Dr. A. Gafur Memorial Lecture
Session: ***Economics of Corruption***

Economists' View of Corruption: The Tension Between What is Needed and What is Possible

H. K. Dey*

Traditionally economists have not had a great deal to say on the subject of corruption. This has been mainly due to the mainstream economists' insistence on keeping their analytical apparatus as value-free as possible. As a result, economists have tended to treat issues of corruption as incidental to their main focus on the efficiency properties of the market allocation of resources. In this lecture, I wish to highlight the fact that though economists have generally avoided taking the problems of corruption head on, they have developed theories that can explain, among other things, the emergence of corrupt practices among self-interested economic agents. It is not difficult to understand why economists as pure scientists find it embarrassing to call self-interested actions on the part of economic agents as corrupt, unlike sociologists and political scientists who are not averse to admitting value premises into their analytical baggage. However, if one is to appreciate how economic theories, which are not primarily intended to explain corruption as such, can shed light on corrupt behavior, one must define acts of corruption in such a way as to fit in with the structure of these theories. This is what I have attempted first.

What is Corruption?

To the practical man in a hurry, the question seems outrageous, even naive. Who needs a definition when corruption is believed to be visible everywhere? If you can easily identify acts of corruption, shouldn't that be enough? When you say your house is on fire, you convey a lot of sense, even though you may utterly fail

Professor, Department of Economics, University of Chittagong

to define fire. Merit of this position notwithstanding, one has to recognize the need for an analytically adequate definition of corruption. To make this point clear, let us pretend for a moment that people can identify acts of corruption without ever defining it. Then it is quite probable that in an opinion survey, one or more of the following will be regarded acts of corruption by one respondent or the other: frauds of all kinds, misappropriation and embezzlement, bribery, graft, illegal political contributions, avoiding or evading taxes, poisoning drinking water, jumping the queue, brain washing, ingratitude and incompetence, robbery and murder including judicial, religious or ideological ones, illicit relationships, extortion, eavesdropping, kidnapping, drug trafficking, plagiarism, infringement of patent rights, forgery, misrepresentation of facts through advertising, propaganda or lying, using religious symbols for sales promotion, leaking sensitive information, receiving or paying unmerited rewards, adulteration, adultery, selling of spurious drugs and so on.

If all these diverse activities are to be called acts of corruption, they must share one or more common characteristics. Evidently it is not easy to find a common thread that binds all of them together. While each one seems to offend the moral sensibility of one kind or another, this cannot serve as a common denominator, because moral judgments can vary widely among individuals and groups. We can then try legality or otherwise of various acts, and we immediately face the same problem, because the same act may be legal in one country and illegal in another. Some scholars, mostly political scientists, have tried to avoid this problem by creating typologies on the basis of two-way or multiple-way classifications (e.g., market vs. non-market corruption, bureaucratic vs. political corruption). The problem with this scheme is that any specific act may belong to more than one category depending on the context in which it takes place. But all are bedeviled by varying degrees of conceptual ambiguity.

It is important to note that, however much we try, we can hardly succeed in keeping the definition totally free from value judgment, especially with respect to the motivation for acts which look like acts of corruption. The reason is that the urge for the same act may spring from different motivations. For example, let us suppose that a murder took place in full view of a group of policepersons who made no attempt to stop it or to apprehend the criminals. From this we may not jump to the conclusion that the policepersons were engaged in corruption, because the police inaction may be explained in a number of ways: (i) they were outnumbered and so they thought that the attempt to protect or make arrest was futile; (ii) they were simply a bunch of cowards, lacking necessary courage or motivation; (iii) they were in league with the murderers who bribed them to look the other way. It is not clear whether they should be punished in case (i), but in cases (ii) and (iii) they will perhaps be punished, though for different reasons: in case (ii) for incompetence and in case (iii) for corruption. Note that in case (ii), the remedy, at least in the short term, is not punishment, but re-examination and review of the process of recruitment and training. Admittedly, only actions are observable; motivations being private information must be deduced from actions. Even so, determination of motivation as far as possible remains important in the quest for appropriate remedy.

Keeping these considerations in mind, I shall try to define corruption in such a way as to keep the motivational value judgment explicit. A person's act will be judged corrupt if it meets the following two conditions simultaneously: (i) The person is endowed with some power or position by other person(s), groups or institutions through explicit contract or solemn promise by virtue of which he is duty-bound or promise-bound to exercise his power or position in the best interest of the concerned party; but (ii) he deliberately abuses his power, position or trust to advance his personal or parochial interest.

The value judgment underlying this definition is quite explicit: it says that it is bad to abuse power or position in the manner indicated. To clarify the idea, let us consider two examples one of which constitutes an act of corruption, while the other does not. If I forcibly prevent you from submitting your tender documents because I want to get rid of a competitor, I am not committing an act of corruption (though it is possibly an unlawful act), because condition (i) does not apply. On the other hand, if you as a doctor in a government hospital ask me (a patient) to have clinical tests done in a laboratory that you own because that increases your income, you may be accused of corruption. In the latter case, both the conditions apply. It may be noted that this definition makes no allowance for any mitigating circumstances (such as sudden need for money, poor pay) leading to the abuse of power, though they may be relevant to the fight against corruption. In other words, the definition does not look for motivation underlying the abuse of power or position.

On the face of it, corruption as defined above is too narrow, possibly covering what are commonly known as bureaucratic corruption, political corruption, or corporate corruption. In fact, it is not as narrow as it appears, if we consider its ability to throw light on some forms of crime that are made possible by acts of corruption somewhere in the society. For example, extortions by organized gangs so common these days in our country may not be called corruption by our definition, but these could be the results of corrupt behavior of policepersons or politicians. For all its apparent narrowness, the definition helps in keeping the distinction between criminal acts and acts of corruption clear (one does not necessarily imply the other).

Economists as Analysts: The Why of Corruption

Elsewhere I have attempted an explanation of the rise of corrupt practices, their sustenance and growth across activities (Dey, 1989). Essentially the argument is that a market for corruption services develops because there are people who demand those services (they derive private benefits in the usual way) and those who are willing and able to supply them at a price (reflecting the marginal cost of provision consisting mostly of various transaction costs and costs of penalty upon detection). At least in its early stages of evolution, this market is threatened by various kinds of uncertainties arising from the demand side as well as the supply side. In order to overcome them, the market participants try to integrate different segments of the individual market vertically and separate markets horizontally. When they succeed the markets flourish (and corruption becomes rampant); when they do not, the markets either become self-limiting or tend to vanish after a brief existence.

The supply side of the market for corruption services is particularly interesting. The demand for corrupt services may exist independently, but why do the suppliers succeed in providing them? Briefly, the economists' answer is that the suppliers (for example, a middle ranking tax official or, a member of the procurement committee) enjoy some discretion that they can turn into private profits. For example, in large hierarchical organizations functions have to be delegated to officials and functionaries at various levels, leaving some degree of discretion. This gives rise to what is known as the principal-agent problem or simply the agency problem. The principal (e.g., the police superintendent) engages the agent (e.g., the investigating officer) to conduct an inquiry. The agent is expected to do what the principal intends. But often this may not happen because their interests conflict. The principal may not be able to successfully monitor what the agent is doing because of the possible asymmetry of information, problems of measuring and monitoring performance, or the sheer costs of doing so. In such cases the agent can be negligent or corrupt. The agent, in his dealing with the clients (here, criminals) can take bribes in exchange for a favorable report. Other things constant, the greater the discretion, the greater is the capacity to engage in corruption. The principal, on his part, may try to devise a system of incentives and penalties to make the agent fall in line, but he seldom succeeds in eliminating the need for discretion or its potential abuse. The principal-agent model is perhaps the single most important generic contribution the economists have made towards understanding corruption, though it was primarily intended to address the problems of internal control in hierarchical organizations. Its contribution is basically limited to the supply side of the market for corruption: it throws light on why and how agents are enabled to supply corruption services.

On the demand side, the recent contribution comes from the rent-seeking literature. As in the case of the principal-agent model, here too the primary motivation has been the explanation of inefficiencies and wastes caused by government intervention in the functioning of the market system. It is argued that government controls like trade quota, statutory price-fixing, exchange controls and licensing create potential rents for various agents, and the competition that ensues to capture these rents leads to bribery, graft and kickbacks. These rent-seeking activities consume real resources with no corresponding production, and have therefore been dubbed directly unproductive, profit-seeking (DUP) activities (Bhagwati, 1982).

Economists' Ambivalence: Is Corruption Bad?

Of course, it is not for those who engage in corruption. Being a free market transaction (except in cases of extortion involving the abuse of power), it is supposed to benefit both the service providers and the demanders. But this is undoubtedly a partial view. If the customs official allows the importer to cheat the government of revenue, it is the government that loses. But then one can argue that it is a kind of transfer from citizens to citizens or from the government to the citizens, and so should not impair efficiency. However, there is no guarantee that the distributional equity will not suffer as a result. This is the typical dilemma economists face as policy advisers. But let us ignore the issue of equity and ask: Can corruption (like bribery) lead to enhanced efficiency? Many will be amused if not shocked to learn that there are social theorists who assert that under certain conditions, corruption may speed up, rather than slacken, the pace of development. Studies with titles like "What is the problem about corruption?" or "Economic development through bureaucratic corruption" are not rare (e.g., Leff, 1964). In this context, let us see how J.N. Bhagwati qualifies his position on the efficiency-destroying property of DUP activities referred to earlier.

"The diversion of resources from directly productive to directly unproductive activities, when undertaken in the context of initially distorted situations, is fundamentally different from such diversion occurring in the context of initially distortion- free situations" (Bhagwati, 1982. p.994).

The theory of the second best supplies the needed justification for this type of views. If you begin with distorted markets, piecemeal removal of distortions here and there may not help; indeed systematic departures from the first best policies may be efficiency-enhancing. Corruption, it may be argued, can inject a measure of competition into an otherwise monopolistic industry that improves efficiency in the long run. For instance, if a particular business house is the sole importer of a commodity under quota, smuggling of the good into the country by bribing can increase welfare. Clearly, it is impossible to take an absolute position on this, because corruption may equally be destructive of competition. For example, a businessman may hire professional killers to eliminate a business rival and get away with it by bribing the people who matter.

Sometimes corruption may behave like oil lubricating market transactions, but more often it works like grit that clogs the system by introducing a host of "bads". Corruption in public recruitment may saddle the government departments with incompetent employees, making public administration costly and inefficient; corrupt building inspectors will allow unsafe buildings to come up; corrupt public health officials may endanger the lives of many; corrupt vehicle inspectors may contribute to more frequent and fatal road accidents; corrupt forest officials may be responsible for quicker deforestation, and so on. In general, corruption can seriously distort economic incentives leading to waste and misallocation of resources; breed cynicism and apathy; encourage general distrust of the efficacy and fairness of the economic and political institutions of the country; encourage capital flight and brain drain, and create many other socially harmful externalities. Many independent scholars and official inquiry committees have extensively documented the negative consequences of these activities in careful studies in many developing countries (such as India, Thailand, Indonesia and the Philippines in Asia; Nigeria, Zaire, Uganda in Africa) (e.g., Gould, 1980). Developed countries too are not immune from the evils of corruption. The recent financial scandals in the U.S. are the most dramatic examples in which fraudulent manipulation of the books of accounts has been used to keep stock prices up and the subsequent bankruptcy have left many ordinary shareholders and employees who exercised stock options with junk stocks.

Economists as Advisers: How Can Corruption Be Controlled?

Needless to say, it is neither possible nor desirable to root out corruption entirely. While a reduction in the level of corruption brings benefits, it also uses up resources having alternative uses. We must therefore define what the optimal level of corruption is. The economists' approach here is broadly similar to the one adopted to determine the optimal level of pollution. In this case, the optimal level of corruption will be the amount for which the marginal social cost of tolerating corruption equals the marginal social benefit of reducing it. A priori, it is not clear whether the optimal amount of corruption is zero for a given organization or for the society as a whole, though realistically speaking it is likely to be positive. The notion of optimal level of corruption also suggests that resources for fighting corruption should initially be employed where the marginal net benefit is relatively high (e.g., corruption in high places).

The explanation given earlier for the existence of corruption would suggest basically two types of measures – those operating on the demand side and those on the supply side, though the distinction is somewhat overdrawn. Demand side measures are those that tend to reduce the demand for corruption services (e.g., reduction of import duty, deregulation measures aimed at increasing competition). On the supply side, measures will be such that they raise the costs of engaging in corrupt activities (strict vigilance leading to frequent detection and punishment, reallocation of duties within the organization).

In principle, both types of measures have something to recommend themselves. The demand side measures emphasize increasing reliance on market forces. The new buzzword here is market reforms to increase competition and getting the relative prices right. In recent years, these reforms included measures like selling state owned assets to the private sector, dissolving statutory monopolies to allow freedom of entry for competitors (e.g., in telecommunication and electricity generation), encouraging private sector provision of public services by franchising or contracting out, liberalizing trade and investment and adoption of similar market-oriented measures. Many of these measures are none other than those that globalization dictates, and the donor agencies recommend for developing countries facing fiscal and balance of payments crisis. Countries that have tried to follow this prescription have brought severe hardships on the poorer sections of their people without reaping the benefits claimed, at least in the short run. As a result, a controversy has been raging for sometime about the very economic logic of these reforms led by a group of theorists known as the New Structuralist School (e.g., Taylor, 1983).

The increasing prestige and influence of the public choice school in recent years have further sharpened this debate. According to the public choice theorists (e.g., Buchanan, 1975), it is an illusion to believe that governments can take care of market failures; on the contrary, they may fail more miserably than markets. What is needed is a study of the behavior of the state which modern economists have generally tended to ignore. This neglect has been specially glaring in areas of preference revelation and incentive compatibility (which are currently areas of active research).Buchanan and his followers argue that politicians and the bureaucrats are self-interested like everyone else, and so it will be naive to expect them to single-mindedly maximize social welfare. They are interested in the growth of the government, if possible, to the Leviathan proportion. The role of the government as the provider of public goods, the regulator of private monopoly, and the agency for correction of market failures has come under criticism. The traditional arguments for government intervention have been rejected in favor of free play of market forces, even where the markets are less than perfectly competitive. The bureaucrats and politicians are not thought of as slaves of some defunct economist (as Keynes did). Rather they are seen as clever manipulators of the theories of market failure that they use in their interest for expanding the areas of government intervention in economic affairs. The property rights school goes a step farther. It denies the existence of very many public goods in the economy (Wiseman, 1978) and asserts that what is in short supply is a proper system of property rights. Totally ignoring the possibility of prohibitive transaction costs (and the absence a full set of futures markets), it insists that exclusion is possible in many more cases than is usually thought possible so that private markets for many of the so-called public goods can be established and sustained.

The irony of the situation is that while in the long run the bureaucrats and politicians may have a great deal to lose from the downsizing of government activities, in the short term the withdrawal of the state gives them ample opportunities for grafts and kickbacks. During the 1990s there has been increasing concerns in many countries (including the developed ones) about the fall in ethical standards and probity in public life, because of the widely reported public sleaze and abuse of public office, mostly in connection with the sale of public sector assets, contracting out and the constitution of regulatory bodies following privatization.

Supply side measures seem less controversial, but perhaps more difficult to implement successfully. Basically these have to do with restructuring the internal governance structure of the organization (e.g., the customs department). The aim is to take care of conflicting interests of the various actors within the organization (principals and agents). The instruments are reallocation of responsibilities, frequent transfers, superior monitoring and accountability (e.g., occasional surprise checks), improved transparency (e.g., keeping proper records of money collected), encouragement of public complaints, etc. The success of these measures depends to a large extent on the honesty of higher echelons of the management or administration. Lower ranking corrupt officials can be subjected to administrative sanctions. Honest officials can be rewarded, even when the corrupt ones cannot be brought to book. The high-ranking official has usually to remain content with favorable publicity, or with the reputation of being "poor nobleman" whose lifestyles would reflect his rectitude.

The attempts to implement departmental control are complicated by a further problem that has been called the principal-principal problem. In fact, this is a variation of the principal-agent problem. The problem may arise between various layers of administration of the same organization (e.g., the superintendent of police and his deputy), or across organizations at various levels of hierarchy (e.g., the police department and the ministry of home affairs). Within the police department, while a middle ranking official is a principal with respect to another lower ranking official (an agent), the latter may be a principal to his junior officer. Similarly, the ministry of home affairs by virtue of its being the higher authority is a principal to the inspector general of police (agent) who is also the principal with respect to officials working in his department. In other words, officials in a given hierarchy are bound by a chain of principal-agent relationship, each combining the roles of a principal and an agent, depending on the direction from which the relationship is looked at (above or below).

The problem that this kind of principal-principal relationship raises is that if the superior principal is corrupt, the weaker principal cannot come down heavily on corrupt agents (principals) down the line. The extreme case of this problem brings to fore the puzzling question: Who is the ultimate principal in the context of the whole country whose interests are to be protected by the whole array of greater or lesser principals (agents)? The answer will appear to be the government of the country. But the government itself (which is but a collection of institutions like the judiciary, the bureaucracy, the police force) is an agent of the citizens who are the ultimate principals.

Now ordinary citizens, unlike company shareholders, do not or cannot take active interest in what the agents are doing. One reason for this is that they are widely dispersed, and any benefit or harm is spread over a large number of people, sometimes over a long period of time. As a result, the impact of corruption often escapes notice, and when it does, an individual citizen, or a small group of them, may not feel sufficiently threatened to undertake organized effort to resist it. Moreover, in a democracy people get temporarily disenfranchised between two consecutive elections. Unlike the shareholders of a company, citizen voters cannot sell (!) their votes until the next election. This temporary monopoly (best possible scenario for many fledgling democracies) creates ample opportunities for political corruption.

The ultimate responsibility of fighting corruption rests with the politicians in power who run the country on behalf of the people. They hold office (and in a democracy get elected) promising to do certain things for the people, sometimes including a crusade against corruption. If they fail to deliver on their promises, or worse still, if they themselves get involved in corruption (a common experience in many developing countries), the electoral process in a well-functioning democracy is expected to take care of them: they are thrown out of power. But in many developing countries, this is not to be expected. Why? Is the electoral process flawed? Are the voters apathetic? Can the voters be bought off, or scared away with the help of hired gangs who had been allowed to make fortunes through crime and corruption? Are the media people corrupt, timid or willing collaborators? Are the criminal justice system and police administration above board? Is the civil society vocal, upright and forthcoming? Answers to many of these questions in a country like ours are no doubt difficult. In this context, an instance from our neighboring country will be instructive. This country is held up an ideal example of a functioning democracy with a free press and an independent judiciary. In response to a recent directive from the apex court to reform the electoral process in order to keep candidates with criminal records out of public office, politicians of all hues came together to oppose vital aspects of the proposal. This is because all parties are known to use the criminals during elections and at other times.

Globalization and information revolution have made corrupt practices easier than before. The increasing integration of the national economy into the global economy, especially through financial liberalization, provides greater opportunities for transferring ill-gotten wealth abroad for laundering or investment. Prevention of international corruption like the promotion of international peace is an international public good whose provision needs international cooperation (e.g. transparency in international contracts, extradition of economic offenders).

Concluding Remarks

Our discussion above has not captured many nuances and fine points of the contributions economists have directly and indirectly made towards understanding the issues of corruption. But hopefully it has laid hands on the fundamentals of theories that are directly relevant. As mentioned at the beginning, the mainstream economic theorists' primary concern has not been an explanation of corrupt behavior, excepting a few sporadic and peripheral efforts (e.g. Johnson, 1975; Acemoglu et al., 1998). The tension between the economist as analyst and the economist as adviser in the context of corruption is the familiar one; it springs from the desire to steer clear of value judgments and the need to remain socially relevant as policy adviser. However, in so far the economist is willing to offer any advice at all, he can be of help only in a limited way, because the issues of corruption are necessarily complex and multi-dimensional, requiring inputs from many branches of social sciences; psychological and sociological investigations may sometimes be more important than rational analysis.

The most harmful cases of corruption are undoubtedly those originating in high places. They affect the current as well as future generations in significant ways. Examples of such corruption are those related to the construction of the air ports, hospitals, large bridges or tunnels, highways, exploration of minerals, laying gas or oil pipe lines, disinvestments of large public enterprises, major administrative changes, major arms deals, large public procurements, and so on. Decisions regarding these activities (assuming they are in the public domain) are taken at the highest administrative and political levels often in an environment of substantial uncertainty about the quality of product, methods of implementation, or the entire range of consequences. Misjudgments and wrong choices may result because of ignorance, incompetence, or sheer unpredictability of ultimate results. But there are cases when these riders do not exactly apply, and these acts could then be described as corrupt behavior.

Government's determination is a necessary condition for a successful campaign against corruption. In order to succeed the different branches of the government should share the same determination to fight. If they do not, some branches will frustrate the efforts of the rest. In many cases, the government cannot be fair and transparent in dealing with corruption (and crime generally), e.g. when it wishes to use corruption revenues for attaining or retaining office. If it has promised to fight corruption during the election campaign, it can kill two birds with a single stone by coming down heavily on political opponents who often corrupt themselves.

Finally, it is well not to lose sight of the ethical and cultural dimensions of the problem. In a money-metric society in which money is the measure of success, corruption is spurred on by need (narrowly defined as command over goods and services for a reasonably comfortable life) as well as greed. This is more so because the sources of wealth have ceased to be a matter of shame in the eyes of the public. The economist may set great store by the technical advice that corruption is sometimes the optimal response to incentive problems and incomplete contracts. But the measures proposed are only second best measures, because they insist on creating environments in which corruption does not pay, but not on environments in which corruption will be shunned even when it pays well. The same could be said of technological remedies for corruption (burglar alarms, lie detectors, DNA tests, concealed cameras, video-taping, etc.) that may give one the impression that fighting corruption is just a matter of a war of technology on human greed and avarice.

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Part III

Articles