

S t u d i a i A n a l i z y
S t u d i e s & A n a l y s e s

*Centrum Analiz
Społeczno – Ekonomicznych*



*Center for Social
and Economic Research*

3 2 2

Vladimir Dubrovskiy

**Towards Effective Anti-Corruption Strategies in Ukraine:
Removing the Cornerstone without Toppling the Building**

Warsaw, March 2006



The materials published here have a working paper character. They may be subject to further publication. The views and opinions expressed here reflect the authors' point of view and not necessarily those of CASE. Author is solely responsible for any shortcomings.

The materials of this report were developed during the project supported by UNDP Ukraine. However, the analysis and policy recommendations contained in this report do not necessarily reflect the views of UNDP Ukraine. This report is fruit of a collaborative effort by a team of eminent authors. The UNDP Ukraine accepts no responsibility for any views presented here nor for any errors or misrepresentations contained in this report.



The Author is grateful to Bertram Spector, Jerry O'Brien, Eric Rudenshiold, Svetlana Winbourne, and Management Systems International for the inspiring discussions and useful literature; Marek Dabrowski for careful editing; James Cabot for improving of the language; and participants of the round table discussion 2.02.06 for the useful comments.

Keywords: **corruption, policy making, policy implementation, political economy, transition, governance, Ukraine.**

© CASE – Center for Social and Economic Research, Warsaw 2006

Graphic Design: Agnieszka Natalia Bury

ISSN 1506-1701

ISBN 978-83-7178-404-0 EAN 9788371784040

Publisher:

CASE – Center for Social and Economic Research

12 Sienkiewicza street, 00-010 Warsaw, Poland

tel.: (48 22) 622 66 27, 828 61 33, fax: (48 22) 828 60 69

e-mail: case@case.com.pl

<http://www.case.com.pl/>



Contents

Abstract	5
1. Introduction.....	6
2. Why does Ukraine need a framework for anti-corruption strategies?.....	6
3. Is corruption always vicious?	7
4. Who should be active in anti-corruption and why?	10
4. Why is corruption in Ukraine so persistent?	13
5. Why were the effects of anticorruption policies in Ukraine disappointing before?	17
7. How to fight systemic corruption?.....	20
7.1. The roots of corruption must be eliminated first.	20
7.2. Take the side effects into account.	21
7.3. Build a winning political coalition.....	22
8. Analytical framework	22
9. Policy implications.....	24
Application 1: Capture of the legislative process and extortion in legal enforcement	24
Application 2: Embezzlement in budget execution, collusion in procurement and regulation, and asset stripping (embezzlement and collusion) in state-owned firms.	29
Application 3: “Petty corruption”	33
Bibliography	36



Vladimir Dubrovskiy is a leading researcher and member of the Supervisory Board of CASE Ukraine. He holds an M.Sc. in Theoretical Physics (1985), has seven years experience in managing private sector business operations in various positions, to the level of CEO of a small firm. He has worked in consulting and business training, business software development, and economic policy analysis. Since 1997, he has worked at the HIID/CASE project on macroeconomic reform in Ukraine, and later became affiliated with CASE-Ukraine. His main areas of interest are institutional economics, political economy, microeconomics (primarily, economic behavior and performance of enterprises in transition), and interdisciplinary topics such as corruption, the driving forces for economic reforms, and so forth.



Abstract

The work presents a theoretical framework, and offers a tentative analytical framework for building strategies for combating systemic corruption of the kind that is observed in Ukraine. It argues that, as in some other countries undergoing the process of modernization, corruption in Ukraine plays an important social role by filling gaps between formal (often impracticable) rules, and informal ones. At the same time, it creates incentives and provides the means for maintaining and widening these gaps, as in the critically important case of “capture” of the state by extorting officials endowed with abnormal administrative discretion and affiliated with crony businesses. Systemic factors of such kind make corruption so persistent and anti-corruption so necessary for development.

Effective strategies should primarily address the real sources of corruption, and take into account the possible side effects. Otherwise anticorruption efforts can bring only limited success, and may even become counterproductive, as demonstrated in the examples of previous anti-corruption attempts in Ukraine. Meanwhile, prior to the Orange Revolution, systemic factors prevented the implementation of effective anticorruption strategies.

In order to facilitate the creation of anti-corruption constituencies, it is proposed to classify the corrupt deals as embezzlement, collusion, overtimes, and extortion based on the interests of involved and suffering parties.

Implications from this theoretical analysis are combined with some standard political-economic recommendations in the tentative analytical framework for policy making and public advocacy. As examples of its application, tentative anti-corruption strategies are suggested for some forms of corruption in Ukraine, such as capture in setting up legislation and extortion in its enforcement; embezzlement in budget execution, collusion in procurement and regulation, and asset stripping in state-owned firms; collusion and extortion in public services; and extortion in the public administration.



"Corruption can often more profitably be seen as one of many processes of political influence than as simply the misuse of office in violation of community norms."

Scott (1969)

1. Introduction

We present here a theoretical framework and offer a tentative analytical framework for building strategies for combating systemic corruption of the kind that is observed in Ukraine. Selected issues of corruption in Ukraine are analyzed from the perspective of the development of such strategies, and some solutions are proposed. We do not attempt to develop a comprehensive program, or propose a sort of “one-for-all” remedy. To be effective, the strategies should be as diverse as are the forms of corruption; and the development of such strategies for each specific sector requires the involvement of appropriate professionals. For this reason, we omit some important issues like corruption in the judiciary and criminal prosecution, and we only briefly touch on issues of corruption in health care and education, and so on. We hope that the proposed solutions for some specific sectors in which we possess relevant expertise can inspire professionals in other sectors to develop effective anti-corruption strategies in their spheres too.

2. Why does Ukraine need a framework for anti-corruption strategies?

A widespread view of anti-corruption efforts is that “the government ought to fight corruption more harshly¹”. At least until recently, most anti-corruption initiatives on the part of both the Ukrainian government and the donor community were concentrated on raising public awareness of corruption on the one hand, and catching-and-jailing selected scapegoats, predominantly among low-level bureaucrats or public sector employees, on the other. It was assumed that the anger of the people, if stirred by “public awareness” projects, would be transformed into the “political will to fight corruption seriously”, which, in turn, would substantially increase the risk of being caught and punished, thus reducing corruption.

However, achieving actual success in fighting corruption has been rather frustrating. The new government of Ukraine seems to be sincere in its commitment to fighting corruption, but the methods it pursues are known to be inefficient worldwide, especially in fighting systemic

¹ “Leadership at the highest level, rather than improved legal systems or increased citizen activism, is seen as key to fighting corruption” (The PTS Final Report)



corruption. Neither appeals to morale, nor “replacement of the corrupt officials with the honest ones²”, nor “catching and jailing corrupted officials every week” have proven to be really effective. Unsurprisingly, they have failed in Ukraine too. Moreover, even where some temporary success in fighting corruption has been achieved, its overall social effect has often been proven rather negative, as in the case of the “contraband-STOP” campaign.

We analyze the detailed causes of these failures in this paper. In general, “confronting corruption” is ineffective because corruption in Ukraine, as well as in many other countries, is deeply embedded into societal norms, practices, and structures. All formal and informal institutions have become used to corruption and adapted to it³, including the law enforcement agencies that are heavily corrupted too. Therefore, corruption in Ukraine is **systemic**. Consequently, to be effective and successful in the long run, a good anti-corruption strategy should not just directly address corruption per se by increasing punishment or improving enforcement, but instead focus on prevention, as well as “crowding out” corruption by less distorting and morally harmful mechanisms, performing similar social functions. All of the prominent scholars and consultants on corruption issues agree that prevention is the most or the only effective way to fight corruption⁴. Before starting to fight one must recognize the enemy, however. As long as corruption is a many-sided and systemic phenomenon, the question arises:

3. Is corruption always vicious?

Corruption as a social phenomenon exists to some extent in any state. However, as a rule, mature democracies as well as patrimonial societies with strong archaic traditions suffer less from corruption than countries “in the middle”, i.e. undergoing the process of modernization. For this reason some scholars conclude that corruption is a sort of “growing pain” unavoidable in a certain stage of societal development. Moreover, at such a transitory stage it can play a positive social role, sometimes critically important to the survival and development of the society⁵. We focus on two such roles, which are the most important for our consideration.

² Yushchenko’s program “Ten Steps Towards the People”

³ Paskhaver, 2006

⁴ For more arguments and evidence see, for example, the works of Spector (2005); Kaufmann (1998); Klitgaard et al. (2000)

⁵ “... in the 1960s and 1970s, a group of scholars saw a direct link between the modernization process and corruption and argued that “corruption seems to exist and thrive in countries at similar stages of development regardless of cultural differences.” (Ben-Dor 1974: 69) These “functionalists,” typified by Heidenheimer (1970), believed that corruption helped in social and political integration during periods of great social change, and it filled needs not met by official means. Leys (1965) and Leff (1964) both argued that bribes can, in fact, overcome the obstacles arising from inefficient bureaucracy, while Nye (1967) discussed how corruption can help political



First, at a certain stage of societal evolution corruption is one of the ways in which coercive force converts into capitalized wealth.

In a patrimonial state, capital is a relatively less important source of wealth than power and coercive force. Among other things, this makes the most powerful players uninterested in property rights protection, thus making capitalism impossible. If, however, these players use their power to accumulate wealth, they eventually⁶ become interested in its capitalization and, therefore, in property rights protection. But such conversion of power into wealth is considered, in many cases, to be corruption. In contemporary Ukraine this historical role of corruption has been mostly observed in the process of privatization.

Second, in times of rapid change, corruption fills the gap between formal and informal rules. In Ukraine this role of corruption is very acute and deep-rooted historically.

Formal rules often lag behind actual social practices (under conservative regimes, including the Soviet Union) or become imposed in an attempt to change human behavior (under authoritarian modernization, as of the kind undertaken by Peter the Great⁷, or later by the Bolsheviks). In both historical cases the large discrepancy between formal and informal arrangements have begotten too many lawbreakers to be effectively punished for breaching the law .

As a result, the state officials in charge of enforcement and implementation – and, hence, selection of the “scapegoats” – became endowed with unusually high personal power (*vlast'*) that exceeded by far any standard degree of administrative discretion. For this reason, in the Russian language even the word for a state official is “*nachal'nik*” (the boss), and the main work the bureaucrats are doing is referred to as “settling the problems” (*reshat' voprosy*). So, in fact *vlast'* fills the gap between formal and actual (informal) rules. The deeper this gap, the larger is the scope of *vlast'*.

We propose⁸ to call such an arrangement the “soft rule of law”, similarly to Kornai’s (1986) “soft budget constraint”. The *nachal'niks'* discretion is preferable to an attempt at full enforcement of impracticable and damaging legislation (“the severity of Russian laws is alleviated just by discretion in their enforcement”). But, as long as *nachal'niks* are endowed with *vlast'* anyway, corruption becomes “second best”, because it provides more or less efficient motivation for flexible enforcement. For instance, if firms can buy a waiver from an arbitrarily imposed punishment by bribing the *nachal'niks* in charge, then the most efficient

development by helping economic development ... Huntington (1968) argued that higher levels of corruption coincided with rapid social and economic modernization and helped to offset some of the destabilizing factors brought about by these rapid changes. He said that, even though corruption tends to weaken political development, it can also strengthen the political system by strengthening opposition parties and other institutions that otherwise lack access to a public life.(Marquette, 2004)

⁶ Although not necessarily directly – see, for example, Sonin (2002), Hoff and Stiglitz (2004)

⁷ As was explained by Volkov (2000)



would likely be able to survive. In the short run it is more efficient, as compared to a potential “corruption-free” order, under which firms, all of which have to breach the impracticable law as described above, would be punished randomly or totally.

Another important example is corruption in health and education. These services are declared to be free of charge according to the Constitution, which implies extensive budget funding corresponding to the high priority that the people give to these spheres. However, for reasons that we will not analyze in detail, officially set budget priorities were usually given to “national economy support” and to state capital investments. Besides, the existing system of provision of these services free of charge is inefficient. So, instead of contributing to the state budget with taxes, people pay for these required services directly but illegally. In this way citizens can obtain actually needed services of decent quality while still paying below free market prices. On the other hand, without such support, many doctors and teachers would lose their job motivation, which could result in the collapse of these sectors. Therefore, this kind of corruption fills the gap between the priorities set by the state, and the ones inherited in the society.

Therefore, **in many important cases corruption is not just a matter of poor morale but a matter of survival. Its elimination is barely possible without substantial changes in the economic, legal and social system. Moreover, an anti-corruption campaign may even be counterproductive if not accompanied by certain complementary measures aimed at the elimination of the real sources of corruption.**

The campaign known as “contraband-STOP” that was initiated by the government of Yulia Timoshenko may serve as a good illustration of the limited effectiveness of an anti-corruption campaign focused at corrupt practices, rather than their underlying causes.

The legislative basis for the State Custom Service was characterized by prohibitive import tariffs on the numerous categories of goods that would incur tremendous social cost if applied uniformly. According to the principles of “soft” rule of law the gap between official and actual (much more efficient!) arrangements was filled with numerous officially granted exemptions (like the ones for “special economic zones”), as well as unofficial waivers. Custom control is carried out on a selective basis everywhere in the world, otherwise it would take too much time and effort; so inspectors are endowed with large discretionary power. All together, these factors have created ideal circumstances for corruption.

The campaign was targeted mainly at smuggling. Meanwhile, no measures were undertaken to substitute corruption in its important social role of alleviation of inefficient trade policy. As a result, the overall initial outcome was negative. The import of goods was largely complicated and virtually stopped for several weeks; prices on many goods, primarily meat products,

⁸ Dubrovskiy et al., work in progress



increased; many firms went bankrupt due to the sudden change in the rules of the game; lines at customs increased tremendously; and so on. Eventually, smuggling was reduced only to the extent that tariffs were substantially lowered. Other articles, like meat, are still subject to massive contraband import.

4. Who should be active in anti-corruption and why?

The above-described “virtues” of corruption do not mean that corruption can be tolerated. Apart from its detrimental effect on public morale, corruption distorts incentives and leads to economic distortions that decrease social wealth, so its overall effect is rather negative, even in the short run (Shleifer and Vishny, 1993; Kaufmann and Wei, 1999, and many other studies⁹).

However, the net effect as well as the main winners (resisting to anti-corruption) and losers (most interested in fighting corruption) vary depending on the type of corruption and position with respect to the corrupt deal. We propose to break down the general phenomenon of “corruption” into four basic forms (though the lines between them are sometimes blurred), differing with respect to the interactions of involved parties, and immediate social consequences:

Embezzlement is basically a form of theft. It requires just one person with a clear antisocial interest in diverting public funds to private use. Most often such a crime requires accomplices, but all of them have exactly the same interests. The losers are usually very dispersed and unorganized as they constitute the taxpayers and recipients of state services, thus nearly the whole population.

Collusion is a deal between two parties, a seller and a buyer, in which both parties have positive incentives. Unlike a business deal, however, the corrupt one is essentially asymmetric. A buyer provides a counterpart with some money or other form of favor at its own (private) expense, in exchange for the favor that the seller provides, at least partly at the expense of society. Therefore, unlike business deals, collusion does not usually increase social wealth although with important exceptions (see below).

In petty corruption (health, education, communal utilities, et.) collusion occurs when an employee uses public facilities free of charge to provide private service. For example, a dentist in a public clinic has equipment and often some materials at his or her disposal that are assigned for providing free service to clients. They can also be used, however, for unofficial paid services to private clients at below market price. In fact, a client buying such a

⁹ Within this paper we do not provide a comprehensive literature review on corruption issues.



service colludes with the dentist in using public funds. On the other hand, these funds were anyway allocated for providing this kind of service. So, in the short run there is just a reallocation of public funds (which would be spent anyway) between a dentist and a client, with no direct harm to public. If a dentist demands payment, it may also be considered as a kind of extortion (see below). Still, such reallocation may be efficient because it alleviates the distortions caused by the low official wages of public sector employees, who do not have sufficient incentives to provide high-quality services. On the other hand, poor clients who should be granted services free of charge may be crowded out by those who are able to pay. In a public procurement process, an official in charge may collude with the bidder at the expense of the budget by accepting a suboptimal offer. Similarly, a taxpayer and a tax inspector may collude in reducing tax liabilities.

In the case of regulatory capture (or “state capture”) a businessman (or a group of businessmen) and a public official or politician collude in obtaining certain benefits at the expense of the public. It is “the perversion of the rules of the game, through corruption, to the benefit of the captors, rather than for society as a whole”¹⁰. In some cases, like protectionism and other limitations of competition, public losses may well exceed private benefits, which make such kind of corruption extremely costly for a society.

Another case of this kind is a firm preferring to pay off the inspection instead of compliance with some socially important regulations (environmental or customer protection regulations, for example). In this case, the net social outcome largely depends on the kind of regulation circumvented by means of corruption.

In the civic judiciary, collusion may occur between one of the interested parties and a judge. The other party loses from such collusion directly, while the whole society suffers from negative externalities, such as weak rule of law, mistrust in justice, and increasing inequality. In all of these cases the “buyer” and “seller” share some benefits at the expense of the public, often with certain positive or negative externalities. Importantly, for both parties directly involved in the deal it is a positive-sum game. Therefore, building a constituency against collusion should necessarily involve outsiders representing the suffering third party, like disadvantaged customers of public services. However, in this and other cases outsiders suffer from information asymmetry and coordination problems. Thus, effective strategies should involve the enhancement of transparency, the internalizing of externalities, and the facilitating of collective actions.

However, when a “buyer” pays for the circumvention of a socially inefficient regulation, society wins. For example, collusion between importers and custom officers in circumventing trade barriers increases social wealth (and may even partly offset the effect of state capture).

¹⁰ Anticorruption in transition. The World Bank, 2000



The main problem here is a thin and opaque line between “good” and “bad” regulations. In the above-mentioned example, there is no distinction between this “good” collusion and excise tax or VAT evasion, which is certainly a “bad” collusion.

“Overtimes” paid for additional efforts (for example, extra classes given by teachers; speed premiums for bureaucrats) result from voluntary deals, which – unlike collusion – seemingly occur not at the direct expense of the public. Thus, such kind of bribing may be efficient in many important cases. In particular, it may increase job incentives for the respective categories of public employees, and focus their efforts on the most efficient tasks.

However, such privately paid overtimes, to the extent they substitute regular salaries, may distort incentives to regular work. The worse the results of regular work, the more the need to pay overtimes, so employees become motivated to underperform their standard job tasks. For example, teachers offering informal and well-paid extra classes for underperforming pupils have a reduced motivation for helping them to catch up within the regular process, which constitutes an important part of their job task. In the extreme case where, say, all of the applicants for firms’ registration offer equal overtimes, they play a sort of “prisoners’ dilemma” game. Eventually, all of them will be treated exactly the same way as if none of the applicants pay a bribe. In effect, such overtimes become a form of extortion.

Extortion is a specific case, in which discretionary power based on some form of state monopoly (including the monopoly of coercion) is used to threaten a citizen or firm, in order to force them to pay off an extorter. Formally, extortion is a zero-sum transaction that occurs between two parties, so it cannot affect outsiders directly. In many important cases extortion done by bureaucrats or public sector employees looks similar to taxation, and may play an important role in securing descent income for these categories of employment.

However, unlike taxation, extortion is discretionary and secret. It also requires a “stick” that often does more harm than extortion itself. Uncoordinated extortion leads to overappropriation (“the tragedy of the commons”), with devastating consequences (Shleifer and Vishny, 1993). But an authoritarian arbiter that is required in some important cases to prevent such overappropriation can also suppress economic freedom, market competition, and abuse property rights (Dubrovskiy et al., in progress). All of these negative effects are magnified tremendously if the extorters “capture” the state through collusion with politicians or by forcing them to adopt decisions suited to extortion. Therefore, the resulting effect on public institutions, although indirect, can be large and even exceed the effect of embezzlement and collusion. Yet, this may be “efficient” in comparison to the use of force. As shown in the previous section, the enormous social cost of extortion may be still smaller compared to the case where the victim cannot “buy” a waiver, other things being equal.

Unlike the other cases, victims of extortion are well defined and aware that they are being extorted, so a constituency can be built through the collective action of the narrower group.



However, the victims will be interested in elimination of corruption only if the means of extortion are also removed.

4. Why is corruption in Ukraine so persistent?

If corruption is indeed a sort of “growing pain” it will disappear as a result of economic and social progress and a special anti-corruption effort will not be required. However, there is vast empirical evidence that corruption can hamper such progress: a country’s institutions become heavily distorted and the economy declines or stagnates for decades. If the gap between formal and informal rules becomes too large and persists, the corruption becomes entrenched and self-supporting. It can create systemic feedbacks, akin to Polterovich’s (2002) “institutional trap”¹¹.

The Ukrainian state used to be captured by the business-administrative groups composed of the extorting *nachal'niks* and big businessmen closely affiliated to them. This phenomenon is a key to understanding the nature of post-Soviet (and Ukrainian) corruption.

Soft rule of law makes every person or firm that is subject to certain laws or regulations a **client** of the respective *nachal'nik* in charge of their enforcement. *Nachal'niks*, in turn, have vast opportunities to blackmail their clients in order to compel them to give bribes – hence, to extort them. Discretion is also a source of rent for the firms affiliated with powerful *nachal'niks*. On the other hand, the same *vlast'*, as well as bribe income, may be used for other purposes, including to put pressure on the legislature by blackmailing MPs and businesses affiliated with them or contributing to their political campaigns (Karklins, 2002). As long as the voters remain manipulated, the local *nachal'niks* can use their *vlast'* for electoral fraud and manipulations known as the “administrative resource”, and thus provide direct support to politicians. Therefore, the *nachal'niks* have both stick and carrot, allowing them to influence the rules under which they should play. This ability clearly distinguishes them from the Weberian bureaucracy (see Table 1).

¹¹ It is worth noting that the particular example studied by Polterovich is not a good illustration of the theory we present. He argues that the vast but windfall rents begot by the, in his view, “too radical” liberalization of import in Russia in 1992 were partly invested in “state capture,” preventing the establishment of market institutions and the elimination of distortions that can generate rents; therefore, some more cautious trade and industrial policies would be more successful. However, this liberalization was undertaken mostly because the government was unable to enforce the old rules, and thus insisting on them would result in massive lawbreaking and corruption. Moreover, protectionism and industrial policy are much more likely potential sources of “institutional traps,” as they certainly generate concentrated rents that could be equally used for state capture.



Table 1: Differences between ideal (Weberian) and post-Soviet bureaucracy

Ideal bureaucracy (by Weber)	Post-Soviet bureaucracy (<i>Nachal'niks</i>)
Highly-paid professional public servants facilitating rational processes of control.	Poorly-paid public servants dependent upon administrative rents (in money or barter)
No decision-making power Implements legislation in a strictly formal (impersonal) way	Vast discretionary power. Relies upon discretionary power and vague and arbitrary informal rules
Operates under constant public scrutiny and political oversight	Controls politicians rather than vice versa. Tries to control mass-media to avoid public scrutiny
Operates under a clear-cut separation of powers	Possesses the political power to magnify ambiguity and non-transparency in legislation
Strictly controlled and separated from business	Uncontrolled and mostly affiliated with business

Unsurprisingly, *nachal'niks* use their power to shape legislation to maximize their power (*vlast'*) and to reduce their accountability, most often at the expense of social wealth. But, as noted above, *vlast'* of the *nachal'niks* is based not on the law but on its selective implementation and enforcement. Thus, they are interested in creating impracticable law – excessively severe, internally contradictory, ambiguous, incompatible with dominant social practices or even with technical constraints; not to mention opportunities for discretionary decisions, directly stipulated in the law.

This is the most important, although indirect, effect of **systemic extortion: it provides incentives and means for making legislation impracticable and, therefore, preserving and strengthening the basis for the whole system of *vlast'* as described above.** In such a way corruption becomes self-sustaining (this is the essence of the “institutional trap” in its application to this case).

On the other hand, as long as corruption alleviates the consequences of impracticable legislation, it reduces incentives for its improvement. For the victims of extortion, bribing in each particular case is an easier way of “settling a problem” than lobbying for better legislation, so even those wrong provisions that have been adopted accidentally or by mistake remain uncorrected. Thus, impracticable **legislation, discretion and corruption form a “vicious triangle”** that is very hard to break.

Besides, **corruption forms specific social structures that persist over time and not only conduct the corrupt practices but also resist changes which could diminish corruptive incentives.**

Under the weak (in particular, “soft”) rule of law, weak contract enforcement requires some alternative arrangements, most often special kinds of social networks (in the case of the former USSR – the so called *blat* networks¹²) able to reduce transaction costs. Under

¹² Reputation-based interpersonal networks of reciprocal exchange with “favors of access” (“*blat*” networks – Ledeneva, 1998) penetrated the whole Soviet society. Nowadays they still play important role as providers of corruption (Karklins, 2002, Ledeneva, 2000).



prevailing extortion such networks appear as a necessary defensive strategy used by people to protect their interests from *vlast'*. However, once these networks have emerged as a means of contract protection independent of the law, such networks may equally serve to circumvent any kind of legislation and facilitate any kind of unlawful deals, including corruption. Therefore, they eventually undermine and crowd out the rule of law necessary for a market economy (Litwack, 1991). This is dangerous by itself because such interpersonal networks are widely used for trafficking, money laundering, and even terrorism.

“Closeness” of corruption within the networks has a particularly negative effect on market entry. Any kind of extortion is an impediment to business since it increases the costs of doing business (so called “bribe tax”). While some firms have to pay significantly lower “bribe tax” because they are better integrated in the informal networks, entry becomes effectively restricted to the members of these networks. In particular, these networks are the main mechanism of “state capture” (Karklins, 2002; Hellman et al, 2000).

“State capture refers to the actions of individuals, groups, or firms in both the public and private sectors to influence the formation of laws, regulations, decrees, and other government policies (i.e., the basic rules of the game) to their own advantage by means of the illicit and non-transparent provision of private benefits to public officials. ... What separates state capture as a form of corruption from conventional forms of political influence, such as lobbying, are the mechanisms by which the private interests interact with the state. State capture occurs through the illicit provision of private gains to public officials via informal, nontransparent, and highly preferential channels of access. It can also occur through unclear boundaries between the political and business interests of state officials, which have been a particularly prominent characteristic of many transition countries. In all its forms, state capture tends to subvert, or even replace, legitimate and transparent channels of political influence and interest intermediation, reducing the access of competing groups and interests to state officials.”¹³

Under these conditions, big business closely connected to state authorities within business-administrative groups (BAGs) can benefit from participation in extortion (Sonin, 2002) and build its privileged position, largely reducing its business costs compared to possible competitors. Furthermore, many such self-selected *nomenklatura* businessmen are non-competitive on the free market. Thus, even being a victim of extortion, a business, which has its own stake in the system of extortion, may be interested in maintaining it, including its important components such as the “soft” rule of law and even weak property rights. This makes extortion so persistent.

On the other hand, as long as personal *vlast'* remains at the core of the whole system of state governance, it is very hard to remove or restrain it without at least a temporary



deterioration in the controllability of the state apparatus. Moreover, the weakening of *vlast'* in the hierarchical system of extortion can deteriorate the coordination of extortion, which may be devastating for business if not offset by some complementary actions.

Therefore, **corruption in certain cases can create powerful interests, social mechanisms and practices that make elimination of its roots difficult; this makes corruption self-sustaining.** Note that the roots of corruption are often more harmful than corruption per se. But none of the components of such vicious circles can be removed without breaking the whole circle.

A self-selection of corrupt individuals occupying respective positions is yet another source of persistence of both grand and petty corruption. For example, imagine that corruption in certain sectors (like health or education) is caused solely by low salaries: if the corrupt arrangement persists for a while, only those employees who can accept such rules of the game will remain working in this sector.

Of course, while some of them are “greedy” and will try to extort the unofficial payments anyway, others - the “honest” ones - play by these rules unwillingly. They would like to return to the normal way of work as soon as their salaries increase enough to provide them with a decent living standard. However, their clients (parents of the pupils, patients, etc.) must accept the same rules as well, and cannot distinguish between “greedy” and “honest” employees in advance, so they will offer unofficial payments to all of them and insist on their acceptance, as long as they believe that such payments increase the quality of service. Under these conditions even “honest” employees will remain corrupt. Besides, there is probably a psychological effect to this: it is very hard to break a moral norm for the first time but it becomes much easier when this “first step” has already been made.

Among other reasons for the persistence of corruption, we must mention some **cultural traditions** inherited from the patrimonial state and archaic societies, which are treated as corruption in modern societies. These are various kinds of gifts that were used as signs of respect, as well as nepotism, and some rather minor abuses of power, like using office cars for private purposes. The main problem with such practices is that they are deeply embedded into the culture. They are the most acute in traditionalist societies but in some cases (as with gifts to teachers and medical personnel; and minor abuses of privileges) they can be seen in Ukraine as well.

¹³ Anticorruption in transition. The World Bank, 2000



5. Why were the effects of anticorruption policies in Ukraine disappointing before?

The most obvious reason is that the authorities were not committed strongly enough to anticorruption, as noted above. As long as *nachal'niks* formed a patron-client hierarchy, it was plausible that the upper-most patron at the top of this hierarchy was “captured” enough to be motivated to preserve favorable conditions for corruption. However, this reason, even if true, is far from being sufficient.

First of all, under the “soft” rule of law any kind of **anticorruption policy will be ineffective until the rule itself is changed.**

According to Klitgaard’s (1988) famous formula:

$$\text{Corruption} = \text{monopoly} + \text{discretion} - \text{accountability}$$

As long as both monopoly and discretion are vitally needed for the exercise of the *nachal'niks*’ societal role, accountability remains the only system-compatible “degree of freedom” for any kind of anticorruption effort. For this reason, prevention of corruption in the post-Soviet countries is usually understood as mostly a matter of improving accountability. However, although sometimes needed and mostly useful, it does not touch the *vlast*’, which is a key to extortion.

Moreover, as long as corruption remains a part of the unofficial rules of the game, only some arbitrary selected low-level *nachal'niks* or public sector employees may be punished for corruption. Therefore, **any special anti-corruption law will be applied “softly”** and will, in fact, only reallocate *vlast*’ towards higher levels of hierarchy and law enforcement agencies. As a result, corruption usually wins. Most often, the only visible effect is an increase in the amounts of bribes due to an increase in “costs” (i.e. the share that should be transmitted to the top or to law enforcement) and risk. Of course, such an increase in “price” reduces “demand”, and hence to some extent can reduce the number of instances of bribing (but not the bribe tax).

However, in many cases such an effect is hardly desirable. For example, when extortion in a certain industry intensifies, firms that cannot afford higher bribes go out of business, competition decreases and the product and service prices go up until they at least partly cover the additional costs of extortion. Besides, **increasing risk further arrests corruption within its interpersonal networks**, which largely magnifies its distorting effects. Thus, **improvement of accountability may be counterproductive if it is not supported by more fundamental changes.**



Under weak civic institutions some people believe that dictatorship and totalitarianism can be the only remedy. This is a very controversial idea. As long as the authoritarian government has to rely on the *vlast'* of *nachal'niks* (and thus, extortion or clientism as described above), corruption will persist even if accountability is improved. Strong authoritarian regimes sometimes improve coordination of corruption (particularly, preventing “overappropriation”, resulting from uncoordinated extortion), and can succeed in fighting petty corruption. However, they are usually more vulnerable to high-level corruption, and can even become plutocratic.

The second reason is underestimation of the **systemic role and spillovers** created by the above-described **state capture** by the BAGs and the extorting *nachal'niks* in particular.

1. It undermines the rule of law, and in particular corrupts law enforcement, which largely reduces the efficiency of any traditional anti-corruption strategies based on punishment and enforcement.
2. The division line between “neutralizing” inefficient and deliberately impracticable legislation, and obviously harmful collusion is unclear.
3. It undermines public morale, therefore facilitating the proliferation of other types of corruption and provides an excuse for petty corruption
4. State capture is used for maintaining non-transparency, political monopoly, and discretion needed for embezzlement and collusion; it also stimulates non-transparency as a defensive behavioral strategy
5. It supports the emergence and maintenance of interpersonal networks of *blat* that facilitate any other kind of corrupt deals, including petty corruption.

For all of these reasons, there is little that can be done against corruption as long as the state remains “captured”. However, this phenomenon is very much persistent as described above. Fortunately, after the Orange Revolution the situation is no longer hopeless. But one should derive as many lessons as possible from the failure (or sometimes – only limited success) of the previous attempts against corruption.

Let us briefly analyze the anti-corruption strategies that were pursued in Ukraine from the viewpoint of the theoretical framework described above.

The very first Law of Ukraine “On the Organizational and Legal Basis for the Struggle Against the Organized Crime” of June, 1993 stipulated that the aim of this struggle is not only the elimination of organized crime but also “elimination of the causes and conditions [favorable] for the existence of the organized crime” (Article 2). Article 6 mentioned “discovering and elimination or neutralization of the negative social processes and phenomena that beget and facilitate the organized crime”. However, the later Law of Ukraine "On the Struggle Against Corruption" passed in October 1995 reduced prevention to the rules improving accountability



(still, due to some assessments of the legal specialists, these provisions are poorly written and generally insufficient).

The current Concept of Fighting Corruption for the Period of 1998-2005 places prevention ahead of punishment. It also contains several references to the excessive authority of the state apparatus, unjustified administrative discretion, unfavorable business climate, and lack of accountability and transparency as the causes of corruption. Some of these provisions were further developed: we should admit the limitation and partial ordering of inspections; implementation of simplified taxation for small and micro business; and some other measures that have indeed resulted in some decrease in corruption in the state-business relationships that plausibly took place by the year 2000 (see Figure 2). Still, in subsequent years corruption has increased again, so the Concept did not become a breakpoint in the overall trend.

In response to deteriorating trends, a few subsequent Cabinet and Presidential Decrees were passed¹⁴ that have also contained some provisions addressing the roots of corruption. However, these points were diluted among dozens of other articles. Under these circumstances, mostly the punitive measures that go in-line with the above-described traditions of soft rule of law are sometimes – selectively! – implemented; while the most needed laws potentially subversive to these traditions and the whole system of *vlast'* remain idle. For example, the Law on the State Regulatory Policy adopted in 2003, obliging any government body to expose all of the drafts of regulatory acts to public discussion, is widely ignored by state authorities. We attribute this phenomenon to the same soft rule of law, which largely reduces the effect of any kind of legislative anti-corruption barriers that contain certain requirements to the officials.

However, in most cases “prevention” is associated with exactly this kind of measure. No doubt issues like the precise definition of a corrupt deal, the definition and resolution of conflicts of interest, control over the incomes of state officials, and so forth are important and should be stipulated by the law as soon as possible. But under the soft rule of law, these measures will, most probably, remain insufficient, thus having little, if any, systemic effect. Moreover, when increasing accountability is not packaged with a substitution of corrupt income with legal income, it threatens the deterioration of the important social functions that bureaucrats carry out. Last but not least, it is also very hard, if not impossible, to build a winning political coalition in support of such measures as long as *nachal'niks* maintain their *vlast'*, especially in terms of their influence – on the legislature. This factor also obstructs

¹⁴ The Decree of the President of Ukraine “On The Measures on Securing Support and Further Development of Entrepreneurial Activity” (906/2000) of July, 15, 2000 amended by the Decree No. 477/2004 of April, 24, 2004; The Decree of the President of Ukraine “On the System of Measures Aimed at Removal of the Causes and Conditions that Facilitate Criminal Acts and Corruption” (175/2004) of February, 9, 2004 amended by the Decree



improvement in transparency that is critical for the prevention of embezzlement and corruption in the process of public procurement.

The current strategies for combating petty corruption in health and education also tend to underestimate its actual social role in providing job compensation to employees.

7. How to fight systemic corruption?

7.1. The roots of corruption must be eliminated first.

Ironically, the considerations presented above suggest that in order to be effective, an effective anti-corruption strategy should not focus primarily on “fighting corruption” per se. Instead, the main effort should concentrate on measures to eliminate its institutional roots, searching for less distorting mechanisms of regulation and self-regulation able to “crowd out” corruption, or simply legalizing the accustomed social practices if they are less distorting and costly for the society than attempts to eliminate them.

According to the best international experience, deregulation and simplification of rules and procedures are the most effective corruption-prevention measures in relations between the government and the private sector. Unfortunately, as these policies (simplification of taxation for small business, abolishment of mandatory certification and licensing of some activities, ordering of inspections, etc.) were not primarily targeted at anticorruption, no monitoring of their impact on corruption was conducted. But some indirect and anecdotal evidences suggest that these measures have essentially reduced corruption in these spheres. For example, the recent experiment with implementing a “one-stop-shop” in order to obtain business permits (BIZPRO, 2005) has reduced the number of applicants reporting the paying of bribes to the respective offices by half or more in most cases¹⁵.

In the above-described case of “contraband-STOP”, the government has proposed - better later than never! - trade liberalization that has narrowed the gap between formal and actual rules. We have to admit that the crisis caused by the “contraband-STOP” campaign has helped in forming a winning political coalition that has successfully overcome the pressure of protectionist lobbies representing many important industries. The trade liberalization did not include, however, such crucial products as meat, sugar and cars (especially used ones). Along with other factors, liberalization contributed to legalization and some increase in

No. 266/2004 of March, 3, 2004; The Decree of the Cabinet of Ministries of Ukraine “On the Approval of the Program of Development of the State Service for the years of 2005-2010” No. 746 of June 8, 2004.

¹⁵ Interestingly, in the towns where corruption was initially high, it has been substantially reduced; while in the single case where it was initially low it has somewhat increased. The authors of BIZPRO report attribute this paradox to the effect of change in the rules of the game, which was offset, in the other cases, by their substantial improvement.



imports, reflected by an increase in fiscal revenues. Therefore, the combination of punitive and “crowding out” strategies has proven to be eventually effective. However, the social cost could be smaller if they would be undertaken simultaneously.

As a side effect, trade liberalization should have reduced collusion in circumventing VAT on imported goods. However, for some kinds of goods the elasticity of demand is so high that this makes the premium for VAT avoidance big enough to counterbalance the risk associated with corruption. Thus, tax corruption has remained, although at a somewhat reduced level.

In the case of culturally rooted corruption, anticorruption efforts may lead to an increase in the gap between formal and informal rules, and thus to a proliferation of the “soft” rule of law. Such a cost may be too high, compared to potential benefits. For example, as long as everybody is obliged to bring the traditional gift, and this is implicitly assumed in the remunerations of respective categories of employees, the distorting effect of this practice is probably smaller, compared to the expected costs of elimination of this kind of petty corruption. The best way of coping with detrimental moral effect is legalization of such small gifts or abuses, just as in the case of restaurant tips. The legalization could help clarify the distinction between legal and illegal behavior, thus making the definition of corruption sharper.

There are also some more radical measures that can completely eliminate the very grounds for this kind of corruption. For example, the deeply accustomed tradition of gifting dentists in public health care becomes legalized in the commercial clinics where a patient simply pays for medical treatment. Commercial firms legalize the private use of “official” cars by leasing these cars as part of job compensation to employees who need them for executing their job tasks.

7.2. Take the side effects into account.

Anticorruption strategy, as is the case with any kind of policy, can have various side or external effects that should be taken into account in the process of their design. For example, the methods of implementation of the above-mentioned “contraband-STOP” led to delays in custom clearance of the cargos, which imposed additional high (and in many cases prohibitive) burdens on importers. So, even those who did not use corruption for circumventing the tariffs have lost from this campaign, and therefore became its political opponents. On the other hand, in the years 2000-2001, a ban on mutual settlements and barter in budget and tax settlements, as well as similar measures in the energy sector, has increased the demand for money and allowed for the rapid re-monetization of the Ukrainian economy, which, in turn, has strengthened the banking system.



7.3. Build a winning political coalition

As in other cases, it is generally a bad idea to implement any policy without confidence that this attempt will succeed. A failure usually discourages voters or participants in a collective action, complicating subsequent attempts. This question is not specific to anticorruption campaigns, however, and thus is not the subject of detailed analysis in this paper.

8. Analytical framework

Based on the above-described theoretical frameworks, we can formalize the process of analysis of certain kinds of corruption and the development of effective anti-corruption strategies as follows:

Step 1: Identifying the roots of corruption and devising core actions.

1.1. Institutional:

Are there any circumstances that beget this kind of corruption or make the corrupt behavior rational?

Yes \Rightarrow focus on the primary causes first (apply this framework); if this is impossible then be aware that success may be very limited in its duration and magnitude

1.2. Cultural:

Are any specific cultural norms associated with this kind of corruption or its primary causes (e.g. gifts or expressions of gratitude)?

Yes \Rightarrow legalize, to the extent possible, the least distorting among the accustomed and widespread practices, make a clear-cut distinction between them and obviously illegal practices; then focus on the latter

Intermediate result: plan of core actions

Step 2: Identifying side effects and devising supplementary actions

2.1. Which kinds of side effects will the proposed measures create? Who are the tentative winners and losers from these effects?

2.2. Does this kind of corruption play any important social role? Could it be the case that certain important social functions will become non-performing should this kind of corruption be eliminated, other things being equal?

Yes \Rightarrow



- Put forward a substitute arrangement, most appropriate for Ukrainian conditions (there should be a good choice between ones working decently around the world) and make necessary preparations for its implementation
- Ensure that core and supplementing strategies can be introduced simultaneously in a package

Intermediate result: the tentative policy package

Step 3: The political economy issues:

- 3.1. What kind of constituency can be built to oppose this kind of corruption?
- a. What type of relationships between the parties to the corrupt deal (embezzlement, collusion, overtimes, or extortion) is most applicable to the case in question?
 - b. How are the victims of this kind of corruption organized?
 - c. How are they represented politically?
 - d. Can the proposed policy package be presented in a politically appealing style that could attract more votes?

Which kind of action is more feasible and effective: facilitation of a collective action (e.g. strike), or strengthening of political representation (e.g. including the respective priorities into the party programs)? Or, in which proportions should both methods be used?

- 3.2. Who is interested in preserving this kind of corruption?
- a. How are they organized?
 - b. How are they represented politically? Are they strong enough for “capturing the state” (defining the rules they play by)?
- Yes ⇒ Where is the weakest link in this vicious circle (e.g. the triangle described above)?

3.3. What are the possible legal impediments (e.g. provisions of the Constitution) that can be hardly overcome or circumvented in a lawful way?

3.4. Is the pro-reform political constituency stronger than the interests behind corruption?

No ⇒

- Determine politically feasible steps that can strengthen pro-reformist interest groups and weaken the opposition to reforms
- Be ready to seize any unexpected political opportunities (have law drafts and plans of action prepared)
- Wait for the right moment



Final result: the “road map”

9. Policy implications

Application 1: Capture of the legislative process and extortion in legal enforcement

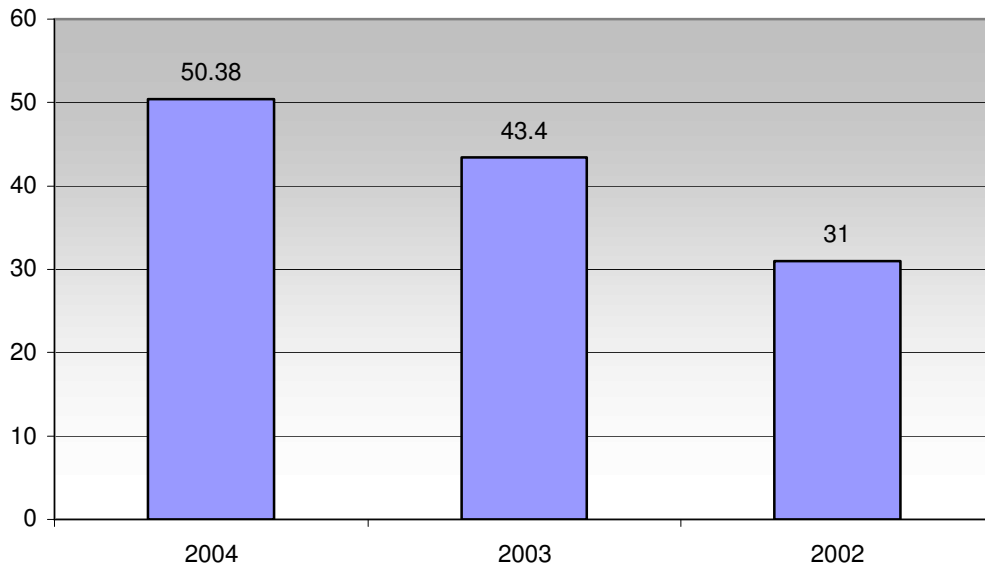
This seems to be the most distorting among all the forms of corruption considered in this work due to its detrimental effects on the overall rule of law and quality of legislation. In this phenomenon the line between “petty” and “grand” corruption is sometimes blurred due to the hierarchical organization of corruption (as in police and customs service). This type of corruption is most severe in **state-business relations**, where it plays the most important role. Business is primarily affected by large-scale extortion because it is considered a lucrative target. On the other hand, “state capture” is, by definition, a state-business collusion.

Among the individual respondents surveyed by the Partnership for a Transparent Society program (PTS)¹⁶, more than 43% had to give a bribe in 2003 (see Figure 1), which is high by any standard. However, comparison of these general data with sectoral data may suggest that most of these respondents meant bribes given in health, education, and public utilities, hence unrelated to the issues of regulations and their enforcement. At the same time, among the entrepreneurs surveyed by IFC in the same year (more recent figures are currently unavailable) as much as 72% not only had to give bribes but considered corruption as a very high impediment to their business. Virtually every business firm (with very few exemptions) has to participate in some kind of corrupt activity, which, however, do not necessarily take the form of explicit bribery.

¹⁶ The PTS Final Report

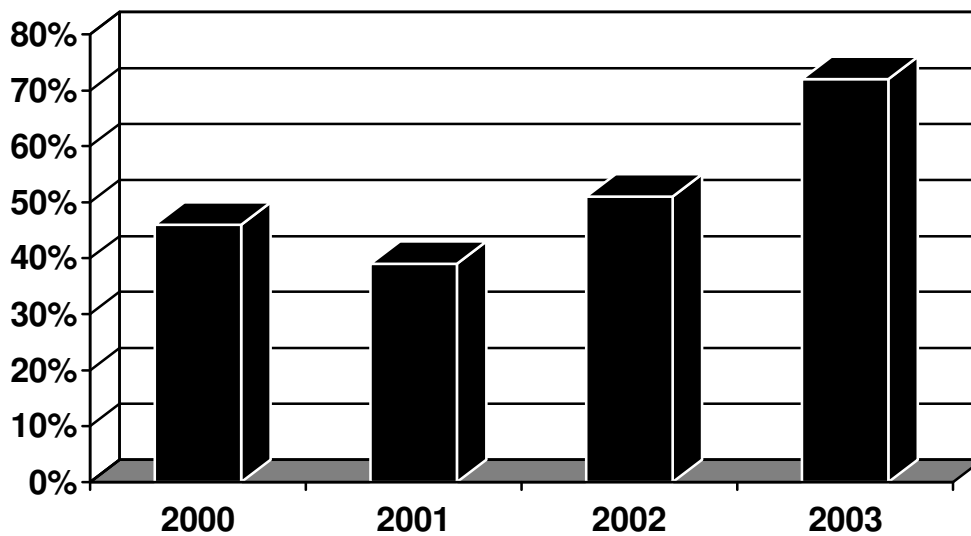


Figure 1. “Did you personally (or your relatives or friends) give a bribe during the last year?, (percentage of those who gave a bribe)



Source: PTS report

Figure 2. Corruption perceived as a high or very high barrier to business activity



Source: IFC annual business survey

Remedy suggested

Step 1. Impracticable legislation can be seen as the main cause of persistent extortion. So an effective strategy against this type of corruption should be based on deregulation, as well as on simplification and clarification of the remaining regulations. We just emphasize that in the case of Ukraine, as long as systemic corruption and soft rule of law are not eliminated, priority should be given to simplicity and straightforwardness of norms that would minimize any kind of discretion, as opposed to sophisticated norms, even if the latter are theoretically justified. What may be more controversial, we argue that in many cases the formal norm should be made closer to the common practices, even when it is considered improper. The actual cost of such compromise is smaller than it may appear because under the soft rule of law there is no reason to expect that sophisticated formal norms will be duly obeyed and can be enforced at reasonable social cost. Simplified taxation for small business and trade liberalization are the best examples of a successful approach; now there is time to change the Law on Enterprise Profit Tax, and many others. The causes of corruption will be addressed through depriving *nachal'niks* of *vlast'*, which is their tool of extortion.

Small gifts should be decriminalized, as long as they remain a common practice. However, informal relationships between business, on the one hand, and enforcement and regulatory authorities, on the other, should be discouraged to avoid collusion. The usual ways of doing this are (i) depersonalization (for example, reporting via mail or Internet), and (ii) rotation of personnel in touch with business. However, to be effective, depersonalization requires dramatic simplification and clarification of the rules, accompanied by massive training. Rotation under the soft rule of law can largely increase the cost of doing business and its



risks. In 2002, 44.7% of surveyed managers “perceive changes of representatives of public authorities to have a significant impact on business success of their firms” (Akimova and Kuziakiv, 2003). Here we have to reinforce Step 1.

Step 2. Given the role that organized extortion plays in the informal organization of state governance, it should be replaced with some other mechanisms, primarily democratic institutions. Fortunately, these are formally already in place. Another social role of extortion, namely providing state officials with a decent living may be substituted, in an obvious way, by increasing their salaries – which, however, may become politically cumbersome.

The most important expected side effects – would be a strengthening of the rule of law, decriminalization of business, and increase in competition (thus, decrease in prices). They are socially important but the potential winners are mostly dispersed, so their collective action is unlikely to happen. On the other hand, the final outcomes are politically attractive, so are likely to be employed by political forces. However, the link between extortion of business by *nachal'niks* and these potentially popular outcomes are not straightforward, so the respective outcomes may benefit political forces *ex post* but can hardly be used as electoral mottos *ex ante*.

Another important side effect is a decrease in opportunities for state capture – which may beget powerful losers. As described above, big business is not interested in the elimination of extortion as long as it belongs to the BAGs. Until recently, the position of big business (dominating the Ukrainian economy) obstructed anti-extortion efforts. Due to this reason, a similar kind of analysis should be made with respect to “**state capture**”.

Step 1. Its main cause is similar to extortion, namely discretion (*vlast*) of *nachal'niks* unchecked by public oversight. The latter factor seems to be essentially weakened as a result of the Orange Revolution, which increased the chance of building a winning coalition aimed at changing the legislative basis for both extortion and state capture despite the powerful interests behind the “soft” rule of law.

Step 2 boils down to the nexus between extortion and state capture that was already discussed above.

Thus, from a political economy point of view a chance to break the extortion/“state capture” network of interests looks as follows. A “pro-reform” constituency may be built from those who suffer from extortion more than benefit from state capture: mostly small and medium business not belonging to the local BAGs, and foreign investors. Wide pro-democratic and even populist forces would support the fight against “state capture”. Although populism implies extortion as well, and thus should not be supported, at the initial stage it can help in reducing state capture. Decrease in state capture alters the cost-benefit balance of “soft” rule of law for large domestic business, so we can expect an evolution of BAGs into normal financial-industrial groups, with the result that they join the anti-extortion constituency. The



threat of populism can also play some positive role in making big business supportive of the rule of law and strengthening property rights, as long as their selective protection becomes unreliable.

Such a constituency represents a minority of the population. However, as long as the issues of business regulation do not directly affect the interests of larger groups, they may stay neutral. In the meantime, the same policies (primarily aimed at the improvement of legislation) can be pursued with regard to the rest of the regulations, thus benefiting wider categories of voters. Besides, they will be assessed *ex post*, due to improvement in economic performance and competition.

Moreover, if complementary policies for partial compensation of public officials are well-designed, one can expect that a considerable part of state officials will prefer regular and risk-free official salaries than to continue to earn higher income from corrupt practices – and thus they will support the respective reforms.

The anti-reform forces were mostly described above. There is a good chance that the balance of attitudes to many corruption practices has been already changed in favor of anti-corruption. This means that the main problem now has a technical character: too many pieces of the existing legislation must be changed. To perform this uneasy task we propose the following approach:

- Put in place a **filter to screen new legislation**. The draft law “On the Criminological Expertise of the Legislative Drafts” that is currently under consideration by the Verkhovna Rada may provide part of a mechanism for such a filter, if issues like discretionary power, impracticability or selective enforceability can be considered criminogenic factors, since they beget corruption. Similar kinds of expertise can be performed by civil society institutions, especially ones representing the business community, and political parties seeking the support of entrepreneurs.
- Based on **feedback from the victims of extortion**, one may define the **most problematic areas** of legislation and develop respective propositions; then offer them to the authorities and political parties.
- Concentrate the efforts of **non-governmental anticorruption organizations** on **implementation monitoring of the laws** aimed at anti-corruption prevention (as the Law on State Regulatory Policy) rather than particular cases of corruption themselves.



Application 2: Embezzlement in budget execution, collusion in procurement and regulation, and asset stripping (embezzlement and collusion) in state-owned firms.

Collusion in procurement and embezzlement in budget execution are widespread, but hard to estimate in terms of size and effects. Indirect measures of the World Economic Forum's CEO survey (GCR) suggest that, at least in the sphere of procurement, the perceived extent of corruption in Ukraine is not extremely high, compared to the rest of the countries covered by this study. In 2005 the country was ranked 47 out of 114 countries, ahead of Hungary and Poland. However, this may be just a recent achievement, or merely an effect of post-revolutionary euphoria (the survey was conducted in spring 2005), because previously the same rating was 61 (2003) or 62 (2002) in a smaller sample of countries.

According to a report of the Accounting Chamber of Ukraine, about 7.5 billions of UAH were "misused" or "used inefficiently" in 2004, which constitutes around 8% of total **budget expenditures** or 2.17% of GDP¹⁷. This does not mean, however, that all of those funds were embezzled. In some cases they were spent for purposes different from the ones stipulated in the budget; in some other cases violations in procurement procedures were found; frequently budget funds were used to provide some business firms with a sort of zero-interest loan; and in some cases the budget funds were just not used in a timely fashion. In most of these cases the net amount of actually diverted public funds is a small portion of the "misused" ones. Besides, the misuses are often caused by poor management rather than corruption. On the other hand, discovered violations may constitute just a portion of the actual ones. As was reported by the media, very large abuses were discovered after the defeat of Yanukovich at the Presidential elections of 2004. Therefore, the total amount of damage from direct embezzlement and abuses in procurement can be roughly estimated as a few thousandth of GDP – which is still up to a billion UAH annually.

Fraud in VAT reimbursement for fake export is another source of large-scale embezzlement. Estimates for the volume of such fake export deals vary widely. Fraud in the amount of a few hundred million Hryvnias has already been proven in the courts, while the amount estimated by the Security Service of Ukraine (SBU) was five billion Hryvnias in 2004, which can be considered as an approximation for the upper boundary of the volume of fake export. Based on current VAT rates, one-sixth of this would be subject to fraudulent VAT reimbursement, hence embezzlement.



The **state-owned firms** seem to be the most important source of this kind of corruption. The government as their nominal owner receives just tiny dividends (240 million UAH in 2004). Meanwhile, after privatization just one former SOE – Krivorizhstal’ – reported obtaining UAH 1,864 millions¹⁸ in net profits, of them 35% paid as dividends, which totals more than UAH 650 millions. One can hardly believe that the efficiency of a steel mill could increase to such an extent within one year without any substantial restructuring. State-owned monopolies such as UkrZaliznyts’ya, NaftoHas, Khlib Ukraini, UkrEnergo, and others created under former president Kuchma’s rule, are frequently accused of large-scale asset stripping, embezzlement, abuses of monopoly power, and using state-owned assets under their control for private benefit. Hundreds of millions of Hryvnias allegedly came as political contributions from Ukrainian Railways (UkrZaliznyts’ya) and some other state-owned monopolies to the Yanukovich campaign. Unfortunately, very few, if any, of these accusations have ever been proven or denied in court.

Taken together, all these forms of corruption plausibly amount to more than one percent of GDP. Their distorting effects, however, go far beyond this amount:

- Corruption leads to a misallocation of budget expenditures from the most socially efficient use to sectors more vulnerable to corruption (e.g. from social aid to construction and other kinds of capital investment), as well as the inefficient use of funds within these sectors.
- Embezzlement and corruption in procurement undermines the motivation for tax compliance, thus promoting tax evasion and avoidance, corruption in taxation, etc.
- Corruption in the state-owned industrial sector supports the payable political demand for non-privatization and preservation of inefficient management.
- All of these forms of corruption create payable demand for non-transparency and other factors of inefficiency in the public sector.
- Inadequate VAT refund schemes affect honest firms and become the leading barrier to export with almost 70% of respondents¹⁹ (among exporting firms rating customs procedures as a barrier to business) reporting that they had to make unofficial payments in the process of VAT refund²⁰.

¹⁷ In 2003 the same indicator constituted about 2.71%, in 2002 – 2.3%

¹⁸ Utro.ru, Nov.7, 2005. <http://www.ukrrudprom.com/news/nkrivoroj100106.html>

¹⁹ IFC, 2004

²⁰ As recently was reported by Yuri Yekhanurov, the Prime Minister of Ukraine, this problem is considered mostly solved. Of course, these recent developments could not be reflected in the earlier survey.



Embezzlement and collusion in procurement: Suggested remedies

Step 1. Unlike previous cases, there is no factor making this kind of corruption inevitable or country- specific. Instead, as in any other country, the officials in charge of spending public funds face temptation, which is more or less balanced with the risk of being caught multiplied by the severity of punishment. Thus, in this case improvement in enforcement and punishment can be relatively more effective as compared to the other types of corruption under our consideration. In particular, here measures like publishing income declarations, assessment of estates owned by officials, etc. can be relatively more effective.

The problem, however, is that the “broad public,” which has to act through the government as its agent, is the main loser from this type of corruption. But the embezzlers are much closer to this “agent”, and often have personal links to the particular person in charge of law enforcement, who is often corrupt. So, it is a matter of fact that given the pervasiveness of this form of corruption, enforcement and punishment become subject to the “soft” rule of law. Therefore, transparency in possible or alleged **results** of corruption (the unjustified income) is not enough. Even though it makes collusion between law enforcement and corrupt officials less likely, as long as the process of control is restricted to a single General Prosecutor’s office, those having good personal connections to particular officers through the *blat* network of *nomenklatura* can feel relatively safe. Thus, the first and most obvious measure is to break the current monopoly of the General Prosecutor’s office of investigating criminal violations conducted by high and mid-level state officials by allowing other law enforcement agencies to prosecute such kinds of crimes if they have discovered them. Still, even if few other law enforcement agencies become potentially dangerous for the embezzlers, prosecutors will have to coordinate their efforts, and thus could be prevented from interference in some cases.

We argue that exposing the process of budget execution to wider control by means of e-government can dramatically reduce this kind of corruption. For this purpose, we propose to develop a computer system that would automatically upload copies of all documents related to the execution of budget spending (including commercial contracts, payment orders, etc.) onto a special website; and make the uploading of scanned copies of paper documents mandatory. Such a system should be used at the State Treasury, with possible further extension into other institutions (Ministries, State Committees, etc.) responsible for the allocation of public funds. It should be also extended to the State Pension Fund and other social funds based on mandatory contributions; and to state-owned enterprises.



This would allow the higher state authorities, as well as civic organizations, mass media, and private firms suffering from corruption (e.g. being discriminated against in procurement) to monitor budget execution. In such a way this part of e-government would make the threat of exposure instantaneous, and deprive potential embezzlers of any source of influence on mud-diggers. The same computer system could be used for procurement tenders as well.

Step 2. Just as in other cases, corruption provides officials with decent income, so anti-corruption policies should be complemented with an essential increase in their official income.

The above mentioned computer system, if implemented, would substantially increase the internal top-bottom accountability of the executive. On the other hand, it would benefit honest officials because audits could be made non-intrusive and distantly performed. The auditing authorities, in turn, could work more efficiently and save on travel and accommodation costs. These virtues suggest that additional and crucially important allies can be found within the state bureaucracy.

Besides, such transparency would increase competition in procurement. Among other virtues, this may motivate firms currently discriminated against in public tenders to join a pro-reform constituency.

Among the risks, we should admit the possible abuses or incorrect use of information by politically engaged non-professionals and other aggressive but irresponsible actors. Some complementary measures should be developed in order to protect honest bureaucrats from false accusations based on real documents.

The following parties may be potentially interested in the implementation of a new system:

- broad public (represented by civic society institutions and political parties)
- mass media interested in trustworthy sources of potentially acute information
- organs of financial control
- low-level bureaucrats (as of now, unorganized and not represented)
- private sector (currently represented by the business associations, which have not focused on this topic yet).

The opposition consists of corrupt officials and their collaborators from the private sector. It is formally unorganized, but possesses vast political and financial assets that will be used to maintain the status quo.

The balance of power with respect to this proposition is hard to predict. In order to increase the chances of success, it could be useful to unite potential supporters among the low-level bureaucracy under the motto of support for non-intrusive audit and higher salaries.



Embezzlement in state-owned enterprises: Suggested remedies

This is a typical principal-agent problem that should be resolved by the elimination of asymmetry of property rights. The enterprises that cannot be privatized soon should be treated similarly to public sector entities (see above). Among all, such treatment will provide their management with incentives to privatization, thus reducing resistance. Besides, privatization, most probably, would improve the efficiency and economic performance of these enterprises. Pros and contras, as well as supplementary measures, should be considered in each particular case.

Application 3: “Petty corruption”.

Private price setting for publicly provided services, formally free of charge (extortion), “grease money” (overtimes) and using public facilities for providing these services privately (collusion) are widespread in the health sector (identified by 32.7% of respondents as the most corrupt sector²¹), education (15.2% respectively), and communal utilities (15%), and probably in other public services (not asked for in the quoted survey). Although it is “just petty corruption” mostly caused by the understandable reason of low wages, the overall distorting effect may be considerable due to the following:

- These are the most widespread corrupt practices, thus manifesting and enhancing overall tolerance to corruption.
- Erosion of professional morale of the employees opens the way for proliferation of really criminal activities such as issuing fake diplomas and medical certificates. As for other kinds of “gray” activities, minor violations of law make more substantial ones psychologically easier.
- Although the illegal payments secure at least basic job incentives for the employees, their structure is inadequate.

Particularly, in addition to general problems brought about by collusion and overtime, corruption magnifies the conflict of interests that teachers and doctors traditionally have in their work. Usually teachers are responsible for evaluation and teaching at the same time; and doctors should perform both diagnosis and treatment. Therefore they have, in fact, to evaluate their own work, or to define its priorities. Such double tasks require very high professional ethics, which is undermined by corruption. While having a corrupt incentive structure, teachers become interested in an unfairly low assessment of the wealthiest pupils

²¹ Here and after in this paragraph – according to the survey made by Partnership for a Transparent Society program, 2003. The PTS Final Report



in order to compel their parents to purchase extra classes; doctors become motivated to diagnose fake diseases and prescribe unnecessarily expensive treatments, etc.

Deterioration in the quality and availability of health and education harms human capital, which has been so far the major competitive advantage of Ukraine. Extortion in the public administration undermines the legitimacy of state authorities and democratic institutions.

Extortion in the public administration: Suggested remedies

Just as in the case of “large” extortion, a reduction in discretion is the most effective anti-corruption measure. However, unlike systemic extortion, with respect to petty extortion Klitgaard’s (1988) famous formula (Corruption = monopoly + discretion – accountability) applies in full, with direct practical implications.

An increase in the number of service facilities (for example, the number of cross-border checkpoints), state or private agencies authorized to provide registering and certification services, etc. can substantially decrease extortion.

Implementation of universal tests (as currently done by the Ministry of Education) and unification of requirements is a general way of reducing discretion. However, practical implementation requires a great deal of creative thinking needed to eliminate the opportunity for discretion, for example in the process of testing. Besides, as in the case of business regulation, the requirements should not be put so much above the current level that such discretion would be treated as a mercy.

Accountability can be improved by the so called point of service exit surveys (POSES) that every client of public service should be able to fill in and send free of charge via surface mail or the internet (Hellman, 2002). This kind of survey is widely used in the marketing of various services to facilitate feedback from clients. As a first step, we propose to put boxes full of survey postcards at the exit of every administrative building, while civic society organizations and state authorities would be charged with verifying that these boxes are not damaged nor empty. However, such postcards should not be made anonymous in order to avoid abuses. In certain specific but important cases when clients are registered anyway, or receive obligatory forms to fill in (as in the customs), the form can be amended with a short survey printed on the same sheet of paper, while the form should be void unless this part is cut off.

To the extent that petty extortion is used as a specific form of “tax” allocated to certain categories of public employees in order to provide them with decent work compensation, and hence secure job incentives, it should be substituted with an increase in official salaries.

In all these cases, the victims of extortion are natural allies, and the extorters are the opponents of anti-corruption policies. The better the political representation of the former, the



more successful will be anti-corruption policy. Thus, the strengthening of civic organizations should be especially effective in fighting petty extortion.

Collusion and extortion in public services: Suggested remedies

Petty extortion in the health and education sectors was initially caused by the necessity to compensate employees for the lack of budget funding. It played (and to some extent continues to play until now) a vitally important social role by alleviating distortions in budget planning, particularly by providing additional compensation to employees and funding the maintenance of premises and equipment, purchasing materials, etc. It was also a continuation of the old tradition of gifting, which was widespread in these sectors.

Collusion, although sometimes similar to extortion (see the above example of the dentist), should be rather considered as a specific sort of principal-agent problem, thus attributed to the allocation of residual property rights (although the issues of discretion and accountability are still sensitive).

Thus, **privatization** (or at least commercialization) is the best way of coping with both problems. It legalizes and institutionalizes payments for services, largely alleviates the principal-agent problem, and stimulates efficiency. Medical insurance and student credits should be put in place to enable payments for medical aid and college/university education. Subsidies are necessary but they should have a strictly targeted character and their size should be in line with the available public resources and priorities.

The **communal utilities** sector is already half-way to such an arrangement, with most subsidies provided either on an address-specified basis, or in the form of subsidized input (mainly, gas) that cannot be technically allocated to other needs. The process of privatization is ongoing and hopefully will speed up in the course of the reforms announced by President Yushchenko.

It seems that the **health and education** sectors should follow this way. As of now, there is a deep gap between fully subsidized public entities and the private ones that not only receive zero subsidies but also have to pay taxes (with some exemptions) for the same services they provide. At the same time, public schools and hospitals used to collect “gray” payments that are smaller than the fees paid in the private sector but collected unofficially (thus cannot be covered by insurance, financed by credit, or deducted from the tax base) and spent in a non-transparent way. Tuition fees are legalized in most public universities but this practice was condemned as contradicting the Constitution of Ukraine. However, subsidizing talented students with grants (possibly also taking into account the income status of their families), and compensation of bank interest for specialized education loans would be a much more efficient and fair way of providing the same amount of subsidies.



Overtimes stem from the inefficient incentive structure for state employees (see the analysis above). Respectively, they should be institutionalized and legalized in the form of voluntary speed or quality premiums that should be converted to bonuses for employees performing overtimes. However, just as in the case of unofficial overtimes, the legalized ones cannot destroy normal job incentives and become a sort of covert extortion. Therefore, the respective public services should be put under a special kind of scrutiny (see “Extortion” above).

Bibliography

Akimova, I. and O. Kuzyakiv (2003), ‘Business Climate And Investment In 1999-2002: No Significant Improvement?’, *IER Quarterly Enterprise Survey*, Special Issue No. 1 (2), April.

Anticorruption in Transition: A Contribution to the Policy Debate (2000), the World Bank, Washington, D.C.

Ben-Dor, G (1974), ‘Corruption, Institutionalization, and Political Development’, *Comparative Political Studies*, 7(1), p. 63-83. Quoted by: Marquette, 2004.

BIZPRO (a USAID project) (2005), *Main Results of Impact Evaluation of Permit One Stop Shop in the City of Nova Kakhovka*, and similar reports for the cities of Kupiansk, Chervonograd, and Kolomya.
<http://www.bizpro.com.ua/clients/bizpro/weben.nsf/0/A0E6E3F433458154C2257075004CC17E>

Dubrovskiy, V., W. Graves III, J. Szyrmer, E. Golovakha, O. Haran, and R. Pavlenko, *The Reform Driving Forces in a Rent-Seeking Society: Lessons from the Ukrainian Transition* (third draft). Country study within the Global Research Project of Understanding Reforms, The Global Development Network (GDN), www.gdnet.org. Work in progress.

Heidenheimer, A (ed.) (1970), *Political Corruption: Readings in Comparative Analysis*, New York: Holt, Rinehart and Winston, Inc. Quoted by: Marquette, 2004.

Hellman, J. S. (2002), *Strategies to Combat State Capture and Administrative Corruption in Transition Economies*, background paper prepared for the conference: *Economic Reform and Good Governance: Fighting Corruption in Transition Economies*, Qinghua University, Beijing, China, April 11-12.

Hellman, J. S., G. Jones, and D. Kaufman (2000), ‘Seize the State, Seize the Day. State Capture, Corruption, and Influence in Transition’, *Policy Research Working Paper No. 2444*: The World Bank Institute.

Hoff, K., and J. E. Stiglitz (2004), ‘After the Big Bang? Obstacles to the Emergence of the Rule of Law in Post-Soviet Societies’, *The American Economic Review*, vol. 94, No.3, June.



Huntington, S (1968), *Political Order in Changing Societies*, New Haven: Yale University Press. Quoted by: Marquette, 2004.

IFC (2004), *Business Environment in Ukraine*, SME Survey and Policy Development Project. International Finance Corporation, December.

Karklins, R. (2002), 'Typology of Post-Communist Corruption', *Problems of Post-Communism* July/August.

Kaufmann, D. and S.J. Wei.Does (1999), 'Grease Money' Speed Up the Wheels of Commerce? National Bureau of Economic Research, April. [Also Policy Research Working Paper 2254, The World Bank: Washington, D.C., December 1999.] [Also Working Paper No. 00/64, International Monetary Fund: Washington, D.C., March 2000.], <http://www.worldbank.org/wbi/governance/pubs/greasemoney.html>

Kaufmann, D. (1998), *Revisiting Anti-Corruption Strategies: Tilt Towards Incentive-Driven Approaches?* [in:] *Corruption & Integrity Improvement Initiatives in Developing Countries*. United Nations Development Programme, <http://www.undp.org/dpa/publications/corruption/index.html>

Klitgaard, R. (1988), *Controlling Corruption*, Berkeley: University of California Press, p. 75. Quoted by: Karklins, 2002.

Klitgaard, R., R. MacLean-Abaroa, and H. L. Parris, Jr. (2000), *Corrupt Cities: A Practical Guide to Cure and Prevention*, (Oakland, California: ICS Press and World Bank Institute).

Ledeneva, A.V. (1998), *Russia's Economy of Favours*, Cambridge University Press.

Ledeneva, A. (2000), *Continuity and Change of Blat Practices in Contemporary Russia* [in:] S. Lovell, A. V. Ledeneva, and A. Rogachevskii (ed.). *Bribery and Blat in Russia: Negotiating Reciprocity from the Middle Ages to the 1990th*, School of Slavonic and Eastern European Studies, University of London. McMillan.

Leff, N (1964), 'Economic Development through Bureaucratic Corruption', *American Behavioral Scientist*, 8(3): 8-14. Quoted by: Marquette, 2004.

Leys, C (1965), 'What is the Problem about Corruption?', *Journal of Modern African Studies*, 3(2): 215-224. Quoted by: Marquette, 2004.

Litwack J. M. (1991), 'Legality and Market Reform in Soviet-Type Economies', *The Journal of Economic Perspectives*, Vol.5, Issue 4.

Marquette, H. (2004), *World Bank's changing conceptions of graft engender multipronged and single-focus strategies*, Local Governance Brief, March, Local Government and Public Service Reform Initiative / OSI, Arktisz Ltd., Budapest.

Nye, JS (1967), 'Corruption and Political Development: a Cost-Benefit Analysis', *American Political Science Review*, 61(2): 417-27. Quoted by: Marquette, 2004.

Partnership for a Transparent Society (PTS) program. Semi-annual report (May 1, 2004 – September 29, 2004) and Final Report (October 2001 – September 2004) Development Alternatives, Inc. OUT-AEP-1-800-00-00006-02 TO 800.



Paskhaver, A. (2006), *We are becoming more open* – an interview to Nataliya Yatsenko; Zerkalo Nedeli, No.1 (580), January, <http://www.zerkalo-nedeli.com/nn/print/52305/> (in Russian and Ukrainian).

Shleifer, A., R. W. Vishny (1993), 'Corruption', *The Quarterly Journal of Economics*, Vol. 108, No. 3, pp. 599-617, April.

Sonin, K. (2002), 'Why the Rich May Favor Poor Protection of Property Rights', *William Davidson Working Paper* Number 544, December.

Spector, B. (ed.) (2005) *Fighting Corruption in Developing World*. Kumarian Press, Bloomfield, CT.

Volkov, V. (2000), *Patrimonialism versus Rational Bureaucracy: on the Historical Relativity of Corruption* [in:] S. Lovell, A. V. Ledeneva, and A. Rogachevskii (ed.), *Bribery and Blat in Russia: Negotiating Reciprocity from the Middle Ages to the 1990th*, School of Slavonic and Eastern European Studies, University of London. McMillan.