Institute for Public Policy Research

152 Robert Mugabe Avenue PO Box 86058 Eros Windhoek Namibia Tel: +264 61 240514/5 Fax: +264 61 240516 ippr@iway.na www.ippr.org.na

IPPR Briefing Paper

ALMOST ALL THE INGREDIENTS FOR TROUBLE AHEAD

The economics of corruption: implications for Namibia

Robin Sherbourne

This short paper was commissioned by the Namibia Institute for Democracy as a contribution to the publication *"Ethics and Good Governance in Namibia"*. It tries to briefly summarise the conclusions economists have reached on the relationship between corruption and economic development. It further attempts to identify what the implications of these conclusions might be for Namibia. It suggests that, far from greasing the wheels of commerce, the growing consensus amongst the economics profession is that corruption damages a country's economic performance by reducing private investment, distorting public investment, discouraging foreign investment, and reducing the efficiency of the public sector. A further conclusion from the literature is that the causes of corruption in Africa do not differ in any fundamental sense from corruption elsewhere. More worryingly, many of the ingredients that have encouraged corrupt practices elsewhere are present in Namibia.

For the purposes of this paper corruption is defined as the abuse of public power for private gain. Corruption takes place in all countries and cultures. Yet attitudes towards corruption, the extent of corruption, and how countries act to deal with corruption appear to vary enormously. Within both the industrialised and developing world, there is a vast range of country experiences from which Namibia can learn.

The paper is divided into two sections. The first outlines the elementary economic ideas that form the framework within which economists think about corruption. The second presents a summary of the empirical literature of the economics of corruption and speculates what the implications of international experiences of corruption might be for Namibia. The paper draws heavily on an excellent summary article by Vito Tanzi [1]of the IMF and also the World Bank's annotated bibliography of empirical studies of governance and development[2].

ECONOMIC THEORIES OF CORRUPTION

People don't always obey the rules…

The study of economics is based on the view that people are rational utility maximisers, that is to say, people generally act to maximise their own material well-being within the circumstances they find themselves in. When faced with the opportunity of making money illegally, people will make a rational calculation weighing up the costs against the benefits of going ahead and breaking the law. If the chances of getting caught are low, the penalties small and poorly applied, the loss of earnings associated with being caught small, and the potential rewards high then the probability that individuals will break the law increases. However, since enforcing the law also involves costs there is likely to be an optimal level of law-breaking that is not zero.

… and policy makers are not saints

Public choice analysis is the name given to the study of how policy makers make decisions. Traditional approaches to policy analysis assumed that disinterested policy makers designed and implemented policies to promote the public interest. Public choice analysis shows that such analysis is incomplete because the assumption that policy makers are disinterested is unlikely to be true. The underlying principle is that those holding public office - be they politicians or civil servants - are generally as liable to be motivated by self-interest as anyone else. The task of the policy analyst is therefore to design policies which take such behaviour into account to produce beneficial rather than destructive outcomes.

Government intervention creates opportunities for unearned profits

The concept of rent is an important one in economics. Rent is defined as the payment made for a factor of production over and above the minimum payment necessary to keep it in its present use. In perfectly competitive markets no rents are made by any factor because changes in supply bid prices of inputs and labour down to the level just necessary to keep them employed. Thus surpluses above cost, or unearned profits, do not exist.

When a government intervenes in a market by imposing physical quantitative controls, these restrictions give rise to rents in various forms and people often compete for these unearned profits. As the World Bank[3] puts it "any policy that creates an artificial gap between demand and supply creates a profitable opportunity for opportunistic middlemen". Anne Krueger's pioneering study[4] of rent-seeking behaviour in the 1970s gave rise to a considerable economic literature on the subject.

These "rent seekers" compete in various ways some of which are perfectly legal – for example by lobbying or providing information. Other methods, however, involve bribery, corruption, smuggling and the underground economy. The resources devoted by rational rent-seekers will depend on the size of the rent available.

The rent seeking activity has no social value. In the attempt to capture the restriction created rents there is an opportunity cost as real resources are devoted to lobbying or other rent-seeking activities that produce no greater supply of the restricted quantity. As rent-seekers engage in activities to receive the favour of government, resources that go into the rent-seeking activities are diverted from other productive activities. Although the rent-seeking activity is rational in terms of self-interest, it is socially wasteful[5].

In the same way that government policies sometimes restrict the supply of something of value, the limited supply of natural resources can also give rise to rents. Furthermore, since natural resources often require policy interventions if they are to be used efficiently and sustainably, governments generally play a more important role in allocating rights and setting taxes than in other areas of business. This gives rise to greater scope for corruption.

This theoretical framework suggests corruption is especially likely in the following areas of government activity:

- Regulations, authorisations and rights
- Taxation
- Government spending decisions
- Provision of goods and services at below market prices
- Discretionary decisions
- Financing of political parties

Incentives for corrupt behaviour arise whenever public officials have wide discretion and little accountability. Politicians, bureaucrats and judges control access to valuable benefits and can impose costs on private citizens and businesses.

THE FINDINGS OF ECONOMIC STUDIES OF CORRUPTION

Corruption is attracting more attention from economists now than ever before.
As Tanzi[6] points out, there seems to be a whole variety of reasons why this is so. The end of the cold war has meant there is less reason to ignore corruption simply because its perpetrators were in the “right” political camp. The collapse of centrally planned economic systems has also allowed greater freedom to investigate corruption in countries where this was not previously possible. The number of countries with democratic governments and free and active media has created an environment in which discussion of corruption is no longer taboo. Globalisation has increased the contact between individuals from countries with little corruption with those from countries where corruption is endemic. Non-governmental organisations such as Transparency International[7] have been playing a growing role in publicising the problems of corruption and in trying to create anti-corruption movements in many countries. The transition to more market-oriented economies has increased the importance of creating investor friendly environments. Donors are asking themselves why decades of development assistance have often yielded such poor results. One of the major conclusions of this soul searching is the poor quality of governance in many recipient countries. The degree of corruption is an important aspect of governance.

Finally, the US has played an important role in bringing other countries into line with its Foreign Corrupt Practices Act of 1978 which many claimed unfairly penalised US exporters by preventing them from legitimately deducting bribes to foreign officials as costs for tax purposes. This resulted in the Convention on Combating Bribery of Foreign Public Officials in International Business

Transactions signed by the 29 member governments of the Organisation of Economic Cooperation and Development (OECD) in 1997[8].

The increased attention may also have come about because levels of corruption have risen in recent decades. This may be because the size and role of government in the economy has steadily increased in the course of the twentieth century. The growth of government has brought about a corresponding rise in the level of taxation and spending as well as an increase in the regulations and controls on economic activities. If not nipped in the bud corruption generates a momentum of its own which can build up in the course of the years. Added to this, the last two decades have witnessed a global wave of liberalising economic reforms which have changed the relationships between public and private agents. In many cases the profit motive has been embraced in situations where the underlying legal and social conditions which have made it such a dynamic force for growth in some countries have not existed. Privatisation is one area of reform which has provided a massive boost to corruption.

For these reasons there now exists a large theoretical and empirical literature from which to draw upon with some interesting conclusions for a country like Namibia. Much of this research is to be found within a broader literature on democracy, governance and development. This paper is based on studies which have concentrated specifically on corruption rather than broader areas such as “institutional efficiency”, “credibility”, or “policy effectiveness” although these clearly will be influenced partly by levels of corruption.

Measuring corruption

As is often pointed out, if corruption could be measured it could probably be eliminated. As Tanzi[9] makes clear, neither is it clear conceptually what exactly it is desirable to measure – bribes paid, the number of corrupt acts, the degree to which a corrupt act damaged economic performance. This makes it hard for economists to test their theories and carry out quantitative studies.

Useful information is available from the regular news media in the form of articles on instances of corruption. However, quantifying country levels of corruption by quantifying the number of news stories is problematic because the result would depend crucially on the freedom and effectiveness of the media. While a low corruption count could signify low corruption, it could also mean that the media was highly restricted or simply not very good at its job. Further sources of information exist in the form of case studies and investigations but these are often for internal consumption and therefore confidential.

To quantify corruption economists have turned to countrywide surveys on corruption produced by NGOs and rating agencies. These include the Global Competitiveness Report by the World Economic Forum in Geneva, the Political and Economic Risk Consultancy in Hong Kong, Transparency International in Berlin, Political Risk Services in Syracuse, Gallup, and the World Bank. Many of these surveys yield country indexes of corruption which reflect subjective perceptions of corruption on the part of international and local business people and others. One striking feature of these indexes, however, is that they are highly correlated with each other. These indexes allow economists to undertake more rigorous quantitative analysis of the economic consequences of corruption using tried and tested econometric techniques.

Corruption reduces private investment and economic growth…

Most theoretical arguments support the view that, by distorting resource allocation and prices, as well as increasing uncertainty and costs, corruption is bad for growth. While theoretical arguments exist which point the other way, these are confined to some pretty specific sets of circumstances.

Empirical evidence based on cross-country comparisons suggests that, far from “greasing the wheels of commerce”, corruption causes large, adverse effects on private investment and economic growth[10]. In quantitative terms, one study found that a country that improves its standing on a defined corruption perceptions index of 1 to 10 from 6 to 8 will experience a 4 percentage point increase in its investment rate and a 0.5 percentage point increase in its annual per capita GDP growth rate. The same study found no support for the assertion that corruption might be beneficial in the presence of a slow bureaucracy. The most important channel through which corruption reduces economic growth is by lowering private investment which alone accounted for at least one-third of corruption’s negative effects.

The World Bank’s 1997 World Development Report[11] contains an entire chapter on restraining arbitrary state action and corruption. Studies carried out for the Report found a clear negative correlation between the level of corruption as perceived by businesspeople and both investment and economic growth. For a given level of corruption, countries with more predictable corruption had higher investment rates. However, no matter how high the degree of predictability of corruption in a country, its rate of investment would be significantly higher were there less corruption. Furthermore, the Report also found that corruption was more prevalent in countries with highly distorted policies and that there was a negative correlation between reported levels of corruption and judicial predictability.

Corruption reduces foreign investment...

Many good economic reasons exist why developing countries should try and attract Foreign Direct Investment (FDI). In theory it can be expected that the presence of corruption reduces FDI by raising costs, increasing uncertainty, and risking exposure to negative publicity. At least one study[12] has found that FDI is reduced by host-country corruption levels but this result was sensitive to the corruption indicator used. The predictability of corruption is likely to make a difference too since highly unpredictable corruption has a greater negative impact than when corruption can be viewed as a tax. One study[13] which argued that corruption acts as a tax on foreign investment found that “an increase in the corruption level from that of Singapore to that of Mexico is equivalent to raising the tax rate by over 20 percentage points.”

Since Independence Namibia has made strenuous attempts to attract FDI and for good reason. As a small open economy wishing to diversify and industrialise, FDI is of critical importance. While a certain amount of success has been achieved, levels of FDI have not exceeded 5% of GDP and have fallen far short of expectations outside industries based on natural resources. It would be difficult to argue that this is due to corruption since, at this stage, other important explanations appear more plausible. However, if FDI in the form of medium-sized manufacturing operations is to be attracted, it will clearly be important to maintain a corruption-free environment because such firms are likely to be more sensitive to corrupt practices than the larger multinationals. It should also be borne in mind that Namibia is competing for these investments with neighbouring Botswana, a country that consistently ranks higher in Transparency International’s Corruption Perception Index (24th compared to 29th in 1999)[14].

Corruption often raises public investment but lowers its productivity…

Economists often favour high capital spending on public investment because they believe it contributes to growth. However, greater expenditure on highly visible investment projects such as roads, airports, power plants, and ports often comes at the expense of less visible but no less vital expenditures on operations and maintenance, health and education. Large projects are more likely to encourage corrupt practices since they involve large sums of money upon which correspondingly large "commissions" may be paid. Furthermore, political discretion in awarding such contracts may also be high since "strategic" considerations are often used to overrule tighter arguments about value for money.

At least one study[15] finds evidence that higher corruption is associated with higher public investment, lower operations and maintenance expenditures and lower quality of public infrastructure. The evidence also shows that corruption increases public investment while reducing its productivity. This paper's conclusion is that economists should be more cautious in their praise of high public investment.

The importance of public investment in infrastructure is well recognised in Namibia and regularly referred to in the debate on the national budget. In 2000/01 the government proposes to spend some N$1.1 billion on capital expenditure, some 13% of total estimated expenditure. Despite the rise in personnel spending since Independence, capital expenditure does not appear to have been unduly squeezed.

Expenditure takes place through a prescribed tender process with decisions taken by a tender board consisting of all permanent secretaries plus two private sector representatives. There appears to have been at least one well-publicised case of tender procedures being circumvented, in the case of government's purchase of approximately 800 Chevrolet vehicles from Barden International in 1998 at the behest of the President.

It is impossible to say whether the quality of government's capital expenditure programme has been influenced detrimentally by corruption. The apparent bias in expenditure towards higher profile projects in urban areas and especially Windhoek probably has a variety of causes. Since capital expenditure in Namibia is not generally subject to rigorous cost-benefit analysis and no government-wide discount rate is employed to evaluate projects, the productivity of much of this investment must be questionable. These conditions certainly do not work against corrupt practices. It is possible that the scope for corrupt practices between government and contractors is much reduced in the case of very large projects which require third party external funding, such as regional highways and power stations.

Corruption renders aid ineffective…

A number of studies[16] report a clear link between the effectiveness of foreign aid on the one hand and the institutional efficiency and the quality of economic policies on the other. It is this finding that has prompted donors to move towards supporting programmes designed to promote good governance and away from supporting individual projects. Until recently aid has not been allocated on the basis of the level of corruption prevailing in the recipient country. While it is possible that donors have been able to shield their programmes from the effects of corruption, it is also likely that the incentives for corruption are less than in cases involving commercial projects.

Low public sector wages can encourage corruption…

Many governments increase public sector employment in order to directly reduce unemployment. However, given limited tax and other revenues, a tradeoff exists between the number of public servants that can be employed and the amount they can be paid[17]. This has led to a situation in many countries where public servants earn much less than in comparable private sector jobs. Under these circumstances corruption is likely to thrive, especially if the chances of being caught and disciplined are low. One theoretical counter-argument to this that has been put forward is that, since bribes supplement low wages, corruption actually allows governments to maintain a lower tax burden than it otherwise would and this can favour growth.

Evidence[18] exists to show that corruption is often positively associated with the difference between public and private salaries known as the "rate of temptation". However, relying purely on raising salaries to reduce corruption to acceptable levels will generally be prohibitively expensive. Pay reform will therefore have to be combined with other measures such as strengthening monitoring and law enforcement as well as improving recruitment and promotion mechanisms. There is further evidence[19] that the less recruitment is based on merit the higher the extent of corruption. The World Bank[20] finds that merit-based recruitment and promotion mechanisms that restrain political patronage and create a more impartial public service are also associated with lower levels of corruption.

The debate over corruption and public sector wages takes on particular importance in Namibia where public sector employment has grown dramatically since Independence. Namibia now has one of the highest ratios of civil servants per head of population in the world (approximately 75,000 in central government alone out of a population of around 1.8 million[21]).

A cursory examination of the numbers available suggests that the real value of the average public sector wage does not appear to have fallen since 1990 and this seems to have been achieved as a result of raising the tax burden and squeezing other non-remuneration expenditures. This is not to say, however, that the *relative* value against private sector wages has not changed. Nor does it mean that the wages of those in the best positions to extract gains from corrupt practices have not fallen in either real or comparative terms. The issue of "compression" in public sector salaries – that is to say reducing inequalities between the highest and lowest paid civil servants – is one that regularly arises in the course of public wage negotiations. Given the extreme inequalities that exist in Namibia as a whole, it is politically difficult for government to raise the salaries of more senior officials despite them being the ones most likely to be involved in the most damaging corrupt practices. Furthermore, reducing the relative pay of public sector professionals is likely to give rise to a process of "adverse selection" whereby those most skilled and able end up finding better remunerated positions elsewhere leaving poorer quality workers behind. A more cost-effective and politically acceptable way of raising public sector salaries to discourage corruption may be to follow the example of those countries which have attempted to raise salaries in particularly sensitive areas of government such as customs and tax administration. Realistically, however, the rewards from corrupt practices in some areas may be so great that only impossibly high wage increases are likely to act as a disincentive. This is compounded by the fact that so many public servants in Namibia also have private business interests and that, as a young institution, little "esprit de corps" yet exists. Under these circumstances, preventing corruption will demand the presence of effective monitoring and enforcement mechanisms.

While big government requires low levels of corruption…

It appears plausible that higher taxes provide greater incentives for taxpayers to evade taxes or join the unofficial economy. There is evidence[22] that corruption reduces levels of tax revenue by reducing the effectiveness of tax administration and customs and thus reduces the ability of governments to carry out needed public expenditure. Another study[23] shows that corrupt governments become small governments while only relatively uncorrupt government can sustain high taxes. Those countries that maintain some of the largest public sectors in the world consistently feature among the least corrupt. A further conclusion from other research[24] seems to be that countries with more corruption in Latin America, the OECD, and the former Soviet Bloc tended to have larger unofficial economies.

Measured in terms of the ratio of tax revenue and public expenditure to GDP, Namibia has a high tax burden and a large public sector by international standards. In terms of tax rates corporate tax rates lie at the higher end of the international spectrum although individual, trade, and indirect tax rates are not especially high. International evidence suggests that if Namibia is to maintain its large public sector it will be important to maintain the existing relatively low levels of perceived corruption.

Natural resource endowments often cause corruption…

Intuitively it seems plausible that the more a country is blessed with valuable natural resources, the richer it is likely to be. It is not difficult to think of examples of such countries. Yet at the same time examples abound of countries apparently rich in natural resources languishing in desperate poverty. One ground-breaking study[25] has identified a negative relationship between natural resource abundance and long-run economic growth. Economists have long been aware that resource booms tend to reduce the competitiveness of the non-resource sector – through the so-called Dutch disease mechanism – and policies have been devised to attenuate this tendency. More recent research[26], however, strongly supports the view that natural resource discoveries create opportunities for rent-seeking behaviour and is an important factor in *determining* a country's level of corruption. The extent of corruption appears to depend on natural resource abundance, government policies, and the concentration of bureaucratic power.

This has implications for Namibia which has important natural resource endowments such as diamonds, minerals, fish, natural gas and is in the process of searching for oil. Whether these turn out to be a blessing or a curse appears to depend greatly on the ability of government to ensure rents do not lead to widespread corruption but are used wisely for the benefit of the entire nation.

But trade discourages corruption…

Economists have investigated the link between corruption and trade. It seems plausible that corruption in a country would hurt trade since foreigners will prefer not to deal with bribe-seeking customs officials and unreliable bureaucracies. At the same time it is equally likely that countries with little foreign trade in the first place have less to gain by working to curb corruption. In each case there is a negative relationship between the volume of trade and the level of corruption. One recent study[27] provides evidence that countries which have a natural propensity to trade with the rest of the world also have substantially lower levels of corruption.

Namibia has many of the characteristics that make for a high natural propensity to trade: it is a small economy with a large coast, English as the official language, and has abundant natural resources. This natural openness manifests itself in the fact that imports and exports are each worth more than 50% of GDP. The study mentioned above suggests that Namibia's openness could act as a strong disincentive to allowing the spread of corrupt practices.

A trade-related phenomenon discussed widely in the literature on rent-seeking is the misuse of import tariffs and the imposition of import quotas by governments. One of the consequences of belonging to an “undemocratic” Southern African Customs Union (SACU) is that the ability of Namibian business or government to abuse the trade regime is severely curtailed. Trade-related rent-seeking activities are therefore likely to have been minimal in Namibia’s case but that could change as SACU is “democratised”. However, the tarifisation of import quotas means opportunities arising from physical restrictions are rapidly being eliminated.

Interventionist industrial policy encourages corruption…

Many governments believe they can accelerate industrial development by intervening in the economy through a host of measures including subsidies, taxes, import tariffs, licenses, exchange rates and interest rates. As explained above, such interventions increase the scope for rent-seeking behaviour and corruption. At least one study[28] of 32 countries shows that active industrial policies are indeed associated with higher levels of corruption and this offsets part of the effects of the policies on increasing rates of investment.

Namibia’s industrial policy as outlined in the Industrial Policy White Paper of August 1992 is based primarily on an incentives package for manufacturers and the Export Processing Zone scheme. The former comprises mainly of a rather complex system of tax incentives and subsidies while the latter combines generous tax incentives with the relaxation of certain labour laws. While in theory these packages have been designed to limit bureaucratic discretion, in practice a certain amount of discretion is required in distinguishing manufacturers from non-manufacturers and exporters from non-exporters. The limited number of companies that have succeeded in obtaining advantages under these schemes suggest corruption is not yet a major problem. What appears more likely is that the design of the packages is inappropriate. There are good arguments to support the view that a reduction in the general level of corporate tax would be more effective way of promoting growth and this would at the same time eliminate the scope for abuse. Contrary to initial intentions, the scheme has recently been extended to non-manufacturing activities but there is nothing to suggest this has come about through dubious means.

In addition to the provision of tax incentives, government appears to have become increasingly ready to alter tender board rules ostensibly to promote industrialisation. This is legitimate provided the rules are transparent and allow competition but there is a danger that rules are created with the intention of creating opportunities for special interest groups. The further use of the Government Institutions Pension Fund (GIPF) to finance projects also has the potential to promote corruption since the Fund is heavily influenced by politicians.

Black economic empowerment initiatives should be implemented carefully…

Black economic empowerment is a phrase much used in those countries of Southern Africa with settler communities who are perceived to dominate their respective economies. While lacking an exact definition, black economic empowerment generally seeks to accelerate the shift in ownership and management of productive assets towards previously disadvantaged blacks through the use of instruments at the disposal of government such as licences, rights, credit, and tender board procedures. In theory these instruments can be applied in a consistent and transparent manner. In practice this is not always the case. The key to success in the whole process is to maintain incentives to ensure assets are used productively.

In Namibia the situation is often clouded by the fact that those making the rules that promote black economic empowerment are often those benefiting from them since there are no limitations on the business interests a public servant can have. Furthermore, in a situation where whistle blowers are likely to come from the established business community, there is always the danger that such actions can be written off as the work of disgruntled racists and issues of corruption quickly become issues of race.

Namibia – almost all the ingredients for trouble ahead?

This brief survey of the economics of corruption suggests that, far from greasing the wheels of commerce, the growing consensus amongst the economics profession is that corruption damages a country's economic performance by reducing private [29]investment, distorting public investment, discouraging foreign investment, and reducing the efficiency of the public sector. A further conclusion from the literature is that the causes of corruption in Africa do not differ in any fundamental sense from corruption elsewhere.

Many of the ingredients that have encouraged corrupt practices elsewhere are present in Namibia. If government continues to use public employment to directly reduce unemployment, public sector wages are likely to decline and this can only encourage corruption. Namibia is blessed with abundant natural resources and is searching for more. If corruption is tolerated now the chances are that these natural resources will fail to promote development and a blessing will instead become a curse. Although tax rates are not punitive, the tax burden as a whole is high and the tax regime is in many ways becoming more discretionary. Merit may not play an important part in the hiring of civil servants and positions in the public service have to be ratified by Cabinet from Deputy Director position up. Worryingly, black economic empowerment initiatives are not taking place within a transparent and competitive policy framework. Military expenditure is rising steeply and purchases of military hardware can be expected to increase in line with the Defence White Paper of 1993 and several very big non-military public sector investment projects are in the pipeline. Finally, in Namibia's small society, whistle blowers are likely to face higher costs than in larger more anonymous societies. The high degree of trust shown in Namibia's political leadership and public service[30] by the general public may make it harder to tackle those instances of corruption which do take place.

Namibia's natural openness and dependence on foreign investment and aid may act as a disincentive to corruption. The civil service is not yet desperately underpaid, tax administration is reasonably efficient, customs payments are determined to a large extent by South Africa, and the media remains relatively free and watchful. As a result Namibia scores well in international corruption ratings.

One issue the economics literature fails to address is whether dominant party economies have higher or lower levels of corruption. In theory there are arguments on both sides. On the one hand the leadership of a party securely in power is not compelled to maintain its position by dispensing favours or turning a blind eye. On the other hand accountability is likely to be weak if a party has an overwhelming majority in parliament and control over the civil service. The conclusion here seems to be that much depends on the leadership's willingness to tolerate corruption and here the signs are not good. The ruling party's commitment on governing with accountability in its 1994 manifesto[31] remain as yet unimplemented. It is hard to believe stamping out corruption is a government priority and its proposed independent corruption commission remains to be established. Yet this is what will have to happen if corruption is not to seriously undermine Namibia's economic future.

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