment inspection, and information sharing.

(1999) argues that a distinction needs to be made between taxes collected by the tax administrators and taxes received by the treasury.

Low level of taxation may lead to a high sub-optimal level of public spending (which may lead to higher fiscal deficits). In effect, tax corruption and tax avoidance may negatively impact economic growth through its effect on fiscal deficits.[16] Simplifying tax and tariff schedules, and keeping rates at moderate levels, thereby reduces the discretion of tax (and customs) staff and narrows the scope for corrupt payments.

4. Public Expenditures

Public expenditure management is instrumental to effective public service delivery and reducing the extent of public sector corruption. Access to information on the actions and performance of government expenditures is critical to achieving government accountability. Unless the public knows what goods and services are provided, how well they are provided, who the beneficiaries are, and how much they cost, it cannot demand (nor expect) effective government. To promote government accountability, government budgets and expenditure programs need to be disclosed to the public. However, many developing countries have weak or inadequate mechanisms for citizens to monitor actions of government.

Another mechanism that promotes transparency and accountability with respect to public good finance is the periodic public sector audit. The public sector audit has proved to be effective in many developed countries (U.S., Germany, France, etc.,). Despite the effectiveness of this mechanism, many developing countries fail to utilize an independent public sector audit as a benchmark standard for enhancing public sector accountability.

A commonly used practice in many developing countries is a paper audit. In other words, there are no spot checks to verify the audit information and there

[16] Ibid. Pg. 16.

may be blanket prohibitions imposed on releasing public sector audit information. As a result, audits in many developing countries become subject to bribes. The creation, and existence, in audit systems of physical audit requirements, sanctions for late submission or data manipulation, and making audit reports available to the public are critical pre-conditions for restraining corruption.[17]

Extra-budgetary accounts are common in many countries. Some of the extra-budgetary accounts have legitimate uses and are established for specific purposes such as pension or road funds. However, many extra-budgetary funds are established to reduce the political and administrative controls that are more likely to accompany spending that goes through a normal budget process.

Government contracting and procurement procedures play a significant role in public service provision, and also account for a significant share of resource leakage and corruption. The provision of goods and services to local communities poses special problems of information and monitoring. These challenges include, but are not limited to: bid-rigging and collusion; manipulation of engineering specifications; over-invoicing or undersupply of materials; and the wholesale diversion of funds. Administrative oversight and audit can help in restraining procurement corruption. However, sometimes the administrative oversight itself can be compromised.

Large capital investment projects have frequently lent themselves to acts of high-level corruption. Oftentimes, high-level public officials have a significant degree of discretion in influencing the scope and magnitude of public investment projects such that the type of public spending can become distorted. Public investment projects have frequently been developed to provide opportunities for some individuals or political groups to gain concessions. In general, this form of

[17] In addition, establishing an oversight board to ensure the integrity of independent auditors may also be warranted. Due to the perceived lack of independent auditing functions with respect to publicly held corporations in the U.S. an oversight monitoring board is being established with the expressed intent to verify (validate) the integrity of the independent audit system.

public good finance corruption has resulted in projects and expenditures that may not have been justified by objective investment selection criteria.

5. Provision of Goods and Services

I n many countries, the government (central, subnational) engages in the provision of goods and services, and resources at below market prices[18]. In other words, various services such as electricity, water, public housing, health and education may be subsidized. Substantial economic and financial analysis indicates that many goods and services are provided to the local citizens without consideration for cost recovery (including amortization/depreciation). Even access to some forms of pensions (i.e., disability) may fall into this category. In some countries, disability pensions have proven to be fertile ground for corruption.

Because many of these ‘subsidized’ goods and services are provided at below market prices, supply may be limited. Rationing becomes unavoidable. In this instance, excess demand for those goods and services is created. Decisions have to be made to apportion the limited supply. These decisions to ration the supply are often made by public employees (civil servants). In effect, the public employee may demand bribes in order to provide the citizen with the good or service.

Good Budget Formulation

`In keeping with the three primary objectives of public expenditure management, the budget preparation process should aim at: 1) ensuring that the budget fits macroeconomic policies and resource constraints; 2) allocating resources in conformity with government policies; and, 3) providing conditions for good operational management. In minimizing the corrosive influence of

[18] For a more thorough discussion see Vito Tanzi “Corruption Around the World”. IMF Staff Paper. Vol. No. 45. No. 4. 1998.

public financial management corruption, it is essential that these three items for effective budget preparation be improved.

The coverage of the budget should be comprehensive. The budget should include all revenues and expenditures of the government, whatever the arrangements may be for managing some particular programs. Operational efficiency requires taking into account the specific characteristics of different expenditure programs when designing budget management rules (e.g., rules concerning transfers of resources from one budget item to another). When there is a strong link between revenue and benefit, earmarking arrangements maybe considered thereby enhancing performance in public service delivery.

Weaknesses in the budgeting process depend in large part on political factors and on the organization of the government (e.g., lack of coordination, unclear lines of accountability, and overlaps in the distribution of responsibility). Unclear lines of accountability and overlaps in the distribution of responsibility all contribute to increases in public financial management corruption. Mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision-making. Strengthening the budget preparation process requires improvements in the following directions:

- Decisions that have a fiscal impact should be scrutinized together with direct expenditure programs.
- Spending limits must be built into the start of the budget formulation process, consistent with policy priorities and resource availability.
- Operational efficiency requires line ministries to be held accountable for implementing their programs. However, they can be held accountable only if they have participated in designing the programs and have authority for managing them. This requires a number of developing countries to review and revise the distribution of responsibilities in budget preparation.

Is program based budgeting or performance based budgeting appropriate in many developing countries? Injecting formal performance related elements into public management in developing countries requires extreme care because better performance orientation is critical for improving public administration and because there are many incorrect (wrong) ways of pushing it (and, only a few ways of doing it correctly). The suitability of performance budgeting (and, performance measurement) and the specific indicators themselves depend among other things on the sector in question. The lessons on international experience include:

- Robust monitoring of performance should include swift and predictable consequences.
- Performance based budgeting (and programs) should consider the probable impact of introducing performance indicators on individuals' behavior and take compensatory measures (if needed)
- In order to install performance-based systems, it is essential to understand the different limitations of input, output, outcome and process indictors of performance, and tailor the use of each to the specific sector in question.
- It is essential to build in provisions for the systematic assessment of performance of the performance system itself. In other words, the performance management system must be subject to a reality check.

Beyond the above caveats, it is important to constantly be on the look out for any possibility to expand the service awareness of government administration, and raise the rewards and sanctions for good and poor performance, respectively.

Transparency and Accountability of Government Actions

Access to information on government performance is critical for the promotion of government accountability and minimizing corruption with respect to public finance. This section expressly reviews institutional controls and rules, laws and public sector accountability issues.

1. Institutional Controls

Corruption within the civil service (bureaucracy) can be minimized with the installation of institutional controls. The most effective controls generally reside inside institutions. This implies that there is honest and effective supervision, auditing oversight and control, and an awareness and internalization of the standards of ethical behavior. Supervisors and their civil servant employees should be held accountable for acts of corruption in their office.

Several countries and cities, including Singapore, Hong Kong, and Argentina, have created anticorruption or ethics offices. To be effective, these offices must be independent from the political establishment, have ample personnel and financial resources, and have high ethical standards. Ethics offices must also have to power to enforce penalties. However, several of these offices must report to the President (or Prime Minister), which may reduce their effectiveness and politicize the process thereby reducing overall effectiveness.

2. Transparency of Rules, Regulations, Laws and Processes

In many countries, the lack of transparency in rules, laws, and process creates abundant areas for corruption. Rules dealing with government procurement process, financial management and accounting are often confusing. Even if an individual exercises some initiative and tries to understand the rules, the documents specifying these rules may not be publicly available. Furthermore, many organizational rules may be changed without public announcements to that effect.

In many instances, regulations and laws are written so that only trained lawyers can understand their true impact. Many laws are often conceptually opaque, thus leaving grounds for different interpretation. In the United States, the judiciary may be called into discern the true nature of the law. In many developing countries, the judicial process is not as efficient. This may lead to additional corruption with respect to trying to obtain an effective interpretation of the regulation or law.

One of the ways to reduce the corruption inherent in opaque regulations and laws is to establish more efficient regulation processes. The establishment of independent regulatory agencies, both at the national and local government level can be effective in promoting efficiency and limiting opportunities for corruption. These regulatory institutions however, must operate with transparency (hold public meetings), simplicity (rules-based principles), and accountability (election of regulators or term based regulators).

3. The Audit Function

Management controls are the policies and procedures put in place by the managers of an (government) entity to ensure its proper and effective operation. Developing an effective system of controls requires, first, a careful assessment of the risks confronting the organization. Policies and procedures can then be selected to control those risks effectively and at reasonable cost. No system of controls can provide an absolute guarantee against the occurrence of fraud, abuse, inefficiency, and human error. However, a well-designed system of controls can give reasonable assurance that significant irregularities can be detected. There are effectively two types of audit procedures, including:

- Internal Audit is part of an organization's management control structure. The internal audit office on behalf of management audits lower level units. Among its most important functions, internal audits test the management controls themselves and assists senior management in assessing risks and in developing more cost-effective controls.

- External Audit of government operations is typically performed by a supreme audit institution (SAI) or an independent external auditing firm. External auditors typically perform compliance / regulatory audits, financial assurance audits, and value-for-money (efficiency) audits.

To be effective, the external audit staff must have the professional skills required for the audits being performed. For an external auditor to move from ex-ante and regulatory audits to financial assurance and value-for-money (performance) audits, its present staff will have to be more extensively trained in the more complex audits. In order for the external audit function to be effective, especially when pursuing the strategic objective of improved management controls or undertaking more advanced type of audits, an effective means of communicating audit results and a sound approach for encouraging effective appropriate corrective action must also be developed.

Given the limited capacity to absorb change in most developing countries, anticorruption strategies need to focus on a few crucial elements rooted in the specific characteristics of each country. The World Bank's Prem Notes (Number 33, 1999) illustrates that Latvia's anticorruption strategy for revenue administration was part of a broader national strategy guided by a Vigilance Unit. The organizational structure of the State Revenue Service was improved to integrate tax customs, social securities, and to create internal control and anticorruption functions. The Vigilance Unit operated independently of the financial police to: monitor and educate staff on a code of ethics, conduct disciplinary hearings, develop incentives to foster integrity and good conduct, and monitor declarations of income and assets by public servants. The importance of citizen engagement and oversight (and, social audits) is crucial to maintaining the integrity of public financial management.

III Corruption and Investment

Public finance corruption may affect investment in a number of ways including:

- Adversely affecting the total amount of investment;
- Adversely impacting the amount of foreign direct investment; and,
- Adversely impacting the size and quality of public investment.

In several papers, Paulo Mauro (1997, 1998) of the IMF has shown that corruption can have a significant negative impact on the ratio of total investment to GDP.[19] Regressing the investment ratio in relation to the corruption index, GDP per capita income, secondary education, and population growth, Mauro shows that a reduction in corruption could significantly increase the investment/GDP ratio. On the other hand, a drop in the investment/GDP ratio as a result of corruption was shown to have an important effect on growth. Mauro (1997) estimated that a reduction in corruption equivalent to 2 points in the corruption index would raise the annual growth rate by about 0.5 percent through its positive effect on the investment/GDP ratio.

In a paper focusing on foreign direct investment (FDI), Shang Jin Wei (1997a) showed that while a one percent increase in the marginal tax rate on FDI by about 3.3 percent, an increase in the corruption index by a single point reduces the inflow of FDI by 11 percent. In a related work, Wei (1997b) showed that the unpredictability of corruption (as measured by the dispersion of individual ratings of corruption) has a further negative impact on FDI. Wei concluded that '"the effect of uncertainty on FDI is negative, statistically significant and large."

Does corruption affect operation and maintenance expenditures? Despite substantial difficulties in obtaining good data, Tanzi and Davoodi (1998) have provided evidence that high levels of corruption are associated with low operation and maintenance expenditure and a generally poor quality of

[19] See Paulo Mauro. 1997.

infrastructure. Tanzi and Davoodi show that in terms of statistical significance the impact of corruption is strongest on the quality of roads, and power outages.

In summary, Tanzi, Davoodi, Wei and Mauro have shown that corruption reduces total investment, distorts the composition of public sector investment, and generally reduces the quality of a country's infrastructure. The combined impact of these changes on economic growth is bound to be negative and substantial.

IV Policy Considerations

In 1998, the World Bank engaged in a cross-country analysis of data based on perceptions of corruption against institutional and other factors to better understand its causes and consequences. Detailed surveys of corruption were conducted in Albania, Georgia and Latvia. Preliminary results provide a picture of systemic corruption that hurts public welfare, taxes private sector activity, and is deeply institutionalized.[20] The results of the survey indicate:

1. There are many types of corruption, and each country's pattern of corruption is distinct.
2. Institutional causes of corruption differ, suggesting different priorities for reform.
3. Enterprises would pay higher taxes if corruption were eliminated. And,
4. Corruption disproportionately hurts the poor.[21]

Confronting corruption in developing economies requires a complex approach that recognizes the diverse factors underlying the persistence of corruption. Creating interventions that combat corruption generally requires a

[20] World Bank. 1998. PREM Notes No.7. "Frontiers in Diagnosing and Combating Corruption." Page 2.
[21] Ibid Pages 3 – 5.

tailor made strategy that takes into consideration the particular contours of the problem in different countries.

IMF "Code of Good Practices and Fiscal Transparency"

In the context of the architecture of the international financial system, the IMF in 1998 developed a Code of Good Practices on Fiscal Transparency aimed at increasing transparency in fiscal policy. The IMF code contains a number of principles that could be followed by countries to increase fiscal transparency. In effect, the application of these principles would make fiscal policy more transparent and enhance public sector governance. Among the principles are the following:[22]

1. The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.
2. There should be a clear legal and administrative framework for fiscal management.
3. The public should be provided with full information on the past, current, and projected activity of government.
4. A public commitment should be made regarding the timely publication of fiscal information.
5. Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.
6. Budget data should be classified and presented in a way that facilitates policy analysis and promotes accountability.
7. Procedures for the execution and monitoring of approved expenditures should be clearly specified.

[22] See IMF. 1998. "Code of Good Practices on Fiscal Transparency".

8. The integrity of fiscal information should be subject to public and independent scrutiny.

What are the lessons that can be drawn from the discussion above? Actions to improve governance, public financial management, and to fight corruption need to be taken on numerous fronts.

Reform Priorities for Public Financial Management[23]

Improvements in the public financial management system are largely a function of creating the political will to develop reforms and make (and sustain) institutional change. However, it is the distinction between institution and organization and the interplay between the two, which is the key to understanding how the public financial management system can be improved. In other words, budgeting and public financial management organizations can be improved, but economic, social and political behavior will not change unless the rules and procedures change (and are internalized) as well. The reverse is also true: rule modification is unlikely to produce results in an operationally meaningful time frame unless organizational improvements proceed apace.[24] In other words, improving public expenditure management requires both institutional (regulatory and procedural) reform and organizational development.

1. Operational Approach

Reforming public sector management and public finance requires: instilling meritocracy and adequate pay in public administration; clarifying

[23] For an exceptionally thorough discussion with respect to reform priorities for public financial management see Shiavo-Campo and Tommasi, "Managing Government Expenditure", ADB. April, 1999, Manila.

[24] Schiavo-Campo and Tommasi, 1999. "Managing Government Expenditure" Pg 103.

government priorities, institutional goals and strategies, and institutional structures; enhancing transparency and accountability in fiscal management; and, stimulating policy reforms in service delivery (See Table 1, below).

A general review of governance and functional structures in ministries should be given high priority. Some governments have moved central government functions into quasi-private sector structures. These structures blur the lines of policy direction and accountability. In addition, these types of organizational structures create a large number of highly paid supervisory jobs that can serve to increase the political for corruption and opportunities for payoffs. Off-budget agency funding also contributes to budget fragmentation and lack of transparency.

To improve transparency and accountability in fiscal management, it is necessary to ensure full budget control and coverage. Latvia, for example, diverts substantial resources into off-budget accounts. These accounts typically lack oversight and transparency. These off-budget transactions take different forms, from extra budgetary funds to the lack of integration of investment planning. A further challenge is to eliminate (or reduce) contingent liabilities (off-balance sheet guarantees) stemming from non-transparent off-budget commitments. Argentina and Brazil are classic examples of the moral hazard that is created with these off-balance sheet liabilities

In many developing countries, the budget formulation is often flawed by the ambiguity between the executive and legislative branch of government, poor parliamentary processes, lack of policy coordination, and the inability to impose trade-offs at the executive level. In Bosnia, for example, expenditure projections lack a medium term perspective and revenue forecasts are often extremely unrealistic. The inability to develop realistic forecasts leads to non-transparent adjustments during budget execution. The potential for public sector finance mismanagement increases dramatically. In addition, unclear budget appropriations and unreliable disbursements leave budget managers unable to deliver reliable services.

Reforms to promote greater accountability and control over budgetary expenditures require strong accounting and auditing systems. In order to be effective, treasury systems must be strengthened. Investment in information technology seen in USAID funded treasury, accounting, and audit systems in Russia, for example, needs to be grounded in broader institutional reforms. Furthermore, transparent competitive procurement is necessary to prevent corruption from inflating public expenditures.

The effectiveness of external and internal audit entities varies greatly by country. In Kazakhstan, for example, the external audit function is dominated by the executive thus limiting its credibility. To be effective in reducing public sector corruption, the external audit must be independent and equipped with strong auditing and diagnostic skills. In addition, an internal audit oversight must be strengthened with public dissemination of audit findings.

2. The Multi-Pronged Approach

Stand-alone efforts to tackle administrative corruption in public administration and public finance are likely to have limited impact. Table 1, below, details some elements that can be applied to developing countries with respect to reducing corruption in public financial management.

Each country however, must be diagnosed individually, and associated interventions must be country specific. In addition, there is no simple formula for the proper sequencing of these anti-corruption activities. Nevertheless, the sequencing of reforms should be designed to enhance the credibility of the leadership, and the program, to ensure early tangible results. This type of approach effectively strengthens the constituency for reform.

Table 1. Four Column Approach to Financial Management

MACROECONOMIC STABILITY	**EFFICIENCY IMPROVEMENT**	**TECHNICAL INFRASTRUCTURE**	**ACCOUNTABILITY**
Identification and assessment of the future implications of current policies.	Measurement and publicizing of the costs of important activities.	Establishment of an information system, which makes relevant operation data available to all policymakers and program managers.	Specific costs and expected performance, as an integrated part of the overall framework of accountability.
Recognition of the resource constraint	Factors or areas contributing to expenditure increase should be identified and addressed.	Focus on core tasks by central agencies responsible for financial management. These tasks include policies, costs, and the specification of the desired performance levels.	Avenues for people to secure information on historical series such as government accounts.
Maintenance of an extensive database and profile of all agency expenditures.	Pursuit of alternative strategies for the delivery of services when costs tend to increase.	Managerial autonomy for spending agencies in the use of allotted resources.	Establish oversight bodies (where none may currently exist).
Maintain cost data where services funded by public agencies are provided by private and non-governmental sector.		Selective conversion of accounting systems to an accrual basis particularly in agencies with large inventories.	Disseminate information.
		Eliminate patronage for public service appointment.	
		Eliminate off budget / off-balance organizations / accounts. Independent audit functions, and strong	

		budget execution	

3. A Diagnostic Questionnaire: An Example

To improve the effectiveness and efficiency of programs, the first essential steps are to implement sound budget process, and effective management (internal, external) control systems. Although it is beyond the cope of this brief desk study to design a multi-pronged public finance anti-corruption program with full diagnostics, the following section provides a brief questionnaire with respect to some of the necessary diagnostic tools. This would be a one-step approach. A more rigorous two-stage approach could be used: the first stage would be to fully document the existing system and the second stage would assess each element of the system, and design improvements according to national priorities.

The brief questionnaire below is believed to be faithful to the principles of public finance and government budget. A diagnostic questionnaire should include: comprehensiveness (the budget should include all revenue and expenditure); accuracy; authoritativeness (public funds should be spent as authorized by law); and transparency (the government should publish timely information etc.,). A program which implemented improvements based on the use of the questionnaire would have all the technical tools needed to improve its public financial management performance and enforce disciplined financial management. Technical tools alone do not guarantee public financial management improvement; the other key ingredients include well-trained and highly motivated staff and, above all, political will and strong focused leadership.

As stated above, the intention of this desk study is not to design diagnostic tools with respect to public finance anti-corruption programs. The limited questionnaire is provided as an example of the type and manner of diagnostic tools available. This diagnostic questionnaire is not intended to be an exhaustive (or comprehensive list) but merely an example of some of the tools available. The questionnaire can (and should) be expanded to include a broader range of diagnostic tools.

Table 2. Example of a Diagnostic Questionnaire

DIAGNOSTIC AREA	**QUESTION**	**YES**	**NO**
A. Budget Legislation	Provide a clear and comprehensive definition of public money?		
	Establish the following elements of intergovernmental fiscal relations?		
	1. Basic principles of supervision, intervention and audit responsibilities; 2. That budget accounting classifications are coherent and common to all levels of government?		
	Establish the definition of budget deficit and surplus, which excludes borrowings from receipts and excludes repayments for principal from expenditure?		
	Provide a legal basis for management (internal) control and internal audit?		
	Defines the authorities and responsibilities for issuing and reporting on government guarantees?		
B. Scope of the Budget	Clearly defines appropriation and spending authority?		
	All transactions of statutory extra-budgetary funds with the budget?		
	All fiscal transfers to sub national governments for general and special purposes are defined?		
	Does the budget document include: 1. Fiscal policy objections 2. Complete information on past and projected spending 3. Complete information on financial plans and operations of statutory extra-budgetary funds 4. A statement of contingent liabilities		

DIAGNOSTIC AREA	**QUESTION**	**YES**	**NO**
D. Measuring and Monitoring the Government Deficit and Debt	1. Are there figures released for different fiscal balance definitions? 2. Are the fiscal definitions calculated on a cash or accrual basis? 3. Do government data allow a clear distinction to be made between domestic and external debt? 4. Which ministry is responsible for contracting and managing debt? 5. Is it the same ministry that is in charge of guarantee debt?		
E. Budget Execution and Monitoring	Are there laws, regulations and procedures that: 1. Ensure that all public revenues are directly deposited; 2. If separate bank accounts are permitted, who is responsible for opening, monitoring the banking operations?		
	The ministry of finance/treasury controls cash balances daily relative to borrowings?		
	There are procedures to report and correct overspending?		
F. Legal and Policy Framework	Are there laws, regulations or policies which: 1. Limit and define the authorities at each level of the administration for transferring funds within the approved budget? 2. Prevent transfers between personnel costs and other subheads of the budget? 3. Specify how budget funds that are unspent at the end of the fiscal year should be treated? 4. Establish sanctions for overspending? 5. Bind all persons responsible for spending money to implement management control practices?		

DIAGNOSTIC AREA	QUESTION	YES	NO
G. Performance Monitoring	Does the government foster an environment that supports and demands improved performance by organizations and individuals?		
	Is performance information on easily measured activities collected and used by spending units? By the ministry of finance?		
	Are managers who are responsible for government programs and projects given clear short / long term operational goals and targets?		
H. Evaluation	Is there an evaluation capacity sufficient to respond to the demands of the public sector/accountability?		
I. Accounting and Reporting	Is there a unified accounting and budgeting classification system regulated by the ministry of finance/treasury?		
	Are the final accounts produced, audited and tabled in parliament shortly after the end of the fiscal year?		
	Does the system provide for recording commitments (obligations) as well as cash transactions?		
J. Internal Audits	Are internal audit units established in line ministries?		
	Does the mandate for these units include: 1. Financial audit? 2. System audit? 3. Procurement audit process? 4. Review of management internal control arrangements?		
K. External Audit?	Is there an external auditor established by law with independence from government?		
	Does the external auditor have authority to audit/clear all public and statutory funds and resources?		
L. Organization and Capacity for Reform?	1. Is there a coherent written strategy for bringing public financial management systems into line with general accepted standards?		

DIAGNOSTIC AREA	QUESTION	YES	NO
	2. Does this strategy have the support of the ministry of finance?		
	Are there training programs to complement any reform process?		

Source: For additional information, see "Managing Public Expenditure: A Reference Book For Transition Countries" edited by Richard Allen and Daniel Tommasi.

In brief, the primary criteria for judging the effectiveness of public financial management systems are the extent to which:

- It includes a priori controls;
- Exiting laws and secondary legislation enable the recovery of amounts lost; And,
- Structures are in place to fight fraud and / or corruption.

V. USAID and Anti-Corruption[25]

USAID has undertaken a number of projects and initiatives with respect to improving public financial management. A substantial number of these projects were not specifically designed to fit under an anti-corruption umbrella. Many USAID programs are designed to attack the lack of transparency in public financial accounts, to increase public sector accountability, and enhance fiscal reform. These projects have had varying degrees of success in stemming the corrosive influence of public financial management corruption.

An illustrative example is in its Russian Fiscal Reform projects during the 1990s. Russia's tax system's failure included the inability to collect adequate revenues, the tax code placed excessive tax burden on enterprises, and encouraged citizens and enterprises to evade taxes. This was compounded by widespread political interference in the enforcement or non-enforcement of tax liabilities.

[25] Please see Annex I. "USAID Public Finance and Anti-Corruption: Current Activities" for brief description of additional USAID program activities.

USAID financed several programs in Russia in the late 1990s in which technical assistance was provided in five key areas: tax policy and legislation, tax administration, economic analysis, intergovernmental fiscal relations and real estate taxes. USAID's ambitious benchmarks included the enactment of new legislation for intergovernmental fiscal relations.

Underlying the five principal areas of technical assistance in Russian intergovernmental finance was the goal to increase financial transparency, to enhance government revenues, to establish a less onerous tax code, and to improve government accountability in revenue collection and public financial expenditure. To a significant extent these goals were not reached owing largely to adverse environmental factors among which were frequent changes in political leadership, and coordination problems within the Federation government.

Does the varying degree(s) of success of the Russian Fiscal Reform program mean that USAID's technical assistance with respect to fiscal reform and stemming corruption was a failure? No. Some progress on reforms has been realized. Many of the key obstacles to public financial management reform in Russia, for example, were the inability of the Russian Government to adopt and implement reform. Under this context, perhaps the most that can reasonably be expected is that donor assistance gradually increases the level of understanding on the part of the civil service and political officials of the need for reform and to generate the right types of requests for reform.

Taking the Russian fiscal reform project as an example, providing advice to Russian regions on how to raise incentives for municipalities to improve their tax transfers to the regions could be regarded as a waste of resources if set within an overall national tax environment that runs counter to the goals of transparency, accountability and consistent revenue and expenditure assignments. In effect, the goals of decentralization of revenue assignments ran counter to the goals of the tax environment. Corruption with respect to public sector financial management may actually increase. Hence, this example may serve as a red flag to USAID program designers that in providing technical assistance, more attention should be given to determining whether programs actually contradict each other with the unintended effect of potentially increasing public finance corruption.

USAID's public finance programs could be improved by directly incorporating the notion(s) that prudent public financial management (budgeting, transparency, accountability etc.,) are 'effective' anti-corruption tools. In enhancing its public finance anti-corruption programs, USAID should continue to strengthen the following non-exclusive areas:

- Comprehensiveness (the budget should include all revenue and expenditure); accuracy;
- Authoritativeness (public funds should be spent as authorized by law); and,
- Transparency (the government should publish timely information etc.,)

V Conclusion

The approach of this desk study note has been to review adverse impacts upon public financial management. The general conclusion is that programs to stem corruption with respect to public financial management need to consider carefully the country specific context. Pragmatic anti-corruption programs may deteriorate in their effectiveness if they are not guided by coherent and universal principles: strengthening governance (accountability, transparency, predictability, and participation); reinforce the foundation of civil society; and, engage in improvements in public expenditure management programs to reduce opportunities for corruption.

Annex I – USAID Public Finance and Anti-Corruption: Current Activities

COUNTRY	PROGRAM
Armenia	USAID/Armenia provides technical assistance to the Ministry of Finance and Economy (MFE) to improve the preparation of sound annual budgets and introduce more disciplined and transparent financial management, including budget formulation and execution, public accounting and treasury functions. While the budget process has greatly improved, most line ministries still do not prepare budget proposals. The program will also address the proper handling of off-budget government liabilities, such as energy debts; these liabilities are not part of budget planning and cannot be controlled by MFE, yet are government obligations for which MFE is ultimately responsible.
Moldova	USAID/Moldova has supported fiscal policy since 1995. Following initial work on the legal framework, current efforts focus on capacity building and training in its assistance to the Ministry of Finance's Budget and Treasury offices, local governments, and the Parliament's Center for Financial and Budgetary Analysis (CBFA) which is regarded as producing credible information. Technical assistance focuses on revenue and expenditure forecasting, budget planning and execution, treasury systems and debt management, intergovernmental fiscal relations, and computerization.
Ukraine	USAID has supported programs that helped to ensure that budget proposals for 2001 incorporated extra-budgetary funds into the budget, and eliminated most tax exemptions. USAID has also supported the Fiscal Analysis Office that works closely with the parliament and provides good publications analyzing budget execution. Improving the efficiency and transparency of intergovernmental finance is also an important focus of USAID efforts.
Kyrgyzstan	With USAID assistance, Kyrgyzstan has begun program budgeting, and has started to focus on issues of intergovernmental finance. In 2000, Kyrgyzstan adopted International Accounting Standards.
Macedonia	USAID provides two resident advisors and works in close collaboration between USAID and the WB on funding the MOF Treasury software, training and accounting standards. USAID also finances an economist to support the budget forecasting function. One focus of the program is to bring ministry "special revenue funds" – which account for 20% of the total budget -- into the

	general revenue process and, thereby, improve accountability for their use.
Croatia	USAID/Croatia will work with the Government of Croatia to improve budget and fiscal policies to avoid undue deficit spending or the buildup of budgetary arrears. An overarching concern for potential investors in a transitional economy is corruption, and clearly inappropriate rent-seeking by Government officials is an aspect of any inefficient public sector system. USAID-assisted programs in this area will emphasize the creation of systems that maximize transparency and accountability.
Georgia	Corruption remains Georgia's greatest impediment to reform. With USAID assistance, Georgia's annual budgets have become more realistic and transparent but additional work is needed. An USAID-supported macroeconomist undertook a public expenditure review in several ministries to identify needs and priorities.
Russia	The primary USAID fiscal activity focused on intergovernmental relations. This activity works with Russian policy-makers at the national level to improve revenue and expenditure assignments through the use of objective criteria. It also works with five pilot regions to improve revenue and expenditure projections based on tax capacity and client-based expenditure norms and in this way, reduce incentives to submit inflated requests for transfers.

Source: USAID, 2002.

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