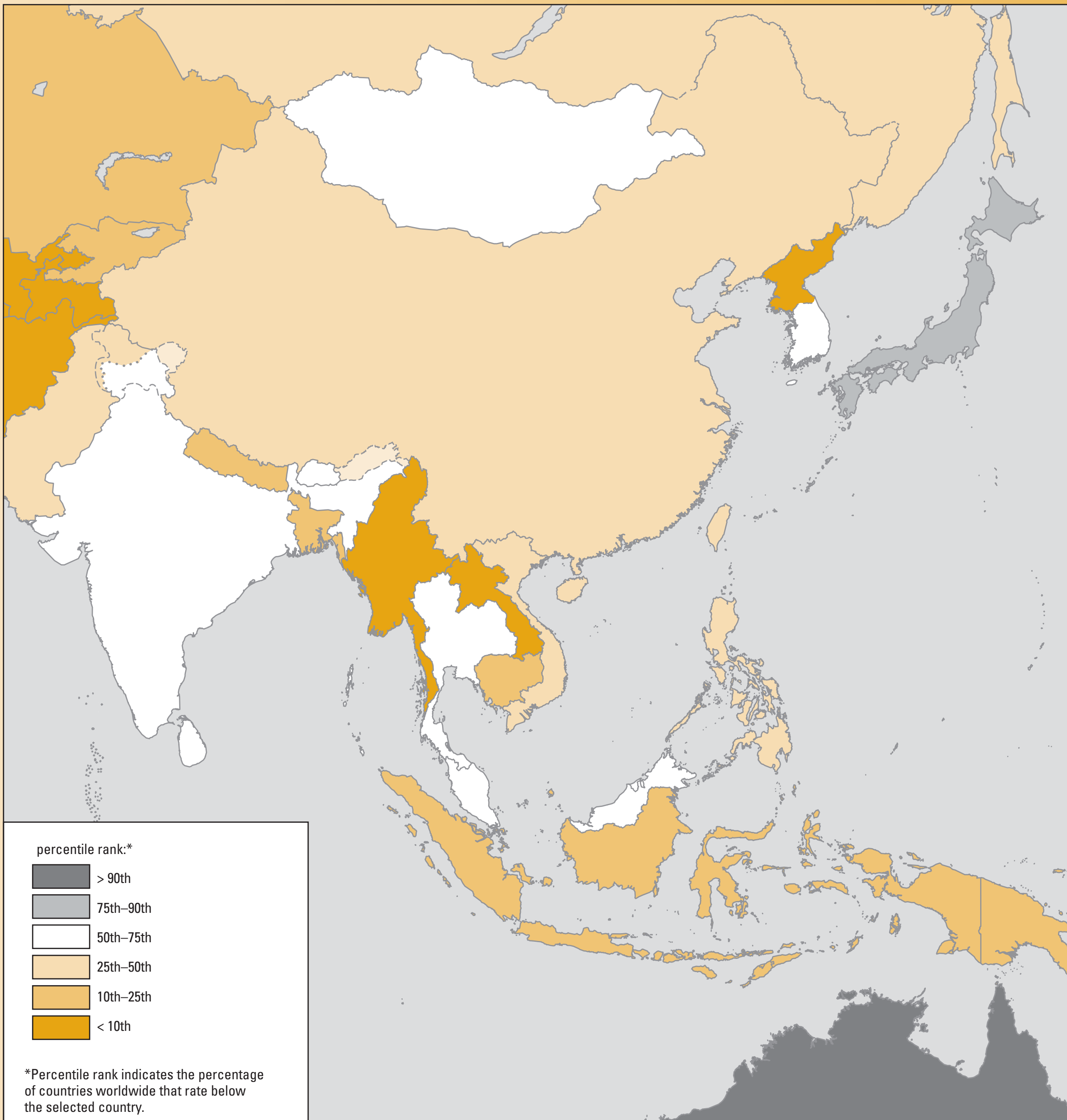
MAP 7.1 **The Quality of the Rule of Law Varies Considerably across East Asia**



Source: Based on Kaufmann, Kraay, and Mastruzzi 2005.

Note: The rule of law indicator encompasses several indicators that measure the extent to which agents have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts. Together, these indicators measure the success of a society in developing an environment in which fair and predictable rules form the basis for economic and social interactions and, importantly, the extent to which property rights are protected. The map depicts the percentile rank of the indicator, subject to a margin of error. The percentile rank shows the percentage of countries worldwide that rate below the selected country. Each color follows a simple quartile distribution for illustrative purposes (see the map label). For the top quartile, the top 10 economies worldwide are a dark gray (for instance, Australia on the map), while, for the bottom quartile, the bottom 10 economies worldwide are a dark orange (for instance, Myanmar on the map).

The rule of man is being swept away, but the rule of law has not been fully instituted. Because of lagging anti-corruption efforts, East Asian economies may pay a high price in economic growth.

CHAPTER 7

CORRUPTION

From the Rule of Man to the Rule of Law

East Asia is widely perceived as one of the world's most corrupt regions. Since the 1997–98 financial crisis there, corruption scandals have been frequently reported in the regional and international media. The relationship between government and business in East Asia is often described as crony capitalism. East Asia certainly includes many economies in which corruption is widespread, but, after examining the issue, this chapter challenges the idea that corruption is endemic to East Asia and that there is any characteristically East Asian level of corruption.

Corruption in East Asia presents a paradox. In some economies, high levels of corruption have coexisted for extended periods with rapid economic growth and development.[1] Clearly, this runs against the conventional wisdom according to which corruption impedes economic and social progress. The chapter explores the various hypotheses put forward to explain this paradox and assesses their empirical foundation. It investigates the nature of corruption in East Asia and the extent to which the autocratic mode of governance in many East Asian countries in the postwar period may have enabled an East Asian model of corruption that is less damaging to growth and development.

Before the crisis, commentators were quick to point to Asian values to explain East Asia's remarkable postwar success. Postcrisis, the same people were equally quick to say that Asian values explained the crisis and were, in some way, more conducive to corruption than were the values of the West. The chapter suggests that attitudes toward corruption may be evolving as part of the economic and social transformations sweeping the region. Democracy and decentralization have clearly made significant advances across East Asia. The chapter shows that demands for new modes of governance and more effective action to tackle corruption have grown and may continue to grow during East Asia's renaissance. Economic, political, and social transformations have already rendered the East Asian model of organizing and constraining corruption unsustainable.

Countries in the region will move away from traditional modes of governance based on the "rule of man" to modern modes of governance based on the "rule of law" or, as the Chinese say, from *renzhi* to *fazhi*.[2] This chapter notes the evidence that, in the longer term, this may result in more effective governance and less corruption. However, the legal, political, and administrative institutions needed to make democracy and decentralization work will take time to build. In the short term, there is a risk that the challenges of corruption will intensify across the region. For many countries, the road from *renzhi* to *fazhi* may not be an easy one (see map 7.1).

Is There an East Asian Level of Corruption?

Defining Corruption

In English, the term corruption is colorful but vague. In its simplest sense, it refers to a process of decay, rot, or perversion. Beyond this, it is at best a shorthand reference for a large range of illicit and illegal activities.[3] In its broadest usages, it may refer to the act or the process of corrupting and the state of being corrupt. It may refer to such processes in public office, private business, or personal life.

In the context of public sector governance, corruption is often succinctly defined as the misuse of public office for private gain.[4] Even within the limited context of the public sector, however, corruption comes in too many forms to permit easy generalization.

Activities frequently identified as corrupt include bribery; the stealing, misappropriation, or other misuse of public funds or assets; illegal fines, duties, taxes, or charges; vote rigging; the abuse of privileged information; misprocurement; the manipulation of regulatory and licensing authority; campaign financing abuses; influence peddling and favor-brokering; the acceptance of improper gifts; cronyism; and nepotism. However, societal norms may vary about the inappropriateness of each form of corruption or even about whether some of these actions are corruption at all.[5]

Nevertheless, a number of distinctions are often drawn. There is grand corruption (the theft of billions of dollars by a Marcos or a Suharto) and petty corruption (for example, the demand for small bribes by public service providers). There is administrative corruption (perpetrated by lower-ranking bureaucrats and officials), and there is political corruption (sometimes called clientelism or state capture: the misuse of public power by elected officials to shape the rules of the game to the advantage of themselves and those who pay them, at the expense of the rest of society). A distinction is sometimes drawn between corruption of the deviant variety, whereby officials accept inducements to undertake actions they are not supposed to perform, and grease money corruption, whereby officials accept inducements to do what they are supposed to do anyway or to do it more quickly. Finally and arguably of particular relevance in the East Asian context, there is syndicated corruption, whereby elaborate systems are devised for receiving and disseminating bribes, and nonsyndicated corruption, whereby individual officials seek to compete for bribes in an ad hoc, uncoordinated fashion.

Although most people would consider corruption undesirable almost by definition, it seems very likely that these diverse forms of corruption will have impacts that differ significantly in extent and incidence.

The Level of Corruption

Measuring corruption is complicated by its very nature. Not only is corruption typically secretive, but, as discussed above, it takes many forms.

Identifying and applying objective measures of corruption are difficult. Financial measures of corruption are "extremely approximate"[6] and typically available only for the worst cases of grand corruption. The *Global Corruption Report 2004* of Transparency International (2004), for example, includes some estimates of the funds allegedly embezzled by 10 leaders who have been notorious for corruption within the last 20 years. According to these estimates, Mohammad Suharto, president of Indonesia between 1967 and 1998, embezzled from US$15 billion to US$35 billion; Ferdinand Marcos, president of the Philippines between 1972 and 1986, US$5 billion to US$10 billion; and Joseph Estrada, president of the Philippines between 1998 and 2001, between US$78 million and US$80 million.[7]

Among households and firms, corruption levels are often measured by the monetary cost of bribes. The investment climate surveys sponsored by the World Bank have recently been attempting to collect such data among firms. However, firms (and households) may be unwilling to admit to paying bribes, and, so, the estimates of the frequency and value of the bribes paid may be distorted.

Because of the difficulties of obtaining objective information about corruption, the dominant empirical approach to examining the determinants of corruption is the use of perception-based data. Perceptions of corruption may vary from the actual level of corruption, thereby affecting the conclusions of empirical studies. Kaufmann, Kraay, and Mastruzzi (2006) argue that measuring perceptions may nonetheless have direct relevance: "when citizens view the courts and police as corrupt, they will not want to use their services, regardless of what the 'objective' reality is" (p. 2).

Most indicators of corruption that are widely cited are cross-country perception-based indexes such as the corruption perceptions index of Transparency International and the Kaufmann-Kraay control of corruption index. As with all governance indicators, both of these indexes are subject to measurement errors.[8]

The corruption perceptions index of Transparency International, an international civil society organization, is a composite index that reflects the perceptions of business people and country analysts both resident and nonresident.[9] The 2005 survey ranks 159 countries and draws on 16 polls by 10 independent institutions. A country is included only if it has been featured in at least three polls. (Most major East Asian economies are included; the Democratic People's Republic of Korea is not included.) The corruption perceptions index has been produced annually since 1995, although Lambsdorff (2005) describes it as "a snapshot of the views of businesspeople and country analysts, with less of a focus on year-to-year trends" (p. 3). The corruption perceptions index ranks countries in terms of the degree to which corruption is perceived to exist. The surveys used in compiling the corruption perceptions index ask questions relating to the misuse of public power for private benefit, but do not make any other distinctions, such as, for example, between administrative and political corruption or between petty and grand corruption. Figure 7.1, chart a, illustrates the corruption perceptions index for East Asian economies in 1995, 2000, and 2005.

The control of corruption index is a complementary measure. It has been prepared biennially since 1996 with the support of the World Bank and is based mostly on non–World Bank sources.[10] Like the corruption perceptions index, the control of corruption index is a composite indicator drawing on multiple primary indicators of perceptions of corruption to produce country rankings. Also like the corruption perceptions index, the control of corruption index focuses on public corruption, though it otherwise treats corruption as a single, homogenous phenomenon. Whereas the corruption perceptions index is stand-alone, the control of

FIGURE 7.1 **Indexes of Corruption Vary Widely across East Asia**

Sources: Transparency International 2005; Kaufmann, Kraay, and Mastruzzi 2005.

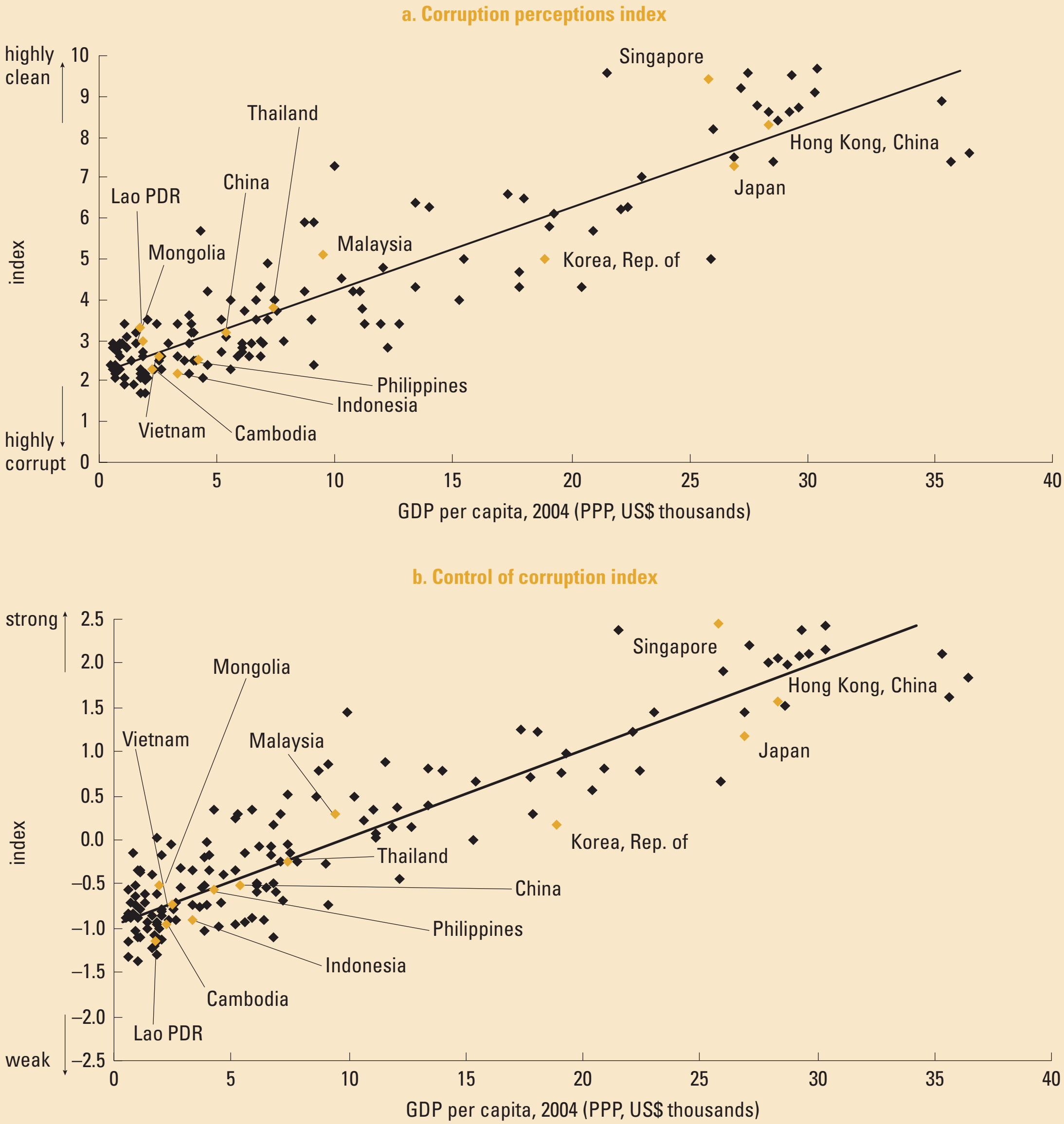
corruption index is one of six Kaufmann-Kraay governance indicators; the others are voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, and rule of law. The Kaufmann-Kraay indicators have a slightly larger coverage than the corruption perceptions index and draw on a wider range of surveys (209 countries and 352 variables culled from 37 data sources produced by 31 organizations). Figure 7.1, chart b, illustrates the control of corruption index for East Asian economies in 1996, 2000, and 2004.[11]

These two perception-based indicators offer broadly similar conclusions as far as East Asia is concerned. A first observation is that there is an enormous range in the indicators. Some East Asian economies rank among the least corrupt in the world; using the corruption perceptions index, Singapore ranks between Denmark and Sweden, Hong Kong (China) between Canada and Germany, and Japan between Chile and Spain. Other East Asian economies rank among the most corrupt; Myanmar ranks between Turkmenistan and Haiti, Indonesia between Iraq and Ethiopia, and Cambodia between the Republic of Congo and Burundi.

A second observation is that there is a correlation between corruption indexes and gross domestic product (GDP) per capita. As charts a and b of figure 7.2 illustrate, the level of corruption in many East Asian economies in 2004 appears to be broadly in line with what one might predict based on their GDPs per capita. The data of both the corruption perceptions index (chart a) and the control of corruption index (chart b) suggest that corruption in China, Hong Kong (China), Japan, the Republic of Korea, Mongolia, the Philippines, Thailand, and Vietnam is broadly at the level one might expect based on GDP per capita.

A third observation is that, despite the general correlation between the perception of corruption and GDP per capita, levels of corruption vary widely among economies at similar levels of per capita income. Thus, for example, based on the control of corruption index, Indonesia, with a GDP per capita of US$3,361 (in 2003, in purchasing power parity terms), has a ranking showing it as more corrupt than Vietnam, with a GDP per capita of US$2,490; China, with a GDP per capita of US$5,003, ranks the same in terms of the control of corruption as Mongolia, with a GDP per capita of US$1,850. As figure 7.2 illustrates, both indexes indicate that Malaysia and Singapore exhibit less corruption than one might predict according to their GDPs per capita, whereas Taiwan (China) has rather more corruption than one might so predict. The control of corruption index (figure 7.2, chart b) also indicates that Cambodia, Indonesia, the Democratic People's Republic of Korea, the Lao People's Democratic Republic, and Myanmar are significantly worse in the control of corruption than one might predict based on GDP per capita. Clearly, corruption is not wholly determined by income.

FIGURE 7.2 **Richer Economies Show Better Outcomes in Global Corruption Indexes**



Sources: Transparency International 2005; Kaufmann, Kraay, and Mastruzzi 2005; World Development Indicators Database, World Bank, http://www.worldbank.org/data/datapubs/datapubs.html.
Note: The gold symbols indicate economies in East Asia.

Is There an East Asian Model of Corruption?

As Campos (2001) argues, the corruption in East Asia presents proponents of good governance with a paradox. China, Indonesia, the Republic of Korea, the Philippines, Thailand, and Vietnam have all managed to trade successfully and to attract large inflows of private investment over several decades (although the Philippines and Vietnam have been latecomers). The social outcomes associated with core public goods have generally been much better than one might predict according to GDP per capita. Economic growth has been among the most rapid in the world. Yet, for much of this period, these economies have figured prominently in global lists of the highly corrupt. How can this paradox be resolved?

A number of hypotheses have been proposed.

Hypothesis 1: A False Paradox

Some authors have argued that the paradox is a false one. An aspect of this, alluded to in the previous section, is that there may be less corruption in East Asia than is popularly supposed. In the wake of the East Asian crisis, there was much media discussion of crony capitalism in East Asia. However, as figure 7.1 illustrates, although some East Asian economies rank among the most corrupt in the world, others rank among the least corrupt.

As figure 7.2 shows, in many East Asian economies, corruption is at about the level that investors and trade partners might expect for economies at their level of GDP per capita. MacIntyre (2001) points to standard economic factors influencing expected rates of return on investment. He notes that, if large profits are to be had, investors are likely to be willing to bear the increased costs associated with bribery and the greater risks associated with less certain property rights. He notes that, in the case of Indonesia, a number of important factors have contributed to the creation of a business environment in which good rates of return might be expected, including, most obviously, the prevailing rate of economic growth, the microeconomic incentive structure, and the sector-specific factor endowments.

Some statistical evidence casts doubt on whether there is a paradox at all. Statistical estimates by Mauro (1995) suggest that corruption does deter investment. In a regression of the total investment–GDP ratio (averaged over 1980–85) on a constant and the corruption index, the point estimate of the slope is 0.012. As Wei (1999) remarks, the simple implication of this is that, if the Philippines could reduce its corruption to the Singapore level, other things being equal, it could raise its total investment–GDP ratio by 6.6 percentage points.

Wei (1997) shows that, after controlling for other factors such as GDP per capita, the impact of corruption on foreign direct investment (FDI) is no different in East Asia than it is in other regions. The implication of his cross-country regressions is that, in East Asia, other factors swamp the negative effect that corruption has on FDI. This offers a possible explanation why East Asian economies have grown more rapidly despite significant levels of corruption.

In an article provocatively entitled "Why Does China Attract So Little Foreign Direct Investment?" Wei (2000) argues that, given China's income and population, the amount of foreign investment it attracts falls well below the level that one might predict based on cross-country regressions. This is particularly the case, he argues, if adjustment is made for the significant amount of Chinese investment that is not really foreign, but is Chinese investment round-tripped through Hong Kong (China). Wei attributes the lower than predicted level of FDI in China to corruption, as well as other government-induced barriers to foreign investment.

Against this, Campos, Lien, and Pradhan (2001) argue that Wei's analysis is potentially problematic because FDI is dominated by countries of the Organisation for Economic Co-operation and Development. They propose it is quite possible that the results would be different if these countries were excluded from the sample as hosts of FDI or, alternatively, if the dependent variable used were private investment (both domestic and foreign). They hold that other middle-income and low-income developing countries would be a more appropriate comparator. Furthermore, they note that Wei's observation regarding the importance of FDI from overseas Chinese indicates that informal institutions may be an important omitted variable that affects the nature of corruption and thus the impact of corruption on investment.

Rock and Bonnett (2004) present cross-country regression analysis offering quite different conclusions to those of Wei. They find that corruption slows growth and reduces investment in most developing countries, particularly small developing countries. However, they find that growth may actually have increased with corruption in the large newly industrializing economies of East Asia (a group they construct to include China, Indonesia, Japan, the Republic of Korea, and Thailand and analyze over four different time periods between 1980 and 1996).

Survey evidence presents us with similar contradictions. Evidence from the World Bank and International Finance Corporation investment climate (enterprise) surveys tends to support the idea that corruption is not a major constraint to business in all East Asian economies. As table 7.1 illustrates, less than one-third of the firms surveyed in China, Malaysia, Thailand, and Vietnam considered cor-

TABLE 7.1 **Corruption May Not Be a Severe Constraint on Enterprises in All of East Asia**
percent of responses to the question: is corruption a constraint to business?

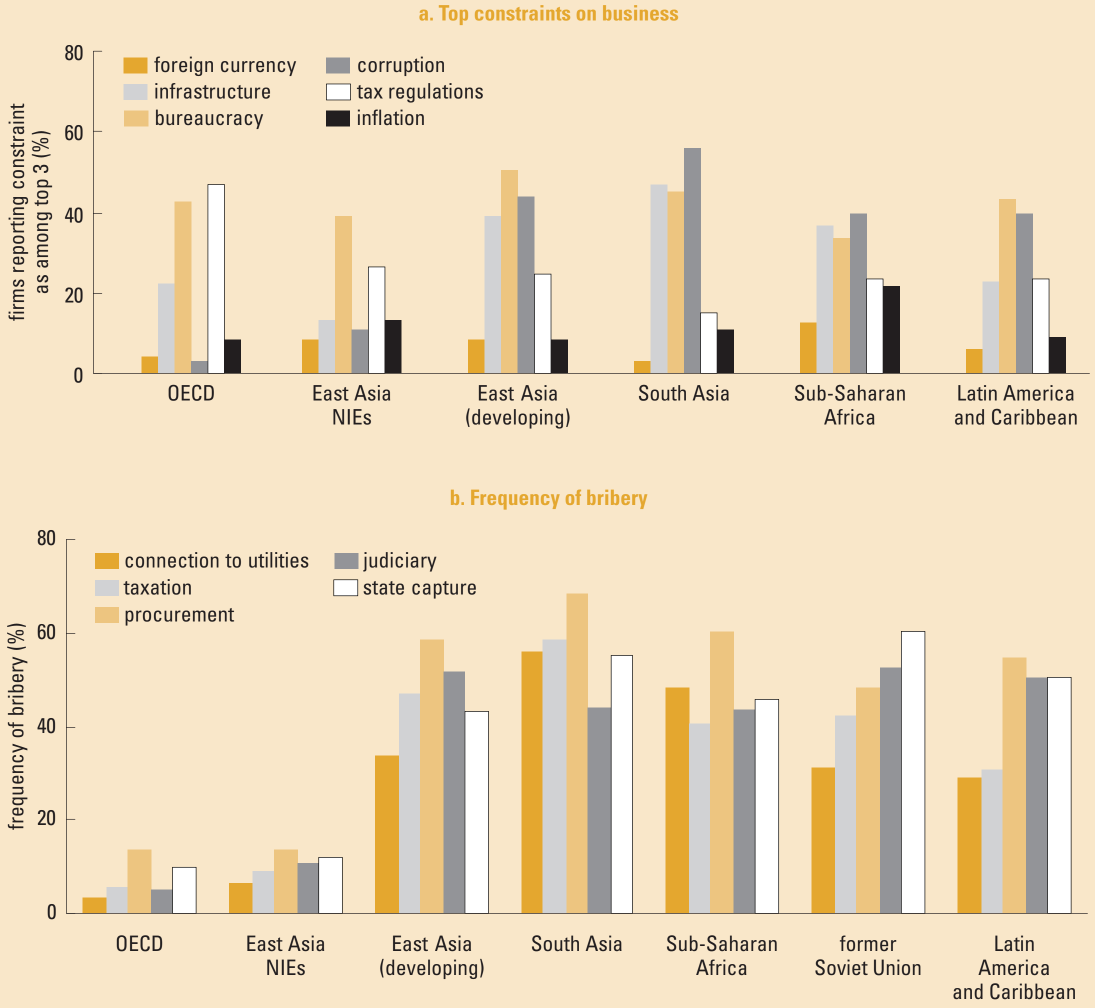
Country	No	Minor	Severe or major
Cambodia	4.7	39.4	55.9
Indonesia	29.3	29.2	41.5
Philippines	40.6	24.3	35.2
China	24.1	48.5	27.3
Thailand	49.7	32.1	18.3
Malaysia	53.8	31.7	14.5
Vietnam	52.3	17.8	14.2

Source: Investment Climate (Enterprise) Survey Database, World Bank and International Finance Corporation, http://www.enterprisesurveys.org/.
Note: The table reflects unweighted averages.

ruption a severe or major constraint to business. Firms in Cambodia, Indonesia, and the Philippines saw corruption as a more serious constraint.

A rather different trend in perceptions across firms in East Asia may be observed in the World Economic Forum's most recent executive opinion survey. Kaufmann (2006) places the East Asian economies in the survey into two groups: East Asian newly industrializing economies (Hong Kong [China], the Republic of Korea, Singapore, and Taiwan [China]) and developing East Asian economies (Cambodia, China, Indonesia, Malaysia, Mongolia, the Philippines, Thailand, Timor-Leste, and Vietnam). Focusing on survey questions about the top three constraints to business, he compares the responses of firms in these two groups to those of firms in other groups of economies. As illustrated in figure 7.3, chart a, corruption is not perceived as a major constraint in newly industrializing economies. Moreover, firms in this group are the least likely among firms in all regions to report corruption as a major obstacle to business. However, the situation seems to be dramatically different in developing East Asia, where the firms surveyed report corruption as a major obstacle to business. Figure 7.3, chart b shows that the venues of bribery and frequency also sharply contrast between the two groups within the region. While the reported frequency of bribery for permits, utilities, taxation, the awarding of public contracts, and the judiciary is as low in the East Asian newly industrializing economies as in the countries of the Organisation for Economic Co-operation and Development, the reported levels in developing East Asia are more on a par with those in the countries of sub-Saharan Africa and the former Soviet Union.

FIGURE 7.3 **Is Corruption a Major Constraint on Business? No Single Answer for East Asia**



Source: Kaufmann 2006, based on the executive opinion survey 2005 of the World Economic Forum.
Note: The survey covered firms in 117 countries. Chart (a) reflects the case of the survey instruction: select among the above 14 constraints the five most problematic factors for doing business in your country. Chart (b) reflects the case of the survey question: in your industry, how common is it for firms to make undocumented extra payments or bribes connected with permits, utilities, taxation, the awarding of public contracts, or the judiciary? Possible responses included "common," "never occurs," and so on. NIEs = newly industrializing economies. OECD = Organisation for Economic Co-operation and Development.

Even if these somewhat contradictory results may convince us that, in the absence of corruption, GDP growth and FDI flows may have been more spectacular, they still fall short of explaining why high levels of corruption do not absolutely undermine growth and development in East Asia as they seem to do in other developing regions.

Hypothesis 2: Economically Efficient Corruption

At the other extreme, some have put forward the hypothesis that corruption is economically efficient. This argument was prevalent in development literature in the 1960s (Leff 1964; Huntington 1968) and still has proponents. The argument is essentially that the toleration of a certain amount of corruption may be a second-best optimal response in the face of another policy distortion; or, as Huntington puts it, "in terms of economic growth, the only thing worse than a society with a rigid, over-centralized, dishonest bureaucracy is one with a rigid, over-centralized and honest bureaucracy" (p. 386).

Thus, bribery may allow firms to perform well in an economy with excessive regulation and licensing (the grease money argument). It is posited that, by allocating licenses and government contracts to the firms able to pay the highest bribes, a system based on bribery might support the growth of the most efficient firms (Lui 1985). It is suggested that corruption may help get prices right by raising administratively repressed prices to market clearing levels or by enhancing civil service remuneration where it is unsustainably low.

Some have also theorized that optimal policy design may not involve minimizing corruption, since that may imply too large of a sacrifice of other welfare goals. For example, Acemoglu and Verdier (1998) propose that there may be an optimal level of corruption and property rights enforcement that acts to trade off the costs and benefits to society. Higher wages for public sector officials would reduce corruption and improve the extent of property rights since the stakes would then be higher for officials if they get caught taking bribes. However, a strategy of high public sector wages may result in high taxes and attract many talented individuals to the public sector, even though they could have been more productive in the private sector. The authors conclude that it may be optimal to allow some corruption and not enforce property rights fully; less well developed economies may even choose lower levels of property rights enforcement and more corruption.

There are strong counterarguments to most of these efficient corruption propositions. As Myrdal (1968) was the first to point out, corrupt officials may actually cause greater administrative delays so that they may attract more bribes. As Bardhan (1997) puts it, "the distortions are not exogenous to the system and are instead often part of the built-in corrupt practices of a patron-client political system" (p. 1323). Shleifer and Vishny (1993) also make the case that a country's regulatory burden may be endogenously exploited by corruption-prone officials for the purposes of extracting bribes. Tanzi (1999) argues that bribes tend to channel resources not to those who are more efficient in economic activity, but to those who are more skilled at bribery. The *World Development Report 1997* (World Bank 1997) illustrates how a competent and honest civil service is the lifeblood of an effective state and provides empirical evidence that adequate pay and meritocratic recruitment and promotion are correlated with economic growth and the perception of investors of bureaucratic quality even when controlling for other factors.

Such empirical evidence as exists for Asia tends to support these counterarguments. Using data from the *Global Competitiveness Reports* for 1996 and 1997, Kaufmann and Wei (1999) examine the relationship between the payment of bribes and the amount of management time wasted. Contrary to the grease money argument, they find that firms paying more bribes are also likely to spend more, not less, management time negotiating regulations with bureaucrats.

Focusing on a subsample of the Asian economies, Kaufmann and Wei undertake an explicit examination of what they term the Asian exceptionalism hypothesis (whereby, for reasons of Asian culture, corruption facilitates economic growth in Asia). They reject overwhelmingly the hypothesis, concluding that, in fact, the amount of management time wasted increases in parallel with the payment of bribes more rapidly in Asian countries than in the global sample.

Singapore's case is an excellent example of how an effective state and low corruption may be supported through competitive public sector wages, together with the recruitment and promotion of the best and the brightest within the civil service (see box 7.1).

Altogether, the empirical evidence weighs heavily against the grease money argument and against the argument that tolerance of corruption is an effective or fiscally efficient way of motivating civil servants.

Hypothesis 3: An East Asian Model of Corruption?

Between these extremes lies a more balanced hypothesis: corruption has been damaging for East Asia and has discouraged FDI and slowed growth, but "corruption regimes" have generally been more well managed in East Asia than they have in other parts of the world, and the extent of the trade-off has thus been

BOX 7.1 Singapore, Corruption, and the Civil Service

Singapore, the least corrupt East Asian economy today, was rife with corruption until the 1960s. The low salaries and rapidly rising cost of living during the postwar period, combined with the inadequate supervision of civil servants, created ample incentives and opportunities for corruption.

When the People's Action Party assumed power in 1959, the pay of civil servants was raised significantly, reaching levels competitive with the private sector, as a pillar of a strategy to establish an honest and effective civil service. In Singapore, public sector salaries average 114 percent of those in the private sector, and senior Singaporean civil servants are better paid than their U.S. counterparts.[12] It is often suggested that the salaries of cabinet ministers in Singapore are pegged to those of chief executive officers in the largest multinational firms in the world. The pay of the prime minister of Singapore is several times that of the president of the United States.[13] This is viewed as a safeguard against the political corruption seen in other parts of the world. "I'm one of the best paid and probably one of the poorest of the Third World Prime Ministers," Lee Kuan Yew, then prime minister of Singapore, told a cabinet meeting in 1985 (cited in Quah 1988: 93).

Merit-based recruitment and promotion and the maintenance of the prestige of the public service were also pillars in achieving a clean and effective civil service in Singapore. Singapore's civil service is among the best in the world in terms of its coherence and sense of purpose. About 5 percent of the top of the graduating class of the National University of Singapore (and more recently Nanyang Technological University) are admitted each year as prospective civil service recruits and are put through a one-year training program to establish a common understanding of what is expected of them and build trust among them. The meritocratic promotion system ensures that the goals of civil servants and their agencies are aligned.

somewhat dampened. There are both theoretical and empirical arguments to support the idea of an East Asian model of corruption.

Huntington (1968) was an early proponent of the view that the structure of political and bureaucratic institutions and processes is important as a determinant of the level and nature of corruption:

> Corruption thrives on disorganization, the absence of stable relationships among groups and of recognized patterns of authority. The development of political organizations which exercise effective authority and which give rise to organized group interests—the "machine," the "organization," the "party"—transcending those of individual and social groups reduces the opportunity for corruption. Corruption varies inversely with political organization (p. 71).

Shleifer and Vishny (1993) propose an economic model of corruption that posits the existence of different types of political and bureaucratic institutions for the management of corruption. They propose that different regimes may create greater or lesser distortions and costs (see box 7.2).

With regard to East Asia, Shleifer and Vishny consider, as an example, the Philippines before and after President Marcos. They argue that, in the Philippines

■ BOX 7.2 **Corrupt Governments as Joint Monopolists**

In an important paper, Shleifer and Vishny (1993) propose a model of corruption in which the structure of government institutions and the political process is an important determinant of the level of corruption. In particular, they argue, weak governments that do not control their agencies experience high corruption levels, whereas stronger and more centralized governments may experience lower levels of corruption.

Their model builds on an analogy from the literature on industrial organization: the idea of a joint monopolist. A joint monopolist is a firm that has a monopoly over two strongly complementary goods. Such a firm will price differently from multiple independent monopolists, each producing only one of the strongly complementary goods. A joint monopolist will price so as to maximize returns across both markets, whereas independent monopolists will tend to push up the price of their respective products regardless of the demand effects in the complementary markets, and all will suffer.

This simple notion may be extended in a model of corruption to a case in which government officials must be bribed before they will provide licenses or permits. In many situations, a private firm needs several complementary licenses or permits to conduct business. For example, a firm might need an investment license and a planning permit. In the case of a strong, but corrupt government with tight control over its agencies, the value of the bribes for investment licenses will be kept down so as to expand the demand for the complementary planning permits, while the value of the bribes for planning permits will be kept down so as to expand the demand for investment licenses.

Alternatively, under a weak and corrupt government with loose control over its agencies, the investment agency and the planning bureau may set bribes independently. Each agency sets bribes so as to maximize the total bribes, while taking the other agency's output as given; so, the per unit bribe is higher, and the output (the number of investments licensed and plans permitted) is lower. By acting independently, the two agencies actually hurt each other, as well as the private buyers of permits.

This analysis holds that any corruption is distortionary and therefore costly (and more distortionary and costly than taxation because of the need for secrecy). However, since bribes are set at higher levels under the weak government scenario, corruption is more distortionary under weak, decentralized governments than under strong, centralized governments.

under President Marcos, it was always clear who needed to be bribed and for how much. All bribes flowed to the top, and the bribes were then divided among all the relevant government bureaucrats, who did not demand additional bribes from the purchaser of the package of permits. Since the demise of Marcos, the authors argue, the number of independent bribe takers has probably risen, the level of corruption has probably increased, and the efficiency of resource allocation has probably declined.

Shleifer and Vishny also imply that more organized corruption may also reduce uncertainty. For example, they argue that, in the Republic of Korea, although corruption was pervasive (at the time of writing in the early 1990s), the person paying the bribe was assured of getting the government good that was being paid for and would not need to pay additional bribes. By contrast, they believe, in many African countries and in post-communist Russia, not only do numerous bureaucrats need to be bribed to get government permits, but bribing a bureaucrat does not guarantee that some other bureaucrat or even the first one will not demand another bribe.

A similar, almost contemporaneous model is that devised by Olson (1993), who, perhaps significantly, draws his metaphor from Chinese history to argue that "stationary bandits" are preferable to "roving bandits." Through uncoordinated competitive theft (or corruption), roving bandits destroy the incentive for economic agents to invest and produce, leaving little for the population or the bandits. Both might be better off if one bandit sets himself up in a stationary position to monopolize and rationalize his thefts (or corruption). The successful, rational, and stationary bandit, Olson argues, will monopolize theft in his domain and will limit what he steals because he knows that, in the long run, he will be able to extract more if he gives his victims the public goods and incentives they need to invest and produce additional income and wealth. Because of this, Olson posits, there will be less investment and growth in countries governed by roving bandits.

Both quantitative analysis and country case studies tend to support the relevance of these ideas in the East Asian context. The simple scatter charts presented in figure 7.4, prepared using Kaufmann-Kraay indicators for 2004, suggest that East Asian countries generally are perceived as having greater government effectiveness and better regulatory quality than would be predicted by their control of corruption percentile.

The simple scatter charts presented in figure 7.5, have been prepared using the 2003 United Nations Development Program human development index. The corruption perceptions index (chart a), and the control of corruption index (chart b), indicate that East Asian economies generally show better human development outcomes than one might expect based only on the level of the corruption indexes.

The impression these data give is that corruption is widespread but orderly in East Asia and that it goes hand in hand with generally effective, well-regulated, and benign (or, at least, developmental) government. In line with the Shleifer-Vishny model, it seems that East Asian governments have typically managed corruption so as to minimize the adverse impacts on investment and growth, and, in line with the Olson model, it seems East Asian governments have also typically managed corruption so as to minimize the adverse impacts on human development and, hence, growth.

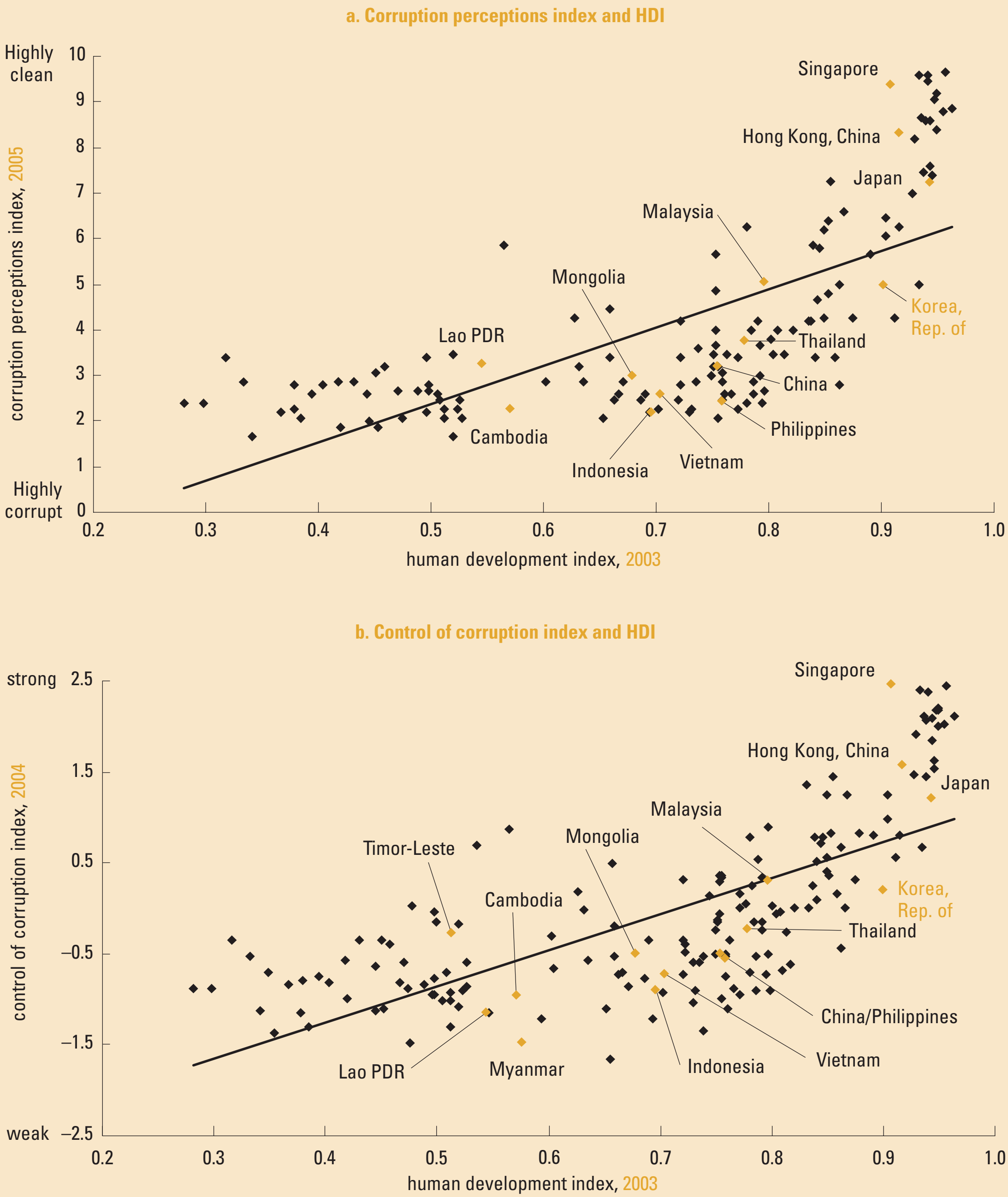
Similarly, the scatter charts in figure 7.6, prepared using data from the World Bank investment climate surveys, suggest that bribes to secure a contract with

(text continues on page 332)

■ FIGURE 7.4 **Government Effectiveness Is Greater Than Corruption Indexes Imply, 2004**

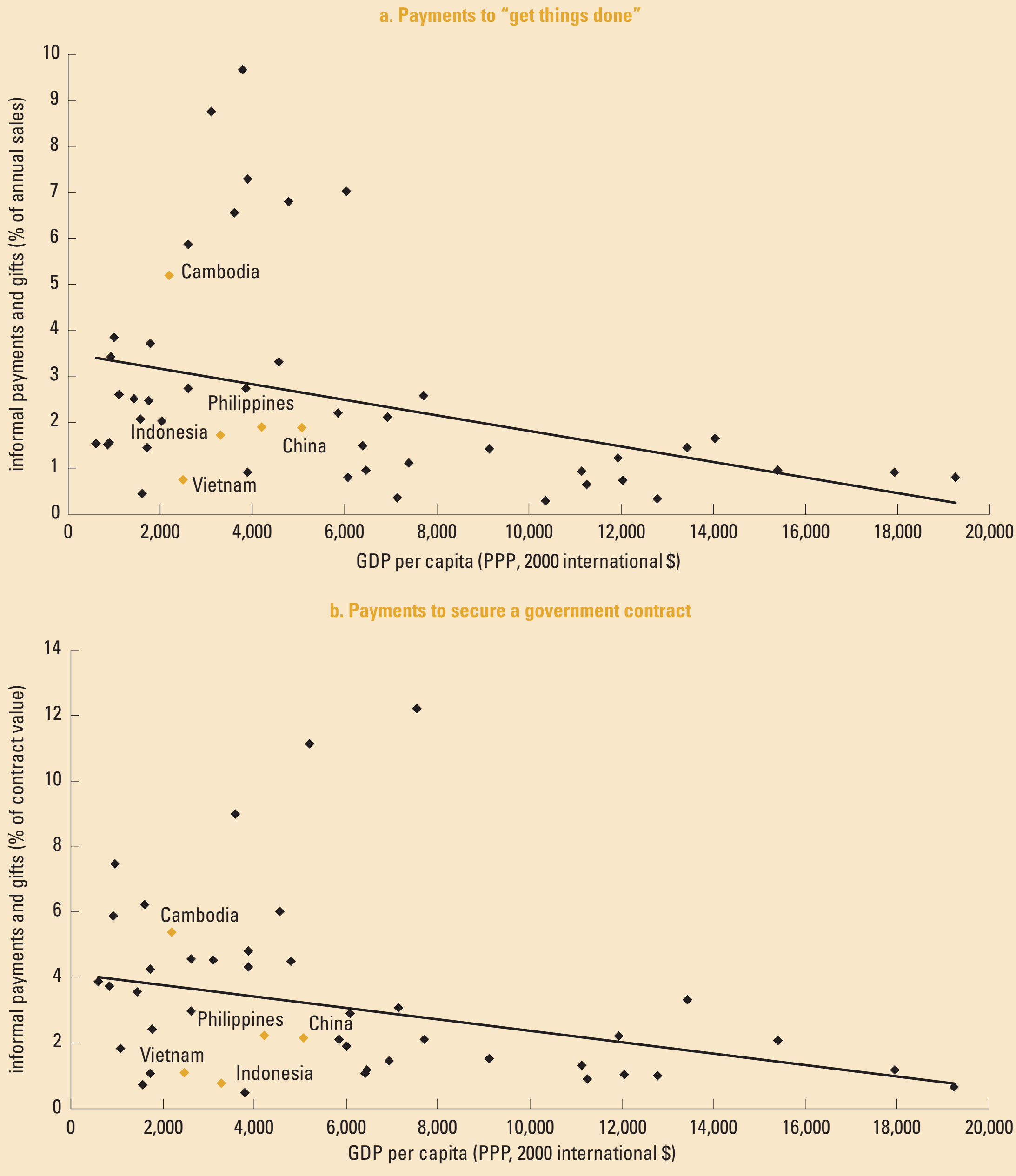
Source: Calculations of the authors based on data from Kaufmann, Kraay, and Mastruzzi 2005.
Note: The figure shows global percentiles. East Asian economies are highlighted.

FIGURE 7.5 **Good Human Development Outcomes Despite High Corruption Levels**



Sources: Prepared using data from Transparency International 2005, Kaufmann, Kraay, and Mastruzzi 2005, and UNDP 2003.
Note: HDI = human development index. East Asian economies are highlighted.

■ FIGURE 7.6 **The Bribes Needed to Get Things Done Appear to Be Smaller in East Asia**



Sources: Investment Climate (Enterprise) Survey Database, World Bank and International Finance Corporation, http://www.enterprisesurveys.org/; World Development Indicators Database, World Bank, http://www.worldbank.org/data/datapubs/datapubs.html.
Note: The figure shows global percentiles and reflects unweighted averages. East Asian economies are highlighted.

government or to "get things done" are lower as a share of contract value or annual sales in most East Asian economies surveyed (China, Indonesia, the Philippines, and Vietnam) than one might predict based on GDP per capita. This finding appears to be consistent with the hypothesis that economies with strong, centralized governments set bribes at lower levels. The exception is Cambodia, which, as box 7.3 illustrates, fits the competitive corruption model more closely than the organized monopoly model.

Campos, Lien, and Pradhan (2001) present cross-country regression analysis to show that, while corruption impacts adversely on investment, it tends to have smaller adverse impacts under regimes in which corruption is predictable (in the sense that the favor, service, or product being sought is more likely to be granted). Using survey data collected for the *World Development Report* of the World Bank (1997), they find that corruption does impact adversely on investment, but that, for any given level of corruption, the predictability of corruption has a positive effect on investment. Other things being equal, countries in which corruption is predictable tend to attract higher relative levels of investment. The authors propose that countries may be classified into three categories: those with high levels of corruption and a low degree of predictability in corruption, those with high levels of corruption and a high degree of predictability, and those with low levels of corruption and a high degree of predictability. While they place most developing countries into the first category and most developed countries into the third, they put East Asia's "miracle economies" into the second category.

MacIntyre (2001) uses a country case study of Indonesia and a centralized monopoly corruption regime argument of the Shleifer and Vishny variety to resolve the East Asian corruption paradox. With reference to Indonesia, MacIntyre argues that special features of the Suharto regime allowed it to function much like a joint monopolist trying to maximize profits across complementary products. He argues that Suharto's system had two pillars: corruption and investment. Suharto's system gave ample opportunity to extract rents and distribute these across the bureaucratic and political client groups involved in perpetuating the system. At the same time, the system managed to keep the costs of generating the rents from squeezing out long-term investment. MacIntyre details a number of occasions when Suharto clamped down on corruption not to eliminate it, but to ensure that it remained under his control. MacIntyre argues that this provided a greater degree of predictability for investors. While investors might have had to pay substantial bribes, they were assured that their investments would be protected from unpredictable and uncoordinated corruption.

■ BOX 7.3 **Competitive Corruption in Cambodia**

At the end of the Khmer Rouge period, no functioning state institutions remained in Cambodia. The legacy of conflict had depleted the country's human talent on which the public sector and entrepreneurship are based and destroyed the social institutions that had glued the society together. After 1979, the Cambodian state and civil society had to be rebuilt. The growth in Cambodia over the past decade has been remarkable in light of the destruction wrought by years of conflict, but it has been heavily dependent upon a narrow base, namely, garment exports and tourism. Corruption may have reduced the rate of growth and the rate at which the economy has been able to diversify.

The problems of Cambodia's weak formal and informal institutions are felt most directly and acutely through corruption. The government has tried to fill the institutional vacuum through administrative measures; these have often proved unsuccessful and have created more opportunities for corruption. Overlapping and expensive regulation has created room for excess discretion and rent seeking, which has added to the cost of doing business.

It takes 86 days to start a business in Cambodia, 36 days more than it takes to start a business in Vietnam and 53 days more than in Thailand.[14] The incentives for the private sector are distorted; staying in the informal sector appears a rational response to the investment climate since informal firms face lower taxes and fewer requests for bribes. The investment climate assessment of the World Bank (2004a) found that doing business in Cambodia involves the most annual inspections, costs the most per capita for the official registration of businesses, and, after China, requires the greatest amount of time among managers for dealing with officials.

Moreover, according to the investment climate assessment survey, unofficial payments do not appear to grease the wheels: bribes do not necessarily expedite services in Cambodia. There is no statistical difference between the speed of administrative procedures for firms reporting higher versus lower ratios of bribes as a share of sales for essential services such as utility connections. Firms of all sizes acknowledge paying bribes; but the larger and more formal the enterprise, the higher the bribes as a share of sales. Private sector firms estimate that unofficial payments cost them an average of 5.2 percent of total sales revenue; for large firms, the figure exceeds 6 percent. Unofficial payments represent a significant component of doing business in Cambodia, to the extent that the share of revenue consumed by unofficial payments is more than double that found in parallel surveys in Bangladesh, China, and Pakistan.

A recent survey found that the institutions considered the most corrupt were the customs service, the courts, the police, and tax collection; among all but the last of these institutions, corruption seems to have worsened between 2000 and 2005.[15] The majority of survey respondents rejected the notion that corruption is acceptable merely because it is so common or that a small salary entitles a civil servant to bribes. To some extent, the perception that corruption has become more severe may be affected by the growing intolerance for corruption.

The same survey found that, on average, each household pays US$24.50 per year for bribes. This represents between 1.4 and 2.2 percent of total household expenditures and 5 percent of total income. The cost of bribes is only a small fraction of the overall burden of corruption. Indirect costs to households range from undelivered services to higher prices for consumption and investment goods and from forgone revenue that would otherwise finance service delivery to the dispossession of poor and poorly connected families from access to common resources because local officials are selling these off as private property.

Sources: World Bank 2004a, 2004b, 2005a.

Indonesia during the Suharto years experienced short-lived, but striking interventions that targeted corruption. Thus, Suharto issued a presidential decree that disempowered the entire customs bureau in 1985 when the corruption became serious enough to jeopardize his whole system of rent extraction. In an unprecedented move, the bureau's bureaucratic functions were outsourced to a foreign company. Similarly, in 1986, when the textile industry was imperiled by the cotton import monopoly, executive action was taken to dismantle the monopoly, and its senior officials were fired.[16] Although none of these interventions were aimed at eliminating corruption, they were seen as necessary to ensure the sustainability of the respective sectors and, hence, of overall rent streams.

Additional evidence exists of the extent of the centralization of corruption in Indonesia under Suharto. In an innovative study, Fisman (2001) created the Suharto dependency index to measure the political connectedness of firms listed with the Jakarta Stock Exchange. He showed that rumors of Suharto's health problems between 1995 and 1997 had a strong negative impact on the share prices of firms that ranked high on the Suharto dependency index, and, furthermore, the impact increased as the rumors grew worse.

Kang (2002) and Chang (2001) present similar arguments in their case studies of corruption in the Republic of Korea. Both find that Korea managed to establish a corruption regime in the postwar period. The regime permitted rapid economic growth despite the extensive corruption it also allowed. Kang says that there was a balance of power among a small and stable set of government and business elites. To fund their operations, political elites took massive donations from the *chaebol* (the dominant firms in Korea). *Chaebol* donations were sometimes used for humanitarian or developmental purposes, but were part of a larger web of money politics. Kang presents evidence that businessmen who did not provide politicians with sufficient "voluntary donations" when they were asked had their loans called by the Bank of Korea, suffered through tax audits, or had their subsidy applications denied. Kang characterizes the arrangement as one of mutual hostages, whereby each side benefits from the arrangement and has strong incentives not to undermine the benefits of the other. The collusion of a powerful business class and a coherent state meant that corruption, though widespread, was constrained.

According to Huntington (1968), most forms of corruption involve an exchange of political action for economic wealth. Where there are many avenues to accumulate wealth, but few positions of political power, he argues, the dominant pattern will be the use of the former to achieve the latter. Huntington held that, in the United States, for example, wealth has commonly been a road to political influence rather than political office a road to wealth. In most modernizing countries, however, the opportunities for the accumulation of wealth through private activity are limited, and politics therefore becomes the road to wealth. Similarly, Kang (2002) concludes that the different development trajectories of the Republic of Korea and the Philippines—though, in both countries, growth and corruption existed side by side for decades—may be explained by the balance of economic and political power. Even during the period of rapid growth in the Republic of Korea, economic power and political power were balanced, and corruption never spiraled out of control. In the Philippines, however, the imbalance in the two factors led to abuses and to corruption that was sufficiently large to choke off growth.

Is East Asian Tolerance of Corruption Declining?

East Asian Values and Corruption

There has been much debate about whether corruption means the same thing in Asia as it does in the West. "What you regard as corruption in your part of the world, we regard as family values," Mohammad Suharto, then president of Indonesia, is reported to have told James Wolfensohn, then president of the World Bank.[17] It is frequently argued, especially with reference to East Asia, that cross-country comparisons of corruption are inappropriate since public ethics are culturally specific.

Some have held that the cultural characteristics of Asia make it more inclined to corruption. For example, Tanzi (1995) has contended that firms in some countries are culturally less inclined to have arm's-length economic relationships, which, in turn, may lead to more ingrained corruption. It is certainly the case that the giving and accepting of gifts are a normal way of doing business in many parts of Asia.

Against this, Mahbubani (2006) writes that a Confucian notion of obligation to society characterizes East Asian elites. Vogel (1991) believes that, while East Asian societies do not focus on binding legal codes as do societies in the West, they have detailed rules about the behavior of the individual with respect to the group. Vogel cites the emphasis on loyalty, the responsiveness of people in organizations to group demands, and the predictability of individual behavior in the group setting as characteristics well suited to the needs of industrialization, particularly in those economies trying to catch up.

Fukuyama (1999) points out that arguments based on Asian values fail to recognize Asia as a diverse location, where values vary significantly from country to country. Thus, Confucianism is interpreted differently in China, Japan, and the

Republic of Korea, and kinship ties vary in importance throughout Asia, playing a minimal role in Japan and a very important one in southern China. Furthermore, as others have highlighted, Eastern religions, including Buddhism, Confucianism, Hinduism, and Islam, each condemn corruption. Fukuyama also says that arguments according to Asian values falsely suggest that values have a direct impact on behavior. He holds that institutions may be at least as significant and that values are mediated through a variety of institutions before becoming manifest.

Neither values nor institutions are static, but may evolve. For example, the long-established tradition of receiving gifts in the Japanese administration has been restricted by the National Public Service Ethics Law of August 1999, which obliges senior officials to report gifts of a value greater than ¥5,000 (roughly US$50 equivalent).

Survey evidence from Thailand shows that people make quite sophisticated distinctions between appropriate and inappropriate gifts. Thus, although Thais set higher limits than those in many other countries on the amount of money officials may take from the private sector before they consider it corruption, they do not tolerate major payoffs involving high-level officials and major investors.[18]

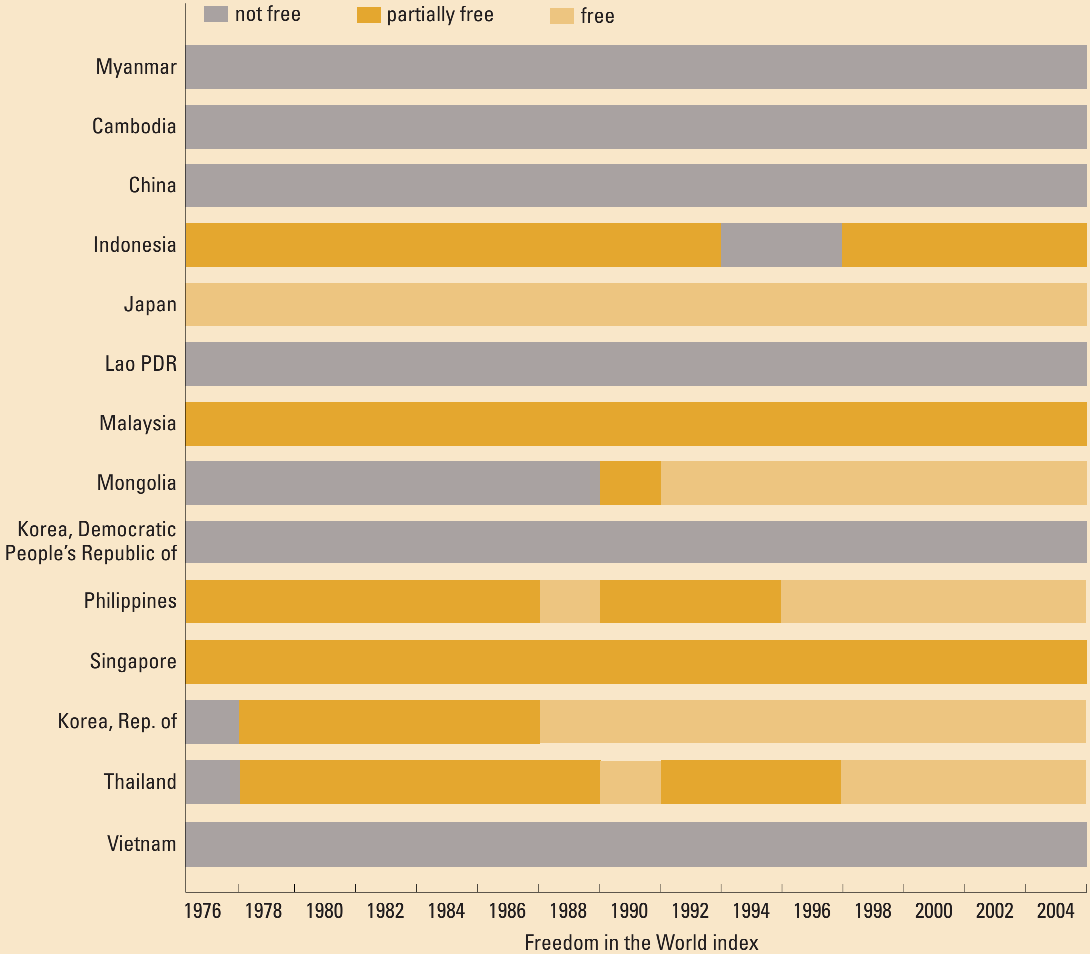
As we discuss in the context of Cambodia, survey evidence shows that households do not agree that corruption is acceptable because it is so common or that low salaries entitle civil servants to bribes. Indeed, the researchers who have conducted the surveys have concluded that, to some extent, the increase in the number of respondents who say corruption has worsened may be affected by their growing intolerance for corruption.[19]

The Demand for New Forms of Governance

Demands for new forms of governance and enhanced anticorruption efforts have been rising across East Asia. Corruption has figured prominently in public discourse and political events, including the convictions of two former presidents of the Republic of Korea, the resignation of President Mohammad Suharto in Indonesia, and the ouster of both President Ferdinand Marcos and President Joseph Estrada in the Philippines. These trends are reflected in the gradual move toward democracy in some countries and a more rapid and general move toward decentralized governance across the region.

There has been a measured spread of political rights and civil liberties around the region. In 1976, only one of the 14 East Asian economies listed in figure 7.7 were considered free (light gold), while four were considered partially free (dark gold), and nine were considered not free (black), according to

■ FIGURE 7.7 **Political Rights and Civil Liberties Are Spreading in East Asia, 1976–2004**



Source: Freedom House 2005.

the Freedom House freedom in the world index.[20] Since 1998, the equivalent rankings are five free, three partially free, and six not free. Although not all observers would agree with the individual categorizations, it is clear that political democracy and civil liberties have made advances in the region during the period under review (particularly between 1986 and 1997, starting with the fall of Marcos in the Philippines in 1986 and the passage of the Constitution of the

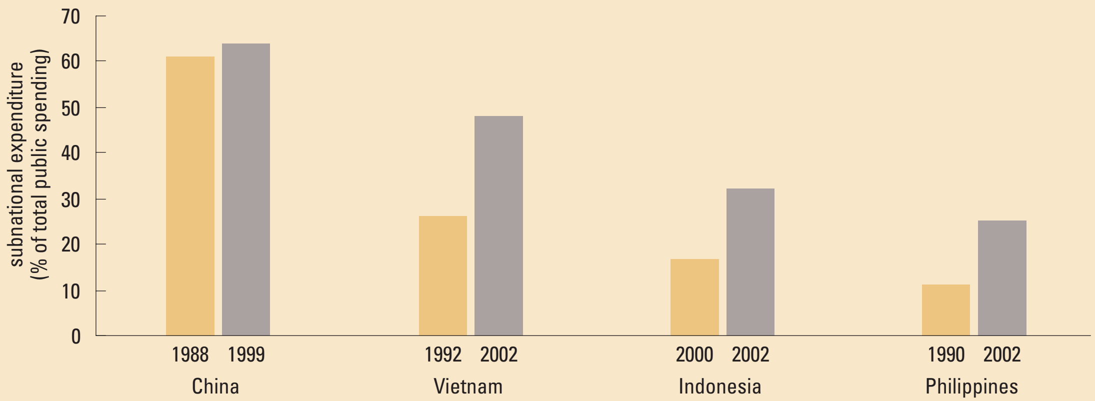
Sixth Republic in the Republic of Korea in 1988 and ending with the East Asian crisis of 1997–98).

More general has been the process of decentralization that has affected almost all countries in the region. Decentralization has come later in East Asia than in many other parts of the world. Before 1990, most East Asian countries were highly centralized. Today, however, subnational governments play a major role in much of the region's development, delivering many critical services and accounting for a significant portion of total public expenditures (see figure 7.8).

It is important to recognize that there are several types of decentralization, each with different formulations on the fiscal, administrative, and political dimensions. The East Asian economies have followed separate paths at varying speeds. Indonesia and the Philippines rapidly introduced major structural, institutional, and fiscal reforms and pushed sweeping decentralization reforms following the sudden end to authoritarian rule, thereby creating the basic elements of a framework for decentralization, subnational democratic elections, and substantial resource sharing. China and Vietnam have taken a more piecemeal, ad hoc approach to decentralization. Cambodia and Thailand have established significant elements of decentralization at the formal policy and legislative levels, but have been slow in implementation.[21]

There are clearly economies in East Asia—the Democratic People's Republic of Korea and Myanmar, for example—that political modernization may not touch

FIGURE 7.8 **Subnational Governments Are Being Given Greater Responsibilities**



Source: Various public expenditure reviews, World Bank.

for some time. Taking the region as a whole, however, it seems likely that the demand for political modernization will continue to grow.

With reference to the United States, Friedman (2005) has argued that, historically, economic growth has created conditions conducive to the strengthening of governance. The standard accounts of European history also suggest various connections between the economic and social transformations of the industrial revolution and the process of political modernization. Growing urban populations and better educated and articulate middle classes may make demands for greater political representation, less corruption, and more effective service delivery harder for political leaders to ignore.

As advanced East Asian countries mature, growth rates may be expected gradually to converge with those of advanced countries in the Organisation for Economic Co-operation and Development. Rates of return will eventually become less spectacular and may no longer be adequate to compensate investors for the prevailing levels of corruption. Investors and trade partners may no longer be willing or able to absorb the extra costs and uncertainty associated with corruption. The ability to control corruption may therefore become a binding constraint to growth in a way that it has not hitherto been. Indeed, a mechanism of this kind may well have contributed to the demand for better governance and reduced corruption in Hong Kong (China), Japan, and Singapore over the last half century.

Domestic and global environments have changed drastically across the region; in an era of sweeping economic, political, and social transformations and full-scale integration into the global economy, no East Asian state has a grip on the whole state apparatus and the economy as Suharto did in the 1980s. It is becoming difficult to imagine that East Asian states might maintain corruption regimes of the kind they have had in the past.

Regional and global integration may create demand for reduced corruption from businesses. In the short term, action to tackle the corruption in customs administrations may be necessary to support accession to the World Trade Organization. The requirement to eliminate remaining trade barriers as part of the Free Trade Area of the Association of Southeast Asian Nations or because of World Trade Organization commitments will further reduce policy-induced sources of rents.

In the longer term, economies will become more complex as a result of the integration process and the increased crossborder flows of capital and ideas. The success of East Asian economies will depend less and less on factor endowments, such as cheap labor or natural resources, and more and more on the ability of these economies to address bottlenecks in the availability of human capital, efficient infrastructure, or innovation. The demand for government that helps address these bottlenecks, rather than simply extracting rents, may also grow as a consequence.

FDI may bring with it international accounting and auditing standards that help deter corruption. Integrity and trust may become prerequisites for success in business in a way that they were not hitherto. Corruption may be harder to broker across national and cultural boundaries as FDI becomes ever more significant. Greater intraregional and international exchanges of ideas may expose citizens to other governance models and to debates about governance that are less widely accessible domestically.

Will Political Modernization Reduce Corruption?

If political modernization accelerates across East Asia, how will this impact on corruption? Empirical investigations are ambiguous about the effects of democracy and civil liberties on corruption and about the effects of decentralization on corruption. On balance, the available evidence tends to support the presumption that the spread of political and civil liberties and the development of more decentralized forms of governance will reduce corruption. However, there is also evidence that these effects may take time to play out and that the full benefits may be contingent on a parallel and necessarily more gradual process of institution building.

A Longer-Term View

Most East Asian countries have experienced unprecedented social and economic change in the past few decades. Economic development, the spread of education, and growing, affluent middle classes have been key drivers for better governance. Scott (1972) argues that, with more equal income distribution, a relatively large middle class is able to survive, act to hold elites accountable, and, as a consequence, foster lower levels of corruption. In similar fashion, Glaeser, Scheinkman, and Shleifer (2003) propose that inequality enables the rich to subvert the political, regulatory, and legal institutions of society for their own benefit.

Empirical studies on democracy and corruption draw our attention to complex and often difficult-to-prove links between the two. Rose-Ackerman (1999) has argued that elections increase the accountability of politicians, but also produce new incentives for corruption as the need for political financing rises. Brunetti and Weder (2003) do not find any impact of democracy on corruption in a cross-country analysis. However, Treisman (2000) presents a more subtle picture. He finds that democracy will not reduce corruption significantly in general, but that a long exposure to democracy does appear to decrease corruption: democracies are significantly less corrupt only after 40 years.

Chowdhury (2004) uses cross-country regression analysis to confirm that democracy and press freedom may have a significant impact on corruption. He notes that the two act together. The presence of press freedom brings public corruption cases to public attention, while democracy allows the public to punish corrupt politicians by ousting them from office. Like Treisman, Chowdhury believes there may be a substantial time lag and that, while a shift toward democracy and press freedom may influence the extent of corruption, an immediate improvement is unlikely. Drawing on a cross-country analysis, Montinola and Jackman (2002) conclude that political competition helps reduce corruption, but only beyond a certain threshold of competition. They find that corruption is slightly more prevalent in countries with intermediate levels of political competition than in their less democratic counterparts, but once past the threshold, higher levels of competition are associated with considerably lower levels of corruption.

It is quite possible that, as countries transition to democracy, democratic consolidation will take more time, and institutions will need to be strengthened before corruption levels come down. It is quite possible that, in an environment with weak institutions and poorly established accountability mechanisms, elections will produce new opportunities and incentives for corruption. According to Diamond (1997):

> Democracy may be the most common form of government in the world, but outside of the wealthy industrialized nations it tends to be shallow, illiberal, and poorly institutionalized. If there are no immediate threats of democratic collapse in most of those countries, neither are there clear signs that democracy has become consolidated and stable, truly the only viable political system and method for the foreseeable future. In fact, of the more than 70 new democracies that have come into being since the start of the third wave, only a small number are generally considered to be deeply rooted and secure (p. xv).

Acquiring effective institutions is a slow process. Even the most advanced countries that now rank among the least corrupt in the world were once riddled with corruption in every sphere of public life. Institutions that enable these states to deal with corruption have evolved over time, but it has not been a linear, progressive path. The U.S. experience is a good example (see box 7.4). Legislative corruption in the United States was so serious that President Theodore Roosevelt is known to have lamented that the New York assemblymen who engaged in openly

BOX 7.4 The History of Corruption in the United States

The incidence of corruption actually increased in the United States for quite some time, in parallel with unprecedented economic growth. Glaeser and Goldin (2006) show this by using public documents—newspapers—to construct an index of reported corruption. Taking advantage of the advent of online searchable editions of long-established U.S. newspapers (including *The New York Times* and a large group of small town newspapers), they searched for the words "corruption" and "fraud" (and their variants, such as "corrupt" and "fraudulent") and counted the number of pages containing these words in newspapers. They adjusted this index to control for the size of the newspapers and the overall amount of attention given to politically relevant stories.

Glaeser and Goldin have found that the extent of corruption increased until the 1870s and then declined between the 1870s and the 1920s, with most of the decline concentrated in the mid-1870s to 1890 and in the 1910s. They argue that the rise in corruption across the 19th century may be explained by the rapidly expanding scale of both government and the economy: the budgets of local governments swelled, thereby increasing the potential benefits of corruption.

Why, then, during the 1870s and the 1920s did corruption in the United States decline despite the continuous rise in the size of government and the high returns to corruption in the judiciary? Glaeser and Goldin discover the answer in a change in the costs of corruption. Before about 1900, many actions that are considered corrupt and illicit today were legal. Institutional checks and balances were inadequate. Governments rarely prosecuted themselves, and the higher levels of government were sufficiently weak that they could not provide a check on local corruption. The lack of information was also a serious problem; although national newspapers might expose corrupt practices, many smaller city media outlets were tied to the political establishment and did not fulfill their informational role properly.

By the early 20th century, however, the United States was able to establish and implement a fuller apparatus of modern checks on corruption. Rules began replacing discretionary approaches in many areas, including patronage networks. Different levels of government became more effective at patrolling each other. Greater competition and political independence in the news media assured more transparency across the nation, not only in the big cities. Finally, voter expectations about corrupt behavior had changed, and officials caught in corruption became more likely to experience defeat at the polls.

selling votes to lobbying groups "had the same idea about public life and civil service that a vulture has of a dead sheep."[22]

Empirical investigations into the effect of decentralization on corruption show mixed results. Treisman (2000) finds that federal countries exhibit higher rates of corruption. However, Treisman's measure of decentralization is a simple one based on the existence or lack of a federal structure. In contrast, Fisman and Gatti (2002) measure decentralization as the share of government expenditure at the subnational level and use cross-country regression analysis to show that this measure of decentralization is strongly and significantly associated with lower corruption. Fisman and Gatti find that their regression results hold with or without including in the sample the countries that decentralized over the period 1980–95. However, their paper does not set out to investigate whether the impact of decentralization on corruption becomes stronger the longer a country is exposed to decentralization.

Much like democracy, decentralization in weak institutional settings is not a panacea for good governance or for active efforts to curb corruption. Nonetheless, the empirical research is scarce, and the evidence is not definitive. There is thus a heated debate about the links between decentralization and corruption. Table 7.2 summarizes some of the potential benefits and risks of decentralization in the short and long term with respect to corruption. The expected benefits from decentralization are all based on the assumption that local accountability mechanisms are effective and that information is available so local actors may demand better governance. In reality, local institutions are often weak, and mechanisms to ensure satisfactory information flows are frequently dysfunctional.

Shorter-Term Dynamics

Country case studies cast some light on the shorter-term dynamics of the relationships among democratization, decentralization, and corruption. While welcoming

TABLE 7.2 **Potential Link between Corruption and Decentralization**

Time span	Benefits of decentralization	Risks of corruption
Short run	Brings governments closer to the people Overcomes information asymmetries Enhances transparency and accountability Allows for local innovation	Local governments may be more susceptible to state capture Local politicians may be more likely to engage in clientelism to win elections Capacity constraints may be a problem for local governments and also for local institutions involved in checks and balances, such as local legislatures, the judiciary, the media, and civil society
Long run	Promotes tax and policy competition Underpins long-term political reform	Creates intergovernmental tension; may increase uncertainty Exacerbates disparities between lagging and advanced regions Fragments economies of scale Intense interregional competition may lead to excessive cuts in tax rates and public goods

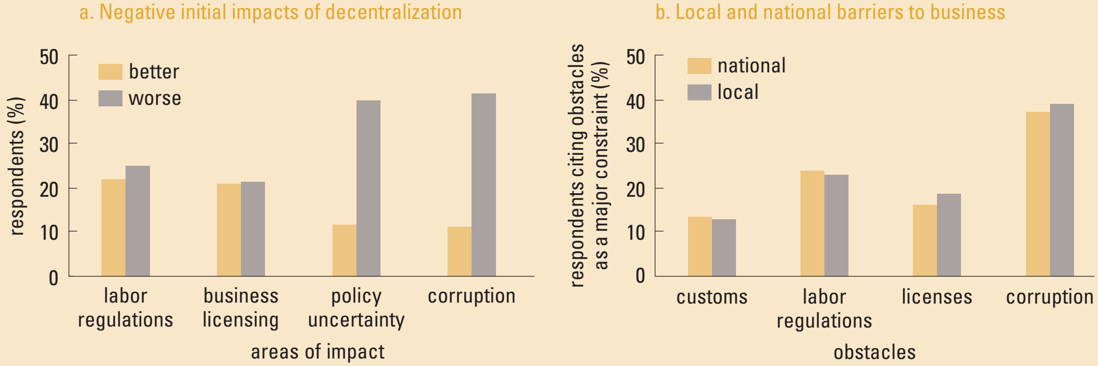
Sources: Based on Kaiser 2006; Campos and Hellman 2005.
Note: State capture covers the actions of individuals, groups, or firms in the public or private sectors undertaken to influence the passage of laws, regulations, decrees, and government policies to their advantage through the illicit and nontransparent provision of private benefits to politicians or civil servants. Clientelism refers to politicians who distribute publicly funded goods to selected members of the electorate in return for votes and political support.

Indonesia's transition to democracy as a positive development in the longer run, MacIntyre (2001) writes that corruption may actually become worse during transition. He notes that the transition represents an important step toward more transparent governance and a more independent legal system. However, in the short and medium term, Indonesia's swing from centralized authoritarian rule to more democratic and more decentralized government may be associated with a less attractive investment climate and greater corruption: it has progressed beyond tight centralization, but has not yet developed a truly independent legal system or transparent governance institutions. In terms of the Shleifer-Vishny model, Indonesia is likely to advance from a situation wherein there is a single monopolist who accepts bribes to a more distortionary situation wherein there are multiple independent monopolists who accept bribes.

Decentralization has been driven by political rationale in many countries with a legacy of authoritarian rule; often, it represents an attempt to deal with cross-cutting social and economic tensions and ease local grievances against the central state. It is considered a shorter route toward the establishment of accountability among policy makers, citizens, and service providers in order to improve service delivery. In Indonesia and the Philippines, decentralization was adopted following the sudden collapse of authoritarian regimes (respectively, Suharto in 1998 and Marcos in 1986), which fueled demands for legitimate, local representation. In the region, these two countries have done the most to implement comprehensive decentralization programs.[23]

Indonesia initiated the process of decentralization in the late 1990s, but the climax of the process was the big bang decentralization in 2001. At that time, control of a significant share of public resources and direct authority over nearly 2 million civil servants were transferred to the local level. Recent empirical evidence from Indonesia appears to confirm that corruption may actually have become worse in the first few years following the big bang decentralization. The World Bank's productivity and investment climate survey asked firms about the impact of decentralization on key aspects of the governance and investment climate. As figure 7.9, chart a, illustrates, firms perceived decentralization as negative in four areas: labor regulations, licenses, policy uncertainty, and corruption. Most notably, more than 40 percent of the firms surveyed thought that decentralization had made corruption worse, while only 11 percent thought it had reduced corruption. The survey data also show that corruption is perceived as one of the major obstacles to business in Indonesia and that local corruption is considered even more serious as an obstacle than national corruption (figure 7.9, chart b). According to the survey, as an average share of annual revenues,

FIGURE 7.9 **The Initial Impact of Decentralization in Indonesia, as Cited by Firms**



Source: Adapted from Campos and Hellman 2005 using the Investment Climate and Productivity Study Database and Development Indicators, Asian Development Bank and World Bank, http://www.adb.org/Statistics/ics/default.asp.
Note: The figure shows the results of a survey among firms in Indonesia.

firms pay 64 percent more in informal payments to local governments than they do to officials at the national level. But informal payments seem not to translate into grease money, because firms also spend 15 percent more of their time dealing with local regulations than they do with national regulations. Although these results are preliminary, it is difficult to argue that decentralization has helped bolster the accountability of the state, at least from the perspective of Indonesian firms.

Clientelism and capture are also a problem at the local level; local legislative candidates are reported to pay national party organizations for ballot slots, and their selection is linked to elite village networks. Voters are often influenced by direct payments and other transfers.

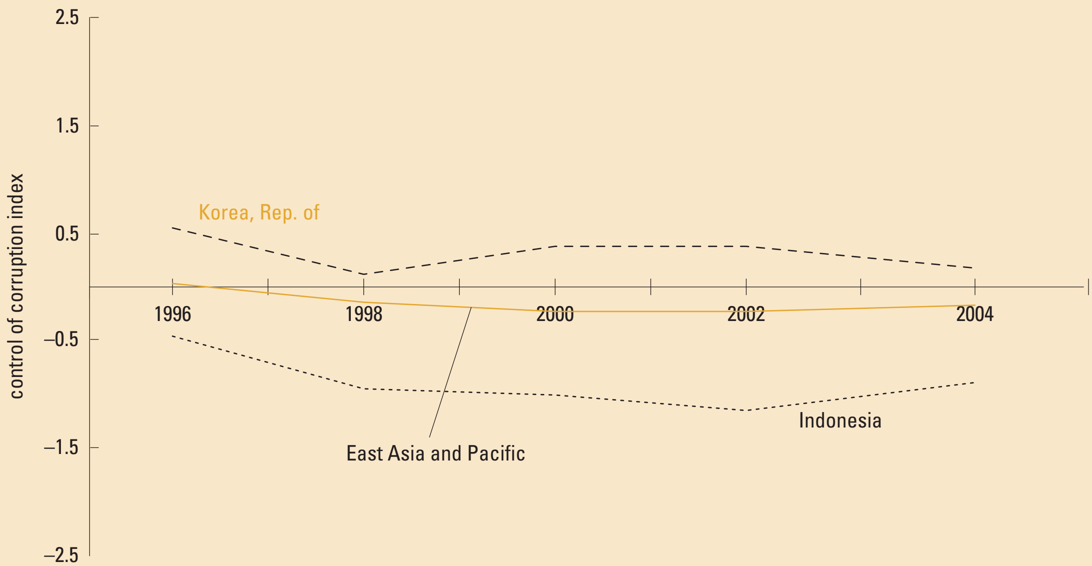
The major decentralization reform in the Philippines took place during 1992–93. Perception-based measures of corruption have consistently improved since then, but it is not clear whether decentralization has been the key driver of this trend. Based on surveys of households and public officials at various levels of government, an extensive study in 2001 by the World Bank and the Center for Institutional Reform and the Informal Sector at the University of Maryland concluded that, while the lower levels of government are perceived to be less corrupt, local governments are no more accountable to local preferences than is the central government.[24] Nonetheless, there are promising developments; in the Philippines, perhaps due to the greater experience with decentralization, reliable information on local government performance is beginning to emerge that is fostering local government accountability and competition among local governments, thereby increasing government responsiveness.

Similarly, in case studies of the Republic of Korea, Chang (2001) and Kang (2002) draw connections between the change in the investment governance regime in the late 1980s and mid-1990s and the 1997–98 crisis. Both authors illustrate this graphically through the corruption scandal that surrounded the rapid rise and dramatic collapse of Hanbo Steel in early 1997. Chang points to the abolition of industrial planning under the Kim Young Sam government, which came to power in 1993, and argues that this exposed even core manufacturing industries to corruption by eliminating the clear limits on the ways influential politicians and bureaucrats might extend favors to their "paying customers." Kang suggests that the crisis occurred in part because the 1987 transition to democracy diffused the power of the state, thereby upsetting the balance of power within the small and stable set of business elites that had managed to restrain corruption and render it (in that context) actually beneficial to growth.

The validity of using corruption indicators to make comparisons over time is subject to some debate. The comparison of corruption rankings is certainly not meaningful. A country or region may stand still in terms of corruption, but slide down the rankings due to advances in other countries or regions. Even comparisons using point estimates need to be made with caution. The surveys used to compile these composite indicators vary from year to year. A change in perception may lag the fundamentals by a number of years. Nevertheless, as figure 7.10 illustrates, the control of corruption index does suggest there has been a decline in the control of corruption in East Asia as a region and in Indonesia and the Republic of Korea as cases in point over the period for which data are available.

Summing up such arguments, MacIntyre (2001) writes that: "the one thing worse than organized corruption is disorganized corruption" (p. 44). This argument is in fact rather similar to that of Huntington (1968) when he said that political modernization, defined as a transition from an autocratic to a more democratic government, is usually accompanied by an increase in corruption because of the underdevelopment of the institutions supporting democracy. Huntington points to the "organizational imperative": the need to assign greater priority to strengthening the political and bureaucratic institutions supporting democracy so that political modernization has a better chance to succeed and corruption will not increase.

■ FIGURE 7.10 **The Control of Corruption Is Seen as More Lax in East Asia in 1996–2004**



Source: A data set in Kaufmann, Kraay, and Mastruzzi 2005.
Note: Best = +2.5. Worst = -2.5.

Conclusions

Despite the frequent use of terms such as crony capitalism and endemic corruption in connection with East Asia, it is clear that there is no uniform level of corruption in the region. The evidence suggests that there is tremendous variation in the levels of corruption across the region. Although some East Asian economies, such as Cambodia and Myanmar, rank among the most corrupt in the world, others, such as Hong Kong (China) and Singapore, rank among the least corrupt. In many East Asian economies, corruption is at about the level that one might expect based on their GDPs per capita. But there are certainly outliers that are significantly more or less corrupt than one might predict based on GDP. This should serve both as a warning to those who are inclined to ignore the issue and as a source of optimism for would-be reformers.

At least until recently, there may have been something approaching an East Asian model of corruption. Countries in the region appear to have been able to achieve higher levels of investment and growth than one might have predicted according to their levels of corruption. Of course, investors may have been prepared to tolerate a certain amount of corruption (bribe payments, uncertainty) given the high rates of return available in rapidly developing economies. Even taking account of such factors, however, the East Asian economies appear to have been able to establish regimes to manage corruption and minimize its impact on investment and growth. The autocratic, centralized mode of governance that has characterized many East Asian countries allowed the persistence of a centralized monopoly over the creation and allocation of economic rents. This was surely damaging to investment and growth. However, it may have allowed for a more orderly, more predictable, and less damaging form of corruption relative to that observed in other developing countries.

Demands for new forms of governance and a reduction in corruption are increasing across East Asia. Economic growth and education are creating an outspoken and articulate urban middle class. Investors and trade partners may no longer be willing or able to absorb the extra costs and uncertainty associated with corruption. The dynamics of growth and integration are clearly driving at least some East Asian countries to new, more democratic, more decentralized modes of governance. The regime for the containment and reduction of corruption will need to evolve in parallel. What was enough before is no longer enough now. Fighting corruption is moving up the agenda, and East Asian governance is moving from the rule of man (*renzhi*) to the rule of law (*fazhi*).

In the longer term, political modernization will probably bring with it improvements in transparency and accountability and reductions in corruption. At the same time, it would be naive to assume that improvement will be continuous and linear. The regimes established to manage corruption under precrisis models of governance have been swept away in a number of East Asian countries, and new institutions to support the rule of law, transparency, and accountability at the central and local levels will need more time to take hold. The result may well be an increase in corruption in the short and medium term. The imperative for institution building has therefore never been greater.

Notes

1. Wedeman (2002) refers to this as "the East Asian paradox" (p. 34).

2. The terms *renzhi* and *fazhi* differentiate political systems and the relationship between the state and its citizens. *Renzhi* (rule of man) vests rights in the larger community or nation defined according

to the ruler's determination of society's greater good. *Fazhi* is a more ambiguous term. It may be translated as "rule by law" or "rule of law." In this chapter, the term is used to denote rule of law: governmental authority is legitimately exercised only in accordance with written, publicly disclosed laws that have been adopted and are enforced through established procedures. Rule by law may be understood to mean that the state uses laws as a tool of social control without reference to the process of the formulation of law and without any implication about citizen rights or legitimacy. Rule *by* law has existed throughout much of East Asia's history. Emphasis on the rule *of* law as a core element of good governance is more recent.

3. As discussed in detail by Bardhan (1997), not all illegal transactions are corrupt, nor are all instances of corruption or bribery illegal. Bardhan proposes wide-ranging examples of actions that are corrupt, but not necessarily illicit or illegal, from tipping the maitre d' to get a better table at a restaurant to cases of gift-giving to politicians by lobbyists, or the assignment of campaign contributions to political action committees for favors, or the provision of postretirement jobs in private firms to bureaucrats of agencies meant to regulate the firms.

4. For example, in Svensson (2005).

5. As Huntington (1968) notes, in the early 19th century, the United Kingdom accepted the sale of peerages, but not of ambassadorships, whereas the United States accepted the sale of ambassadorships, but not of judgeships.

6. See Transparency International (2004: 13).

7. See Transparency International (2004: 13).

8. Both data sets include standard errors for each observation. Adapting a simple rule of thumb used by Kaufmann, Kraay, and Mastruzzi (2005), only half of the East Asian countries in the Kaufmann-Kraay control of corruption index sample and one-third in the Transparency International corruption perceptions index sample may be placed in their relevant tercile with a 95 percent significance level.

9. See http://www.transparency.org/policy_research/surveys_indices/cpi for the 2005 corruption perceptions index, which is described more fully in Lambsdorff (2005).

10. The control of corruption index and other Kaufmann-Kraay indicators are available at http://info.worldbank.org/governance/kkz2004/ and are described more fully in Kaufmann, Kraay, and Mastruzzi (2005).

11. For the Transparency International corruption perceptions index and the Kaufmann-Kraay governance indicators, changes in trends are subject to measurement error, and these may not be trivial. Kaufmann, Kraay, and Mastruzzi (2005) write: "Over the eight-year period from 1996–2004 spanned by our governance indicators, we find that in about 5 to 7 percent of countries we can be confident (at the 90 percent significance level) that governance has changed substantially. And at a lower 75 percent significance level, roughly 20 percent of all observed changes stand out as significant" (p. 41). They show, however, that many data sources agree about the direction of change in a given country.

12. See World Bank (1997).

13. See Wei (1999).

14. Doing Business Database, World Bank and International Finance Corporation, http://www.doingbusiness.org/.

15. Corruption surveys conducted by the Center for Social Development (Phnom Penh), cited in World Bank (2005a).

16. See MacIntyre (2001).

17. Quoted in Mallaby (2004).

18. See Phongpaichit and Piriyarangsan (1994).

19. Corruption surveys conducted by the Center for Social Development (Phnom Penh), cited in World Bank (2005a).

20. For details on the methodology of the freedom in the world index, see Freedom House (2005).

21. See World Bank (2005b) for a detailed review of decentralization in East Asia.

22. Garrathy and Carnes (2000: 472), cited in Chang (2002).

23. The analysis of decentralization and corruption in Indonesia and the Philippines is based on Campos and Hellman (2005).

24. See Azfar et al. (2000).

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