

Governance and Anti-Corruption Reforms in Developing Countries: Policies, Evidence and Ways Forward

Mushtaq Husain Khan

International institutions and in particular the World Bank and the IMF are rightly giving a great deal of attention to issues of governance and institutions in developing countries, and they are particularly concerned with corruption. There is strong evidence that governance and institutions matter in accelerating development and in reducing poverty in developing countries. However, the evidence strongly suggests that there is no common set of institutions that all successful developing countries have shared. More worrying is the observation that governance and institutions in the most successful developing countries have often been starkly at variance with the good governance model that international agencies are committed to. Even the most successful developing countries have suffered from significant corruption and other governance failures during the early stages of their development. However, they did have significant governance capacities that allowed states to ensure that the conditions for rapid growth and sustained political legitimacy of the state were maintained. A sustained pressure to reduce corruption and improve governance is both necessary and desirable but these ends cannot be achieved unless attention is also given to the governance capacities required for accelerating and sustaining growth. The very desirable *goals* of good governance may be neither necessary nor sufficient for accelerating and sustaining development. Nevertheless, some types of anti-corruption and governance reforms are likely to be part of a sustainable development strategy in most countries. The challenge for developing countries trying to devise institutional reform and anti-corruption strategies is to learn the right lessons from the international experience and create feasible governance reform agendas appropriate and feasible for their own circumstances. The current governance and anti-corruption agendas do not achieve this and may even be doing damage by setting unachievable targets for developing countries and diverting attention from critical governance reforms.

Section 1 discusses the analysis behind the new governance and anti-corruption agendas that have been widely adopted by international agencies. This agenda is based on

developments in economics that identify the importance of reducing transaction costs. However, this policy agenda is based on a partial reading of theory and evidence. Section 2 discusses the empirical evidence on which the agenda of good governance and anti-corruption reforms is based. It shows that despite serious weaknesses in this data, in particular its foundation in subjective indices, the data is far less supportive of the dominant policy agenda than appears at first sight. By separating converging and diverging developing countries, we show that the differences in governance and corruption between these groups are negligible. We conclude that while there are significant governance differences between these two sets of developing countries, these are not captured in the conventional governance indicators. A range of case studies have identified some of the critical governance capacity differences between these countries, and policy should focus on adapting these lessons to the initial conditions of reforming countries.

Section 3 discusses the specific analytical arguments behind the anti-corruption policies followed in many developing countries and supported by international agencies. Mainstream anti-corruption policy is based on the assumption that corruption is caused primarily by the greed and discretionary powers of public officials, an analysis that we describe as the ‘greed plus discretion’ theory of corruption. The major policy planks of conventional anti-corruption policy (liberalization, privatization, increasing salaries for public officials, rule of law reforms, greater transparency and democratization), all follow from this. However, here again, econometric and case study evidence suggests that these policies have not achieved very much in reducing corruption.

Section 4 identifies four other types of corruption in developing countries that point to a different set of drivers that are not addressed by conventional anti-corruption policies. The first is the corruption and rent seeking that is associated with necessary state interventions that cannot be addressed through privatization or liberalization. Here the reform priority should be to strengthen state capacities to carry out these functions, and at the same time to legalize and regulate the associated rent seeking.

The second is the important area of political corruption associated with attempts of many developing country states to maintain political stability in a context of severe fiscal scarcity. This driver of corruption cannot be addressed using any of the conventional programmes, and indeed explains why political corruption is ubiquitous in developing countries. The reform priority here should be to identify the organization of patron-client politics in each country and to limit the most damaging effects. The long-term solution is to increase fiscal space to the point where political stabilization can be achieved through transparent fiscal transfers to all deserving constituencies.

The third driver of corruption is the structural weakness of property rights in countries where most assets are still unproductive and cannot pay for their protection. This structural problem is strongly supported by New Institutional Economics but has not found its way into the policy discussions around governance and anti-corruption reforms. We argue that the importance of this driver also explains why weakly protected property rights and the associated corruption appear to be ubiquitous in developing countries, even in high-growth ones. However, high-growth countries have strategies to ensure that critical productive sectors enjoy the stability of expectations that allows high-value investment and growth to continue and this should inform feasible reform efforts in other developing countries.

Finally, predatory corruption and extortion are potentially the most serious problem for some developing countries. While the state collapse that allows predation to become dominant has many causes, its critical characteristic is the collapse of the enforcement capacities of the central state. Here, anti-corruption strategies have to recognize the importance of strengthening the enforcement capacities of states at risk of descending into predation.

Our analysis of the drivers of corruption can help to explain why all developing countries suffer from relatively high levels of corruption in aggregate. But while *all* corruption is damaging to some extent, some types of corruption are much more damaging than others. The evidence strongly supports such an interpretation. While all developing countries

suffer from corruption at early stages of development, high-growth countries suffered less from the most damaging types and they also had governance strategies that allowed them to avoid the most damaging effects of other types of corruption.

Section 5 concludes. The policy implication of our analysis is that the focus on corruption *in general* (and a long list of good governance reforms) in developing countries diverts attention away from feasible policies that can make a difference to economic performance. If there are many different types of corruption in developing countries, and if it not possible to attack all of them simultaneously, it is critical to acquire the governance capabilities to identify and limit the *most damaging* types of corruption. A framework for distinguishing between types of corruption is critical for setting national institutional reform priorities and successful anti-corruption strategies.

All these arguments point to the importance of having institutional reform and anti-corruption strategies tailored to the particular circumstances of countries. Without that, anti-corruption strategies and institutional reform agendas can have a damaging effect by setting developing countries unattainable targets and creating demoralization and reform fatigue.

1. The New Agenda of Good Governance and Anti-Corruption.

Corruption takes place when public officials break the law in pursuit of their private interest. The most odious forms of corruption include bribery and extortion, but it can also include other forms such as the allocation of public resources to favoured clients for political benefit. Clearly, corruption is a cost to developing countries in many different ways, including the subversion of development plans, the diversion of resources that may have been invested productively, as well as disrupting the transparent and normal operation of markets and thereby creating uncertainty for investors. However, in recent years, there has been a much more concerted focus on corruption coming from international agencies based on an integrated analysis of the role of governance in improving the prospects of development in developing countries.

The new analysis of corruption forms part of an integrated analysis of good governance. The core arguments come from New Institutional Economics that has defined efficient markets as markets with low transaction costs. Transaction costs are the costs of conducting transactions, and include in particular the costs of negotiating and enforcing contracts. If these costs are very high, markets are inefficient, and critical transactions like long-term investments are unlikely to happen. It turns out that the good governance conditions that many people in developing countries desire as *goals* of development can theoretically be presented as preconditions or *means* for ensuring development, because they are institutional and political conditions for ensuring low transaction costs in market economies.

<<<Figure 1 here>>>

The economic analysis supporting the good governance reforms promoted by international agencies is summarized in Figure 1. Poor performance in economic development is explained (arrow 1 in Figure 1) by inefficient, high transaction cost markets (North, 1990; North, 1995). The persistence of inefficient markets (arrow 2 in Figure 1) is in turn explained by welfare-reducing interventions of governments, but most importantly, by insecure property rights that are expensive to protect and transact with. The persistence of unstable property rights and welfare-reducing interventions in developing countries is then explained (arrow 3 in Figure 1) by rent seeking and corruption through which small numbers of rent seekers buy themselves the ability to capture property or induce interventions that help them at the expense of broader society (Krueger, 1974; Mauro, 1995; Bardhan, 1997; Mauro, 1997a; Mauro, 1997b; Kauffman et al., 1999). But why are these relatively few beneficiaries of corruption and rent seeking able to continue their activities even though the vast majority of society suffers? The answer (arrow 4 in Figure 1) is that the majority is poorly organized and there is an absence or weakness of democratic accountability that allows the minority to effectively exploit the majority (Clague et al., 1997; Olson, 2000). Poverty and underdevelopment in turn limit the organizational capacity of the majority (arrow 5 in Figure 1), thereby locking the system into sustained poverty and underdevelopment.

It is from this theoretical perspective that the good governance analysis proposes a set of parallel policy priorities that have to be simultaneously followed to break out of the poverty trap described in Figure 1. These interrelated set of policies combine economic reform with institutional and political reform and have come to be known as the *good governance* reform agenda. Some of the critical components of this package are summarized in Table 1. Its novel feature is that it explicitly goes beyond the traditional focus of economic reform on market competitiveness to include a wide range of political and institutional reforms. Thus, instead of simply focusing on arrow 1 in Figure 1, that is on economic reforms such as liberalization, the good governance agenda in Table 1 argues that it is necessary to simultaneously address institutional reforms that improve the stability of property rights and the rule of law (arrow 2 in Figure 1), anti-corruption reforms and attacks on rent seeking more widely (arrow 3) and reforms that seek to improve the accountability of governments (arrow 4). Clearly, anti-corruption reforms play a significant role in the new reform agenda, and this is why anti-corruption reforms have an importance well beyond the importance of corruption seen as a problem in isolation.

2. The Empirical Evidence.

The empirical evidence shows that while there is *at best* a weak relationship between the governance conditions identified in the good governance agenda and improved economic growth; there are other more important governance conditions necessary for accelerating and sustaining economic growth that are not identified at all in the good governance approach. The identification of the most important conditions for accelerating and sustaining economic development is clearly of paramount importance for developing countries. While the good governance conditions are for the most part desirable on their own terms, the empirical question is whether the good governance agenda identifies the necessary conditions and critical priorities for reform. Our examination of the empirical evidence suggests that it does not. Later we will argue that the good governance conditions and in particular a drastic reduction of corruption may not even be achievable in most developing countries, regardless of their potential benefit.

An immediate problem for any comparative empirical work is that governance quality and particularly corruption cannot be directly measured and so proxy indicators have to be constructed using subjective judgements and opinions. These indices have well-known problems of bias and subjectivity. In particular, small differences in scores of countries, either over time or compared to other similar countries are not trustworthy (Khan, 2006a; Søreide, 2006). Nevertheless, even if we use these indicators (which are widely used in policy advocacy) a careful examination reveals that some of the strong results in support of the good governance agenda derived using these indicators cannot be justified. This is a particularly important conclusion given the large number of econometric studies that appear to show some relationship between governance indicators including corruption, the rule of law, and other good governance characteristics and economic performance (Knack and Keefer, 1995; Mauro, 1995; Knack and Keefer, 1997; Mauro, 1997a; Johnson et al., 1998; Hall and Jones, 1999; Kauffman et al., 1999).

These relationships are strongest for relationships between governance quality and per capita income, in effect showing that richer countries have better governance, lower corruption and so on. But the direction of causality is difficult to establish in such studies because it could be that higher per capita incomes and levels of development in general allowed the emergence of better governance conditions. For corruption and other governance indicators to be accepted as policy targets, we need to establish a relationship between these governance indicators and *economic growth rates*. To begin with, the relationship with growth rates is much weaker, and often disappears with the inclusion of other variables such as the investment rate (Mo, 2001). But this is not the only problem.

While there is no reason to deny that if sustainable improvements in corruption and other governance variables could be achieved, overall economic performance, even in terms of growth rates would improve to some extent, the evidence in support of this is very weak and calls for much greater caution in the design of reform priorities. The main problem in empirical studies is that we have to be careful to compare like with like, and it is very difficult to identify two countries that are different only in terms of a governance

indicator. In particular, countries are at different levels of development, and to make sense of their growth performance, we need to at least split the countries into an advanced (high income) country group and the rest, which we can loosely describe as the developing country group including transition economies.

Most of the relationships between good governance characteristics and economic performance appear to emerge when we pool all countries together. But more interesting insights emerge when we split countries into advanced and others, and then split the latter group into a group of converging and a group of diverging countries. Converging countries are developing countries that are converging to advanced country living standards as a result of achieving growth rates higher than the advanced country average. Diverging countries are those that are falling further behind as a result of growth rates that are lower than the advanced country average. Grouping countries in this way reveals some striking features in the data that casts doubt on some of the core aspects of the conventional wisdom. We conclude that while there are very likely to be important governance differences between converging and diverging developing countries, these differences are not captured in the indices of good governance on which conventional policy focuses.

Our figures 2 to 5 and the accompanying tables 2 to 5 use governance and corruption indices from the IRIS centre at the University of Maryland, compiled by Knack and his colleagues (IRIS-3, 2000). While all indices of governance suffer from significant problems of subjectivity, these indices are widely used and suffice to demonstrate the main features of the problem. (Similar results are obtained if we use the World Bank's indices compiled by Kaufmann et al. (2005) except that the latter indices are only available from 1996). The IRIS governance index is available from 1984 and is an amalgam of five separate indices for 'corruption in government', 'rule of law', 'bureaucratic quality', 'repudiation of government contracts', and 'expropriation risk'. It ranges from 0 (the poorest score) to 50 (the highest score). We also use the corruption index separately, which ranges from 0 (the poorest score) to 6 (the highest score).

Looking at the two decades of the 1980s and 1990s, we plot the governance indicator for the beginning of a period against the per capita growth rate achieved in that country in the subsequent decade. As the earliest governance indices are only available from 1984, the exercise for the 1980s is less accurate than for the 1990s. This is because we expect higher per capita incomes to lead to better governance over time, and if a country has been growing rapidly for a while, its higher per capita incomes will dispose it to better governance characteristics even if these did not exist at the beginning of the period. Thus, if our governance data comes for a year in the middle or towards the end of the growth period, we could wrongly conclude in some cases that better governance had caused growth even though the causality was in the opposite direction.

As we would expect, our data plots show that advanced countries score better on all governance indicators compared to developing countries, but to a large extent this could be because there is a reverse causality operating from higher levels of per capita incomes to better scores on these specific governance indicators. The really interesting observations are for comparisons of converging (high growth) and diverging (low growth) developing countries. The data show that the difference in governance indicators for these two groups is negligible both in terms of general governance as well as for each specific governance indicator. Of the different components of the overall governance indicator, we have also shown the results for the corruption indicator.

<<<Figure 2 and Table 2 here>>>

Figure 2 and table 2 show that for the 1980s, the pooled data for all countries shows a weak positive relationship between good governance quality and economic growth. However, a closer look shows that the overall governance indicator was only very marginally better for converging developing countries compared to diverging developing countries. More important, both were significantly worse than advanced countries. The very small difference between converging and diverging developing countries is particularly noteworthy given that the governance indicator for the 1980s is only available for 1984, almost halfway through the decade. But in any case, the very large

difference in growth rates between converging and diverging developing countries is associated with a very small difference in governance quality.

<<<Figure 3 and Table 3 here>>>

The comparison between converging and diverging developing countries becomes even starker when we look at the data for the 1990s in figure 3 and table 3. Once again, there is no significant difference between converging and diverging developing countries, but during this decade, the median converging developing country had a marginally *poorer* governance index compared to the median diverging developing country. We should not read too much into this reversal except to say that this confirms even more definitively that the two sets of developing countries did not differ significantly in terms of their performance in terms of good governance.

<<<Figure 4 and Table 4 here>>>

These results just reported for the overall governance indicator are replicated when we look at indices for each of the component governance characteristics out of which the overall governance indicator is constructed. The corruption index is one of the key constituent indices of most governance indicators, and we now turn to data on the corruption index on its own. In the 1980s, converging developing countries scored slightly better on the 1984 corruption index compared to diverging developing countries, but both scored significantly worse than advanced countries (figure 4 and table 4). This simply replicates the result for the overall governance indicator.

<<<Figure 5 and Table 5 here>>>

However, just as with the overall governance indicator, in the 1990s (figure 5 and table 5) the slight difference between converging and diverging developing countries disappears completely. The median corruption index in converging and diverging developing countries was exactly the same in the 1990s, though both scored significantly worse on

corruption compared to advanced countries. The weak positive relationship between the corruption and other governance indicators and economic growth in the pooled data is therefore misleading. A similar analysis for other governance indicators is available in (Khan, 2006c).

This does not mean that there are no significant governance differences between converging and diverging developing countries. However, it does mean that the important differences in their governance characteristics are not identified by the good governance analytical framework.

<<<Figure 6 here>>>

This proposition is summarized in figure 6. Converging and diverging developing countries (groups 1 and 2 in figure 6) do not differ significantly if at all in terms of their average governance characteristics, but they differ very significantly in terms of their economic growth performance. The lack of any significant difference between groups 1 and 2 is even more remarkable if we remember that countries in group 2 are considerably richer than those in group 1 because they have typically been growing for some time.

The challenge for diverging developing countries is how to improve their growth performance, and for converging countries, to sustain and improve on what they have already achieved. The good governance agenda suggests that diverging countries (group 1) could aspire to become group 3 countries by implementing good governance reforms and moving rightwards and upwards in the diagram. However, this assertion is based on the type of theory and evidence discussed above, and not on any historical observation of any developing country that *first* improved the governance characteristics described as good governance and *then* increased its growth rate even to advanced country levels.

Rather, the historical evidence tells us very strongly that the challenge for diverging countries is to discover the policy and governance changes that allowed countries to graduate from group 1 to group 2 and stay there for several decades. Even for group 2

countries, the challenge is often to understand better what they themselves have achieved often through serendipity or good luck so that the good performance can be sustained over time. It is undoubtedly true that once growth has set in, it is desirable to carry out second phase good governance reforms that allow the country to graduate from group 2 to group 3. This transition is by no means automatic and it may even be that some of these reforms are necessary to sustain growth in countries that are becoming mature. However, there is little evidence that these second stage reforms are fully implementable in poor countries, and no evidence that these reforms are preconditions for growth in poorly performing countries.

The governance capacities that have sparked off and sustained growth in group 2 have been the subject of extensive research by development economists specializing in this field. This research has identified a number of specific governance capacities that distinguish converging developing countries. These include capacities for protecting the assets and resources of critical productive sectors, directing assets and resources to these sectors, assisting these sectors to acquire more advanced technologies, regulating and disciplining the market so that there are credible compulsions for productivity growth in productive sectors, and maintaining adequate social stability and legitimacy through redistributive strategies. Some of this literature is reviewed in Khan (2004).

The problem is that there was no single set of institutions that achieved these ends (and that too to varying degrees) in different countries. The government-business partnership that achieved (some or all) of these goals in South Korea in the sixties was very different from the strategy followed by Malaysia in the 1970s, and very different again from that in China's export-oriented industries or in India's software sector. These differences in the international arrangements that sustained growth can be traced to differences in initial institutional, political and economic conditions, since new institutions do not just have to address critical economic requirements; they also have to be implementable given the political settlement and the already existing institutional capacities of the state (Amsden, 1989; Wade, 1990; Khan, 2000a; Khan and Jomo, 2000; Rodrik et al., 2002; Rodrik, 2003; Khan, 2004; Rodrik and Subramanian, 2004).

In its much earlier study of the role of governance in East Asian development, the World Bank (1993) recognized the critical role of the state in the rapid developers in assisting technology acquisition and upgrading, but concluded that because these governance capacities were missing in other developing countries, it would be very risky for the average developing country to follow these strategies. In one sense this conclusion was correct because without appropriate governance capacities, the attempt by states to accelerate and sustain development would only result in mistakes with the added costs of rent seeking. However, this conclusion was actually very misleading because it implicitly asserted without any evidence that there was another route from group 1 to group 3 in figure 6 that was based on states acquiring good governance capacities. Our argument is that there is no historical evidence for this.

In effect, the World Bank was asking countries with very poor governance capacities to achieve new governance capacities (good governance) that *no poor country* had historically achieved and claiming that these governance capacities would then ensure faster growth, for which again there was no convincing historical evidence. A more reasonable response to the evidence would have been to argue that the best option for developing countries without group 2 governance capacities would be to try and acquire at least *some* of the governance capacities of the rapid developers that would have allowed them to achieve faster rates of social transformation than they were achieving.

Since the publication of the World Bank's East Asian study (World Bank, 1993), a wealth of new case studies and evidence has become available which suggest that this is a critical policy and research agenda. But the objectives of this policy and research agenda will not be a simple blueprint for all countries to follow. Rather, it has to focus on identifying feasible governance reforms tailored for each country that seeks to achieve improvements in performance by finding local solutions to some of the problems addressed in more ambitious ways in the high-growth developers. Examples of these studies include Rodrik (2003) and Khan and Jomo (2000), and some of the critical governance capacities in high-growth developers are summarized in Khan (2004).

These studies do *not* suggest that all developing countries can or should emulate South Korea, China or India. Rather, they advocate a much more nuanced approach that involves looking at the *functions* that the state performed in the better performers, the *governance capacities* that were required and the *institutions* that achieved this in each specific context. To achieve similar functions, even at lower levels of effectiveness, other countries need to ask what types of governance capacities and institutions they could feasibly try to achieve to meet some of the economic requirements for accelerating the structural transformation of their economies into higher growth and higher income economies.

3. Conventional Anti-Corruption Policies: The ‘*Greed plus Discretion*’ Analysis

Having identified corruption and governance as preconditions for rapid development, the mainstream approaches to reform carry out a further simplification that has important policy consequences. They argue that corruption is largely caused by the greed of public officials who have the discretion to offer citizens benefits or cause damage to their activities but who are inadequately monitored or face inadequate punishments for violating laws. If bureaucrats or politicians have the power to offer selective benefits or cause selective damage, and if their risk of detection or risk of punishment is low, they are likely to engage in corruption to enrich themselves.

There is a large academic and policy literature that develops aspects of this analysis of the causes of corruption (Rose-Ackerman, 1978; Klitgaard, 1988; Andvig and Moene, 1990; Shleifer and Vishny, 1993; Mauro, 1995; Bardhan, 1997; Leite and Weidmann, 1999). Although there are differences in detail in the analysis of corruption provided in these and similar contributions, the similarities between them on the core drivers allow us to collectively describe it as the *greed plus discretion theory* of corruption.

The standard policy response to corruption is entirely based on attacking the drivers of corruption identified in greed plus discretion theories. The well-known collection of measures to attack corruption derived from this analysis include

- i) reducing the discretion of public officials through liberalization and privatization,
- ii) improving salaries of public officials, thereby addressing their low living standards in many cases, but also increasing the opportunity cost of corruption since they stand to lose their positions if detected,
- iii) improving the rule of law so that corrupt bureaucrats and politicians can be prosecuted and punished, and
- iv) encouraging greater transparency of government decision-making through deepening democratization, decentralization and the creation and encouragement of civil society watchdogs.

If corruption in developing countries was indeed entirely or even largely driven by the factors identified in the greed plus discretion theory of corruption, the adoption of these anti-corruption measures in a wide range of developing countries would by now have produced significant reductions in corruption in the countries adopting them. Unfortunately, we know from detailed econometric and country case studies that many of the core policy tools identified in the greed plus discretion theories have limited if any effect on corruption.

i) For instance, we have a wide range of case studies from the Indian subcontinent and Eastern Europe that show that policies of reducing state discretion through liberalization and privatization have done little to reduce corruption in developing and transition countries. Indeed, liberalization and privatization have been accompanied by dramatic increases in corruption in most cases (Harriss-White and White, 1996).

ii) Higher salaries and rewards for public officials are unlikely to work even in theory unless they are backed up with a credible probability of officials losing their positions if caught engaging in corruption (Besley and McLaren, 1993). Since achieving the latter requires very deep changes in political and legal structures, it is not surprising that cross-national empirical evidence shows that there is little if any relationship between pay increases for public officials and reductions in corruption (Rauch and Evans, 2000; Treisman, 2000).

iii) While there have been many programmes to improve the rule of law in developing countries, there is little evidence that these have had any effect, and the empirical evidence raises serious questions about the degree to which promoting the rule of law in developing countries has assisted in the reduction of corruption or the achievement of any other development objective (Carothers, 2003).

iv) Strategies of improving transparency and setting up new bodies such as ombudsmen and commissions are the easiest for external agencies to support, so not surprisingly this is an area in which a lot of international policy support has focused. But in a review for the Operations Evaluation Department of the World Bank, Huther and Shah (2000) agree that many strategies such as introducing ombudsmen and raising public awareness of corruption are unlikely to have any effect on countries where governance is poorest. Yet they still argue that reducing the size of the state, increasing citizen participation and (somehow) improving the rule of law are still the best strategies in countries with the worst governance record.

On the link between democratization and corruption, Treisman (2000) in his major cross-country regression analysis finds no evidence that corruption is lower in democracies. Democracy did have a small effect on corruption *after many decades* but these long term effects could have other explanations because only successful economic developers are usually able to sustain long-lasting democracies.

On decentralization, cross-country regression analysis that includes both advanced and developing countries (such as Gurgur and Shah 2000) report that decentralization has a significant effect in reducing corruption. But this study, for instance, also points out that when the regressions are carried out for developing countries alone there is no relationship between decentralization and corruption-reduction. The latter result is more significant because including both advanced and developing countries in the same regressions have problems which we have touched on earlier.

These and other studies that have looked at the empirical evidence on each of the links crucial for the *greed plus discretion* theory of corruption warn us that the policy focus of conventional anti-corruption strategies is unlikely to achieve sustained reductions in corruption, even if the reduction of corruption were indeed a critical precondition for development. The empirical evidence should have alerted policy-makers that there are likely to be other structural drivers of corruption that are not linked to the greed and discretion of public officials (though that may also be one of a number of drivers of corruption).

4. Structural Drivers of Corruption in Developing Countries.

The ‘greed plus discretion’ theory of corruption ignores a number of structural problems that developing countries face that in turn induce high levels of corruption of different types. Understanding these structural drivers of corruption can allow us to adopt more reasonable positions on anti-corruption policies in developing countries, as well as allowing us to design anti-corruption policies to target the most damaging types of corruption. These critical structural drivers of corruption include the following:

a) Corruption associated with necessary state interventions. A very serious problem with the conventional anti-corruption agenda is that it presumes that any discretionary intervention on the part of public institutions is damaging because such powers are not only unnecessary for accelerating development, they create in addition, opportunities for extortion by public officials. But this assumption is wrong. Accelerating economic development requires the management of a number of critical interventions, for instance, to assist domestic producers to catch up by learning to use new technologies (Khan, 2000b). The evidence of such interventions from all the successful Asian developing countries is overwhelming. These interventions are in addition to the interventions that states need to make on a flexible basis to sustain welfare. Many of these interventions are useful and states have to acquire the capacity to identify, sustain and manage these interventions. Whenever states have essential functions that are both socially beneficial and also benefit particular constituencies, there will necessarily be some rent seeking that needs to be managed to

ensure that socially desirable outcomes can continue to be achieved (Khan, 2000a; Khan, 2004).

While liberalization is not a solution here, some of the anti-corruption strategies advocated in the conventional anti-corruption programme may help if they could be feasibly implemented. For instance, improving the rule of law or increasing the opportunity cost for bureaucrats by paying them higher salaries may help in reducing corruption in areas where the state has critical functions to perform. However, we have seen the evidence that shows that these strategies either do not work or take a long time to implement. To improve the effectiveness of states in critical intervention areas, alternative strategies of dealing with damaging rent seeking have to be followed.

Paradoxically, the answer may lie in the ways in which advanced countries have dealt with rent seeking. States in advanced countries play important roles in managing their economies, and inevitably this creates incentives for extensive rent seeking. But much of the rent seeking in advanced countries is legalized because the underlying interventions and rents are themselves legal. This allows the rent seeking to be legally regulated (for instance by allowing industry groups to lobby to promote their interests within prescribed limits) whereas the rent seeking in developing countries often takes illegal forms that are by definition corruption. This is because the emerging modern sectors in developing countries are new and interventions to assist them are often informal and lack wide political support, though this is not the case in all developing countries, particularly the more advanced ones.

A critical distinction here has to be made between the intended outcome of an intervention and the cost of the rent seeking it induces. If the rent seeking does not seriously affect the outcome of the intervention, the resources used up in the rent seeking are a social cost, but the net effect of the intervention can still be very positive (Khan, 2000a). Both the capacity of the state to ensure the effective implementation of the intervention and the institutions that can limit the rent seeking cost are important, but the former are most important, because there is no point in these critical areas to limit the rent seeking cost but fail to achieve the most of the intended outcomes of intervention. Thus, the priority for developing countries

must be to strengthen the capacity of the state to assist growth in critical areas such as technology acquisition or the provision of critical infrastructure for productive sectors. Nevertheless, all developing countries can significantly reduce corruption by identifying these critical state interventions, legalizing these interventions where they are not already properly regulated, and this will allow the legalization and regulation of the associated rent seeking as well. At the same time, policy has to strengthen state capacities and regulatory mechanisms to manage and regulate both the intervention and the associated rent seeking.

If we look at the successful high-growth developers, while all of them continued to suffer from some corruption even in critical areas, their institutional capacity in these sectors ensured that corruption did not compromise critical state functions even if they resulted in some rent seeking or even corruption. Strengthening these capacities should therefore be a critical focus of anti-corruption strategies but it gets very little attention in the reform agenda presented to developing countries.

b) Fiscal Constraints and the Structural Drivers of Political Corruption. The other drivers of corruption in developing countries are even more difficult to deal with, but states need to devise strategies over the medium term to avert the most damaging effects of these types of corruption. One of the fundamental problems faced by states in developing countries is to maintain political stability in a context of severely limited fiscal resources. Maintaining political stability in any country requires, amongst other things, the availability of sufficient fiscal resources for redistribution to constituencies that have political power or social legitimacy but have lost out (even if only in their own perception) in the allocation of income and resources through economic processes. Advanced countries tax between 35 to 50 per cent of their GDP, and a significant part of this is redistributed to different constituencies to maintain social cohesion and political stability. In contrast, the lower share of the modern sector in the economies of developing countries, together with institutional weaknesses means that they can typically tax only around 10 to 25 per cent of their GDP, and their GDP is of course, much smaller to begin with. In most developing countries, after the salaries of public servants have been paid, there is not much left even for delivering essential services or constructing critical infrastructure. In many developing countries, core

developmental spending is financed by domestic borrowing and external flows, leaving very little fiscal space for political stabilization through transparent official redistributions through the budget though some budgetary redistribution does of course take place.

Nevertheless, developing countries do have powerful constituencies demanding redistribution and political stability has to be maintained. The limited redistribution possible through the budget typically does not achieve this goal. This structural problem explains the importance of patron-client networks in every developing country. Off-budget transfers through patron-client networks to powerful constituents are a remarkably common mechanism for maintaining political stability across developing countries (Khan, 2005b; Khan, 2006b). This is unfortunately an inherently corrupt process because political power is used to benefit particular clients, and by extension, benefit their political patrons who stay in power through these mechanisms. While political scientists and sociologists have pointed out the myriad different social cleavages around which patron-client factions are formed in developing countries, the ubiquity of patron-client factions across *all* developing countries regardless of their cultural histories, economic strategies and even their political institutions demands a more comprehensive explanation.

The common economic problem that developing countries face in maintaining political stability in a context of fiscal scarcity provides an important part of such an explanation. If resources have to be provided to specific and critical constituencies that cannot be provided to all deserving groups because of fiscal scarcity, then these transfers have to be arranged less than transparently through patron-client networks. If in addition these resources are not available in the budget, governments have to raise the requisite off-budget resources through processes that are likely to involve corruption or the toleration of corruption on the part of critical constituents. Thus, both the raising of resources for political stabilization and the allocation of at least some of these resources to critical constituents is likely to involve political corruption.

<<<Figure 7 here>>>

While these processes are not desirable and all developing countries aspire to progress to a stage where they can be dispensed with, the fact is that the drivers of these types of corruption have nothing very much to do with the greed or discretion of public officials even though greed and discretion may allow some types of corruption to be deployed in these contexts, and also allow public officials to benefit greatly from these systemic drivers. Rather, as summarized in figure 7, the main driver of this type of corruption is the fiscal constraint and the need for political stabilization, and till the fiscal constraint can be overcome, the chances of making serious dents on this type of corruption are likely to remain rather limited.

However, while patron-client politics and the associated political corruption are common to all developing countries, the outcomes of these processes for economic development are quite different. Thus, as figure 7 shows, patron-client politics can sometimes achieve political stability and thereby allow growth, but at other times it can also fail. The difference between success and failure is not the absence of political corruption in some developing countries, but more subtle differences in the organization of patron-client politics and the management of factional demands (for a more extensive analysis see Khan, 1998; Khan, 2000a; Khan, 2006b).

Our analysis of the drivers of political corruption is consistent with the persistent evidence of political corruption in all developing countries. It is also consistent with the persistent failure of reforming anti-corruption governments in developing countries. Even when elected on massive popular mandates and even when they have just replaced very corrupt governments, reforming governments appear to succumb to corruption with depressing regularity within relatively short periods of time. This evidence suggests that strong structural drivers are at work and that these are powerful enough to eventually overcome the intentions of even committed and honest individuals at the highest levels of government. These experiences should tell us that transparency and accountability reforms on their own are not likely to resolve this problem given the financial constraints of achieving political stability through transparent fiscal transfers. We also have many case studies of corrupt politicians beating honest ones in elections even when their corruption is well-known and

there is no issue of transparency. The conventional analysis ignores the fact that corrupt politicians can win because they are often the only ones who can deliver, even if delivery in this case means delivery to selective but critical constituencies.

This argument does not mean that political corruption is acceptable simply because it is very difficult to fight it. Nevertheless, it does mean that the fight against political corruption should be structured in such a way that it is not doomed to fail, and that achievable results are attained while keeping an eye on the long-term goal. There may be important governance reforms that are needed to ensure that political stability is maintained and the most damaging aspects of political corruption that seriously threaten human and social development, or threaten to destabilize and delegitimize the state are addressed. The identification of governance reforms that are appropriate for addressing these problems has to be a country-specific process, and is not likely to be helped by broad anti-corruption strategies that cannot be implemented to any significant extent.

The differences between developing countries in how they operate their patron-client politics lie in subtle differences in the organization of political parties, factions and patron-client groups. Historical evidence of path changes in economic performance (for instance in South Korea in the early 1960s or in Malaysia in the early 1970s) correlate very well with changes in internal political organization in these countries that allowed political stability to be achieved even if patron-client politics did not immediately disappear altogether (Khan, 2000a). The conventional governance agenda does not provide any entry points for developing and transition countries to identify their governance weaknesses in this area or to assist them in constructing viable governance reform packages that can address some of the more damaging aspects of political corruption.

c) Weak property rights and the prevalence of non-market asset transfers. A related structural problem in many developing countries is that property rights are contested and weakly protected because of the limited public resources available for adequately defining and protecting property rights. In much of the conventional analysis of governance and corruption in developing countries, it is implicitly assumed that the protection of property

rights can be dramatically improved through governance reforms and by reducing corruption. This analysis ignores the economic fact that constructing a nation-wide system of stable property rights is an extremely costly enterprise and advanced countries only achieved significant stability in their property rights at a relatively late stage of their development when most assets had achieved high levels of productivity (Khan, 2002; Khan, 2004; Khan, 2006b).

One of the significant conclusions of the New Institutional Economics introduced by Douglass North and others was to point out that the protection and exchange of property rights was an extremely costly business. These costs were described as transaction costs, and New Institutional Economics pointed out that in advanced economies, transaction costs may account for as much as half of all economic activity (North and Wallis, 1987; North, 1990). An efficient economy has slightly lower transaction costs than others, but it never has zero transaction costs or anything appropriating that. In addition, in an efficient market economy like the US, transaction costs may be low for individual transactors at the point of exchange (this is the definition of an efficient market) but collective transaction costs for the economy as a whole are not low at all. These collective transaction costs can be paid for because almost all assets in an advanced country are very productive (by definition) and so their owners can pay the taxes and incur the private expenditures on legal and security systems that ensure that at the point of exchange, transaction costs are low. In a developing country, most assets are of low productivity and cannot pay the cost of their own protection. It is not surprising that *every* developing country suffers from contested and weak property rights.

<<<Figure 8 here>>>

Figure 8 shows the drivers of this instability in graphical form. When most of the assets in a country have not yet achieved high productivity uses (which is by definition the case in a developing or transition economy), it is difficult to imagine how the protection of property rights *across the board* can be paid for. Developing countries have to live with a much higher degree of property right instability compared to advanced countries, but this is not

entirely or even largely due to the greed and discretion of their public officials. When property rights are not secure to any satisfactory extent, and transaction costs at the point of exchange are high, inevitably many transactions will be too expensive to conduct through the market. This is why non-market transfers are ubiquitous and much more significant in developing compared to advanced countries.

Non-market transfers include not just the high profile cases of appropriation and theft using political power, but also cases of legal but non-market transfers through land reform, state allocation of land for development, and a much more extensive use of the right of *eminent domain* in allocating public resources. These processes are structurally necessary in developing countries but do open up the possibility of abuse and corruption. But as with patron-client politics and political corruption, they are not likely to be stopped by simply addressing the greed and discretion of public officials as there are deeper structural factors driving these processes. And as with patron-client politics, the outcomes of these non-market asset transfers can result in a successful transition to a modern capitalist economy or to predation and loss of resources to overseas tax havens. The difference between these two outcomes is *not* that in one case there was good governance and in the other there was not. Rather, the difference is again a much more subtle set of institutional and political factors that create incentives and compulsions for public and private actors benefiting from non-market transfers to ensure investment in productive enterprises.

The case study evidence strongly supports our analysis. Whether we look at China at one end of the growth spectrum or at many other developing countries in Asia and Africa whose growth rates put them at the other end of the spectrum, they all share a high degree of contestability of property rights in their economies as a whole though with very different economic outcomes. The differences between them are subtle in that in countries like China, investors in productive sectors enjoy considerable stability in their expectations of protection of future profits (provided they continue to remain profitable). However, if we look at property rights across the board, the majority of asset owners even in China are likely to face contestable property rights exactly as our analysis suggests. In contrast, in

poorly performing countries the problem is that productive entrepreneurs often face great uncertainty about their expectations and as a result investments are low (Khan, 2004).

Once again, this analysis should not give us cause for complacency about the importance of governance. Rather it should direct our attention to a more critical set of governance reforms that are able to create stable expectations for critical sectors to enable accelerated investment and growth. In contrast, trying to implement reforms that attempt to achieve property right stability across the board in poor countries that lack the economic resources to make it feasible is likely only to result in frustration and eventually the abandonment of the reform programme.

d) Predation and expropriation. The most damaging type of corruption in most developing countries is predatory corruption by the state where public officials use their political or military power to expropriate from citizens. The patron-client politics of developing countries and non-market asset transfers have characteristics of predation even in the best of cases and are always at risk of descending into a degree of predation and extortion that obstructs investment and development. The dividing line between patterns of patron-client politics that allow political stability to be maintained and the point at which these processes become so damaging to development that they are judged to be primarily predatory is clearly a very grey one. Similarly, non-market transfers of assets often have an element of predation and extortion for those who fail to get what they would consider to be fair value for their assets or are denied access to bid for assets that others are getting access to.

<<<Figure 9 here>>>

The critical difference between cases of patron-client politics and non-market transfers that accompany rapid processes of social transformation on the one hand and predatory corruption may appear to be a subtle one. However, a common feature of the latter countries is the institutional and political fragmentation of the state, which has proceeded to an extent that the state is unable to prevent lower level functionaries acting to enrich themselves even

when this damages the stability, income and survival prospects of the state itself (Shleifer and Vishny, 1993; Khan, 1996). When the state is cohesive and its different agencies can be coordinated institutionally and politically, it is unlikely that ‘normal’ patron-client politics or non-market transfers will descend into outright predation. This is simply because higher agents of the state will in their self-interest restrain lower level officials or particular agencies whose appropriation threatens the interests of those higher up. Nor are the central agencies likely to engage in all-out expropriation if their time horizon is longer than the very short ones that are characteristic of leaders in collapsing states. The critical role of state cohesiveness in explaining the difference between straightforward predatory outcomes is summarized in figure 9.

To the extent that state cohesiveness is a critical factor explaining predatory outcomes, the mainstream anti-corruption programme may be seriously missing the critical problems in some of the most poorly-performing developing countries. In these countries, transparency, salary increases or anti-corruption watchdogs and aid penalties are unlikely to have any significant effect at all. The appropriate policy focus in these vulnerable states should be to strengthen the state’s capacity to behave in a cohesive and effective way. In other words, the agenda in these countries should focus on constructing a Hobbesian state in a context where the state is falling apart rather than to focus on Adam Smithian reforms of limiting the freedom of the state (Khan, 2005a). The latter agenda is very strongly based on the greed plus discretion explanation for the myriad problems besetting poorly performing developing countries.

Our argument is that the descent into predation in some of the weakest developing countries is not primarily caused by the greed and discretion of their public officials but rather by the inability of their public officials to impose and enforce social order. In these countries, reforms based on a partial and limited analysis of the drivers of corruption can end up further weakening already weak states by further limiting state capacity to act in decisive ways. This analysis does not reject the argument that state legitimacy is very important and a state that is acting in arbitrary ways is unlikely to be able to impose social order. But the focus of reform and in particular of anti-corruption reform should carefully identify the

major drivers of the problem and take adequate steps to address the most important problems.

Our discussion of the different drivers of corruption in this section can help to explain the apparent paradox that *all* developing countries appear to have high levels of corruption and they all fail in terms of good governance at early stages of their development. We can explain these observations by recognizing that many of the drivers of corruption and poor governance (such as weak property rights) are structural and therefore not entirely avoidable in any developing country. Nevertheless, the high-growth countries obviously possessed governance capacities that allowed them to avoid the most damaging aspects of these structural drivers.

Policy Implications. Our analysis suggests that policy based on the greed plus discretion analysis of corruption is only relevant where the drivers are indeed primarily the ones identified in these theories. Thus, in cases of unnecessary red tape and other useless interventions by the state, where the purpose of the intervention is only to create opportunities for public officials to extract from society, the conventional policy agenda of liberalization, salary increases, rule of law and transparency would be very relevant. However, given the other drivers of corruption, it is unlikely that these reforms could be implemented to an extent that any observable decline in corruption would follow. This is in fact what we observe when these programmes are implemented. However, there is no reason why unnecessary red tape and other damaging interventions should not continue to be targeted and removed in developing countries.

In terms of necessary state interventions, the reform agenda should be quite different. The historical observation is that successful states suffered from some corruption in these areas, but they had strong state capacities that ensured that the desired outcomes were achieved and the cost of corruption was not big enough to wipe out the net benefit. In contrast, less successful states could not perform necessary functions effectively and the corruption in these areas was therefore extremely damaging because they added a rent seeking cost to an

already poor outcome. We have argued that the reform agenda in this area should be to strengthen state capacities and legalize and regulate the associated rent seeking.

In the area of political corruption, all developing countries have to endure levels of corruption that are not desirable in the long run and they have to take active steps to limit this over time by increasing fiscal redistributions to maintain political stability in a transparent way. However, in the meantime, the reform priority has to be to limit the damage done by political stabilization through patron-client networks. In some countries this may mean restructuring these political arrangements though this is obviously a discussion that developing countries have to have internally.

The instability of property rights and the associated corruption is also a problem affecting every developing country but high-growth ones clearly had the institutional capacities to ensure stable expectations in critical growth areas. The reform priority for other countries must be to learn from these experiences to develop the necessary governance capacities even though acceptable levels of property right stability across the board may not be achievable for many years.

Finally, predation is the most important risk for developing countries. All successful countries were able to avoid predation and extortion to any significant extent because they had strong states that could limit the degree to which lower officials or private looters in association with local officials could operate to the detriment of the state. There are no examples of rapid and sustained development with states that lacked the ability to impose social order, but there are many examples of rapid growth in states that suffer from some corruption. The critical reform message here is (paradoxically) to strengthen state enforcement capacities in states that are threatened with predatory state behaviour rather than to dismantle states that are obviously not working.

5. Conclusions

The governance and anti-corruption agenda that is increasingly championed by international agencies like the World Bank identifies critical goals that all developing countries aspire to.

There is no question about the desirability of good governance. The questions raised in this paper are really about

- i) the extent to which these are not just *goals* of development but also necessary governance *preconditions* for development
- ii) whether they can actually be achieved in developing countries and
- iii) whether a focus on these governance issues is taking our eye off more important and achievable reforms that will enable the goals of good governance to be achieved faster.

Our analysis seriously questions whether the governance agenda can be interpreted as a precondition for development rather than being a list of important and desirable objectives. We also argue that there are strong structural drivers of corruption and weak property rights that mean that these goals are unlikely to be achieved to any significant extent in any developing country, regardless of economic performance. There is a real danger that these structural drivers are not being properly understood. The desire to link lending and partnership with developing countries on the basis of small differences in governance and corruption indicators is seriously misguided according to our analysis. Apart from the subjectivity of these indicators and the possibility of manipulation, our argument is that small differences in these indicators tell us nothing at all about development prospects of developing countries.

Instead, we argue that we need to identify critical governance capacities on a country-by-country basis to accelerate economic and social transformations in developing countries. We also need a framework for distinguishing between types of corruption so that we can set realistic and feasible national institutional reform priorities and anti-corruption strategies. And finally we argue that by focusing on a long list of unachievable goals as immediate reform priorities, we are losing the opportunity to carry out critical reforms that enhance the chances of developing countries moving from diverging to converging status, or remaining sustainably in the converging group once they have enjoyed a growth spurt. On the contrary, this reform agenda is in serious danger of creating disillusionment and reform fatigue as its goals are unlikely to be achieved.

FIGURES AND TABLES

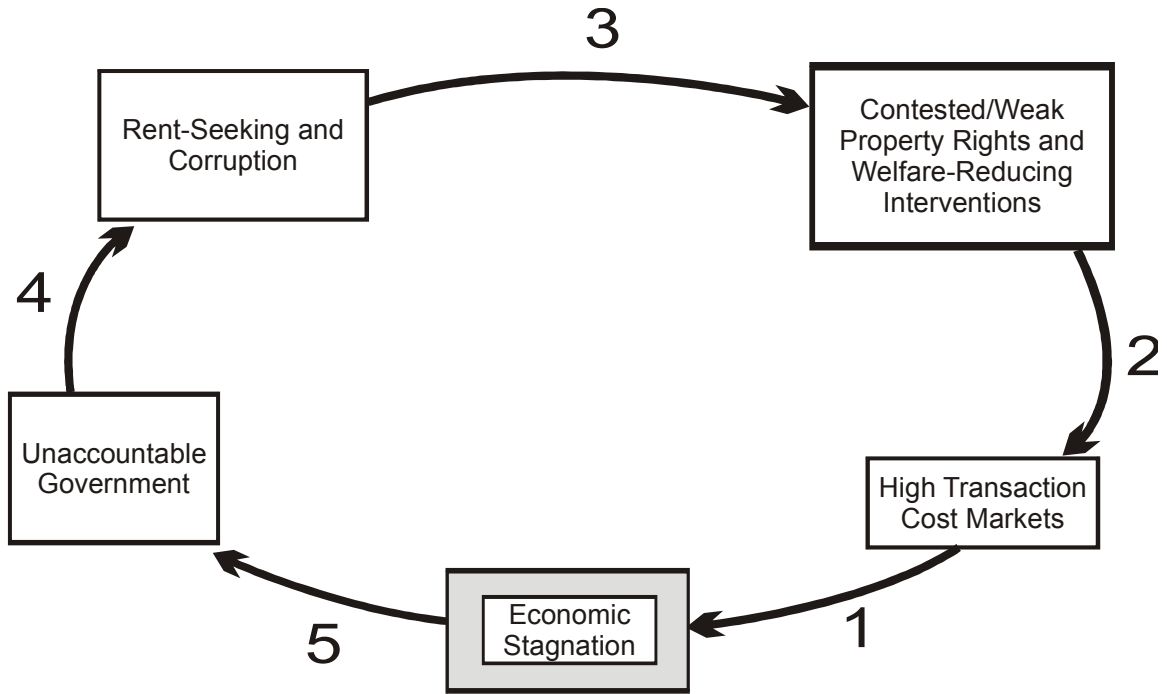
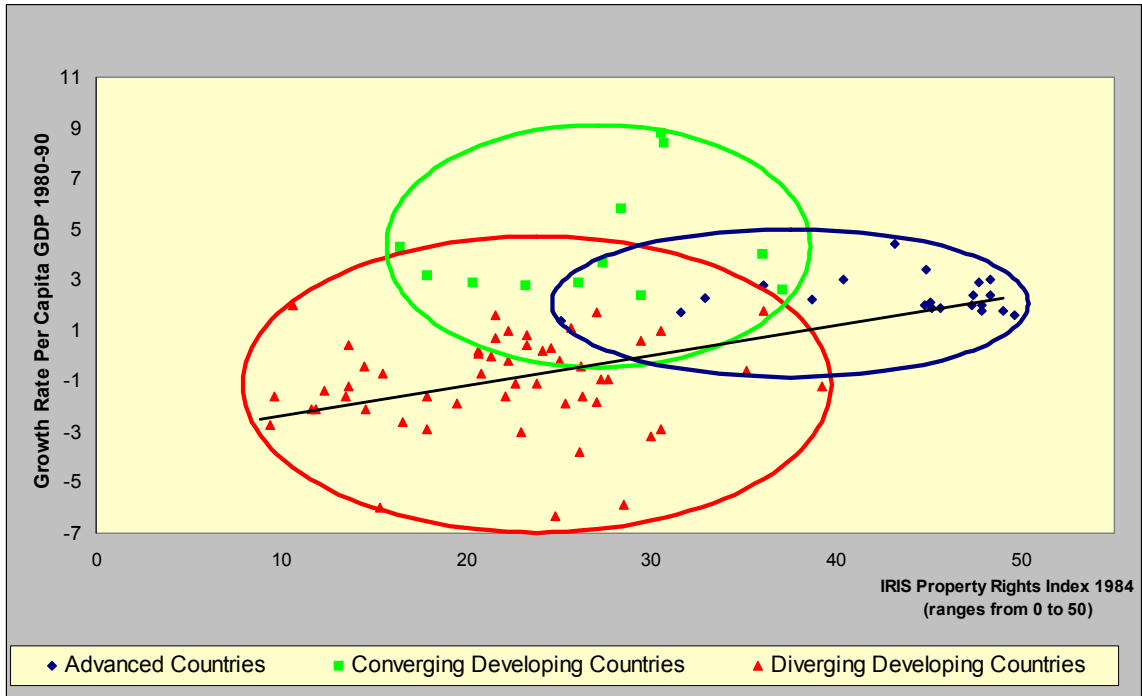


Figure 1 Analytical Foundations of Good Governance

Table 1 Interdependent Good Governance Reform Agenda

Policies to Improve Accountability of Government	Policies to Counter Corruption and Rent Seeking	Policies to Stabilize Property Rights across the board
PRSP, PGBS, (in some countries), Accountability Reforms, Decentralization.	Anti-corruption policies, Liberalization, WTO restrictions on subsidies, IMF fiscal requirements	Policies to improve rule of law, reduce expropriation risk, strengthen judiciaries



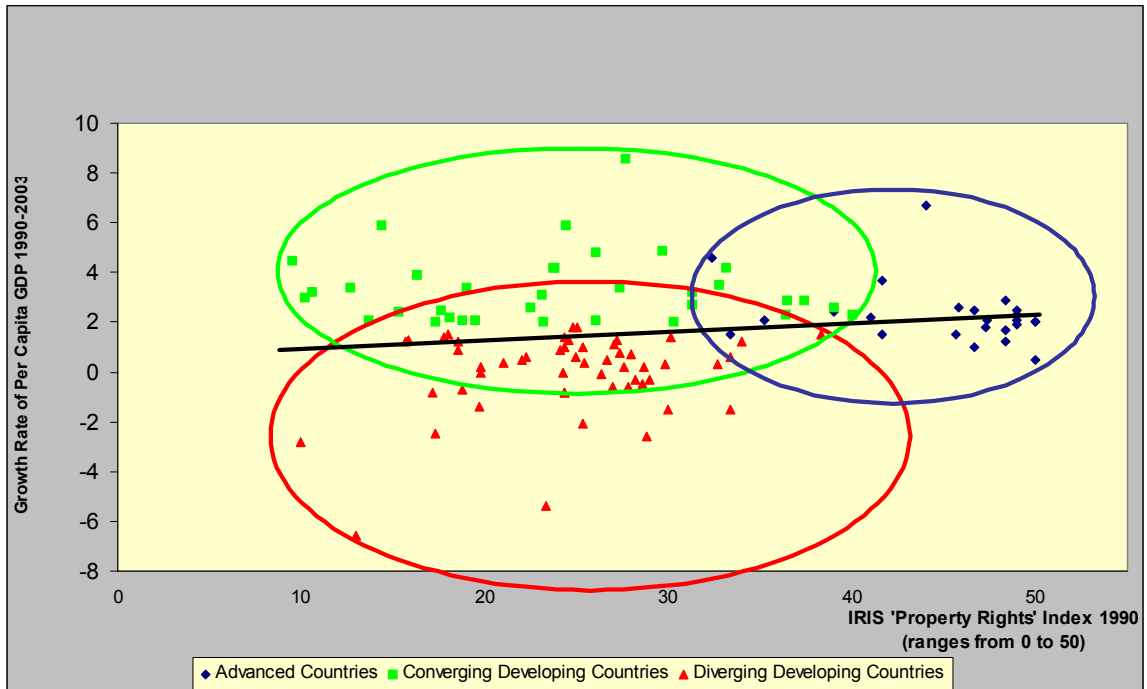
Sources: IRIS-3 (2000), World Bank (2005).

Figure 2 Governance and Growth 1980-90

Table 2 Governance and Growth 1980-90

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	21	52	12
Median Property Rights Index 1984	45.1	22.5	27.8
Observed range of Property Rights Index	25.1 – 49.6	9.4 – 39.2	16.4 – 37.0
Median Per Capita GDP Growth Rate 1980-90	2.2	-1.0	3.5

The IRIS Property Rights Index can range from a low of 0 for the worst governance conditions to a high of 50 for the best conditions.
Sources: IRIS-3 (2000), World Bank (2005).



Sources: IRIS-3 (2000), World Bank (2005).

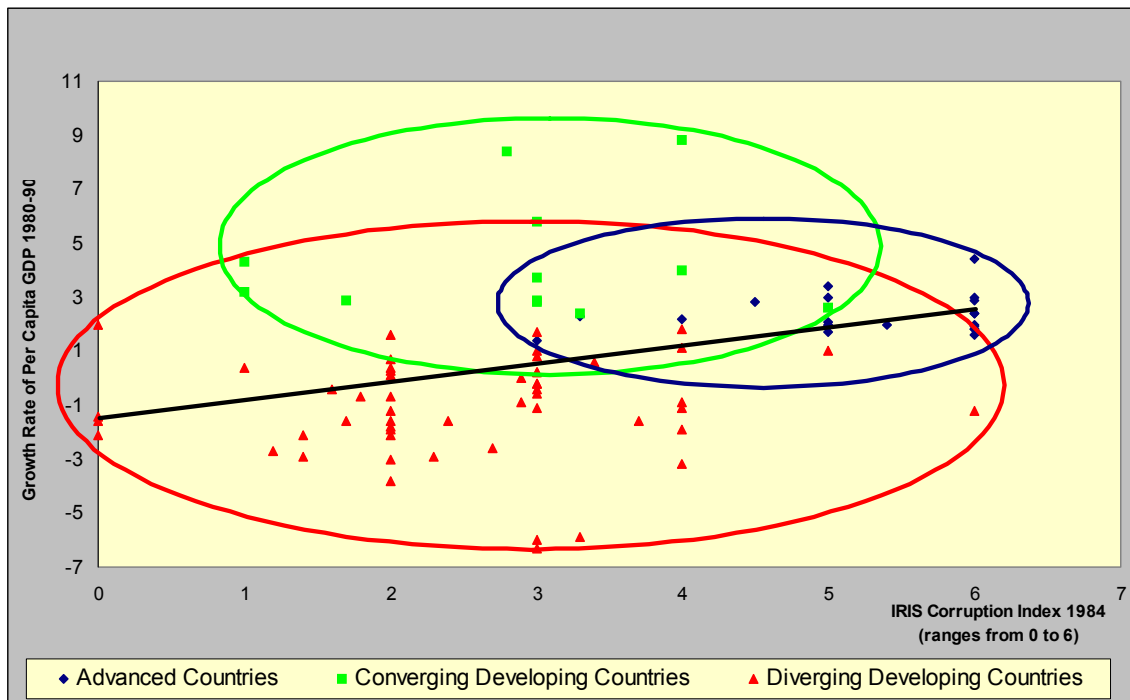
Figure 3 Governance and Growth 1990-2003

Table 3 Governance and Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Property Rights Index 1990	47.0	25.0	23.7
Observed range of Property Rights Index	32.3 – 50.0	10 – 38.3	9.5 – 40.0
Median Per Capita GDP Growth Rate 1990-2003	2.1	0.4	3.0

The IRIS Property Rights Index can range from a low of 0 for the worst governance conditions to a high of 50 for the best conditions.

Sources: IRIS-3 (2000), World Bank (2005).



Sources: IRIS-3 (2000), World Bank (2005).

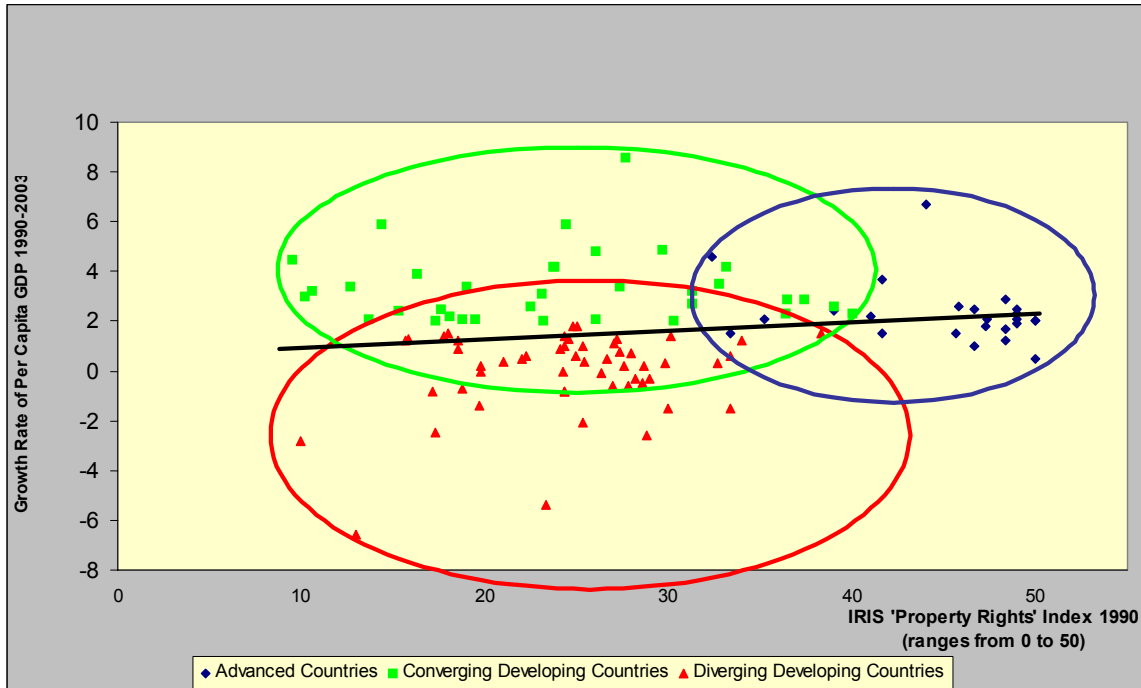
Figure 4 Corruption and Growth 1980-90

Table 4 Corruption and Growth 1980-90

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	21	52	12
Median Corruption Index 1984	5.4	2.6	3.0
Observed range of Corruption Index	3 – 6	0 – 6	1 – 5
Median Per Capita GDP Growth Rate 1980-90	2.2	-1.0	3.5

The IRIS Corruption Index can range from a low of 0 for the worst corruption to a high of 6 for the lowest corruption.

Sources: IRIS-3 (2000), World Bank (2005).



Sources: IRIS-3 (2000), World Bank (2005).

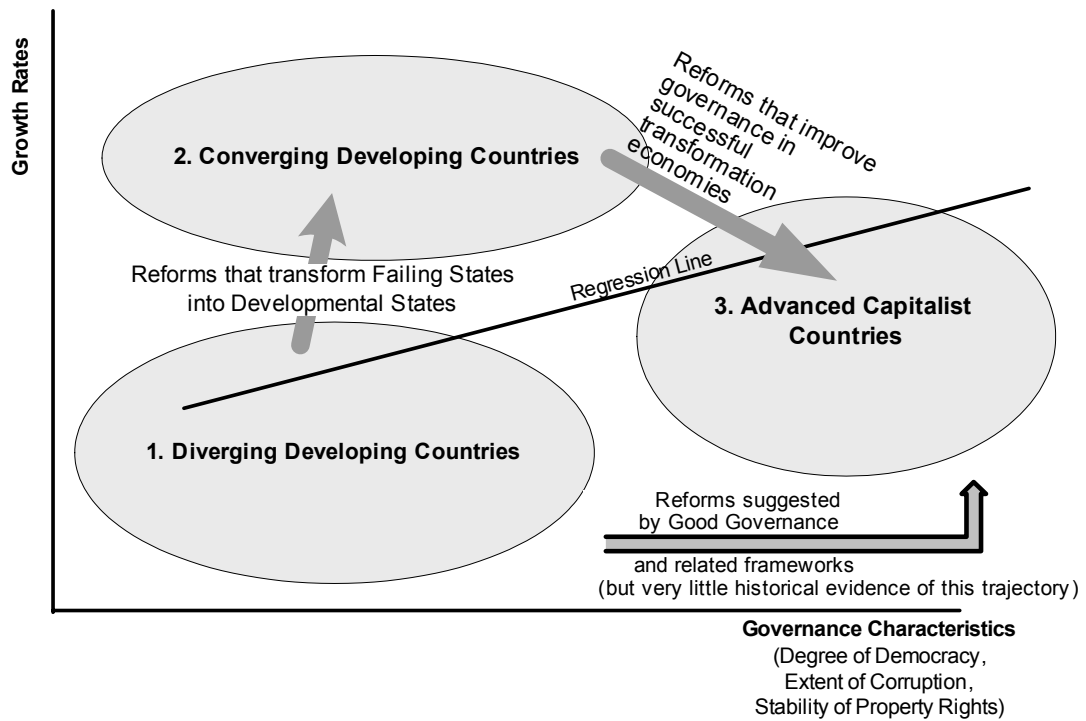
Figure 5 Corruption and Growth 1990-2003

Table 5 Corruption and Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Corruption Index 1990	5	3	3
Observed range of Corruption Index	2 – 6	0 – 5	0 – 5
Median Per Capita GDP Growth Rate 1990-2003	2.1	0.4	3.0

The IRIS Corruption Index can range from a low of 0 for the worst corruption to a high of 6 for the lowest corruption.

Sources: IRIS-3 (2000), World Bank (2005).



Source: (Khan, 2004)

Figure 6 Governance reforms critical for growth versus good governance reforms

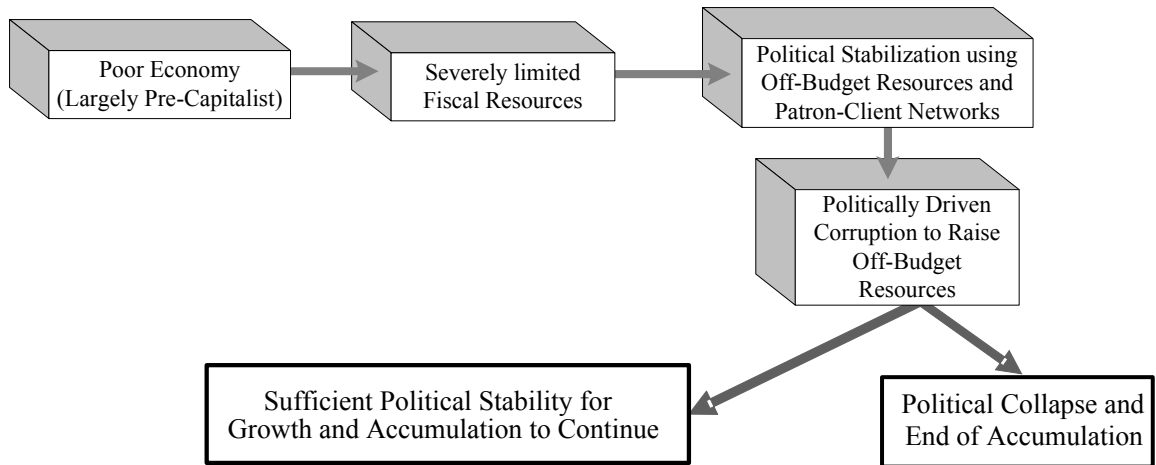


Figure 7 Drivers of political corruption in developing countries

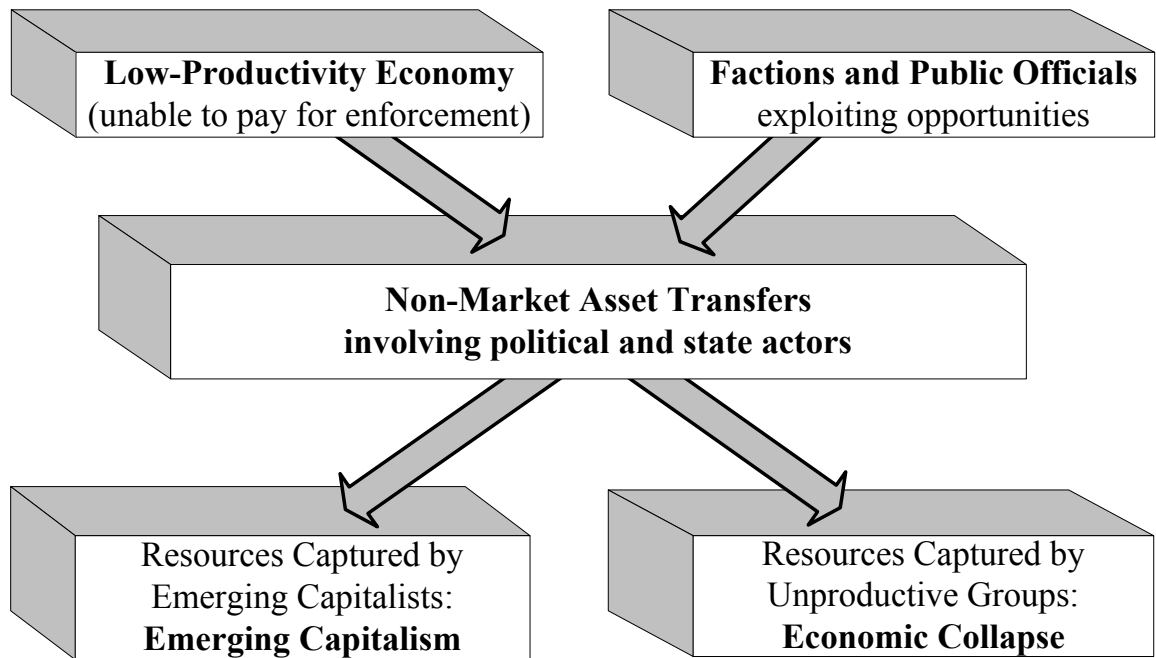


Figure 8 Drivers of non-market asset transfers in developing economies

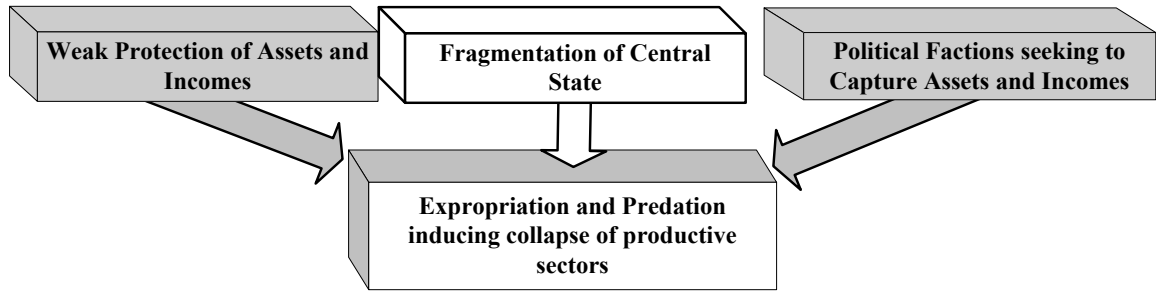


Figure 9 Critical drivers of predation and extortion

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