



BUSINESS CONFEDERATION MACEDONIA



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Costs of Corruption

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INTRODUCTION

In countries where corruption is ripe and has a long tradition, such as Slovakia and Macedonia, people often say it is ‘just the way things are.’ They suggest, that although frustrating, corruption has always been here and nothing can be done about it. Wide-spread corruption often leads to apathy and is self-perpetuating, which makes it difficult to fight. However, this paper argues, that there is a good reason to take a stand against corruption: corruption is a costly phenomenon for individuals, businesses as well as for states and their economies in general. The purpose of this paper is to explain how corruption affects states and their economies and to present evidence of the forbidding costs of corruption.

In order to discuss corruption, this paper first defines it and presents established sources of data on corruption worldwide. In the final section, research is presented indicating corruption inflicts significant costs on the economy and corruption is placed in the context of everyday data, namely international business rankings.

1. WHAT IS CORRUPTION?

Corruption is a widely known concept, prominent in today's public discourse just as it was hotly discussed in ancient times. In spite of its notoriety, the scope and variability of corrupt practices warrant a definition in order to be able to understand, combat and prevent it. According to the Organization for Economic Cooperation and Development (OECD), an international economic organization, a 'frequently-used definition that covers a broad range of corrupt activities is the 'abuse of public or private office for personal gain.'" (OECD, 2008) Transparency International (TI), an international non-profit organization dedicated to fighting corruption around the world, broadens the concept, defining corruption as 'the abuse of entrusted power for private gain.' (TI, 2009) Corruption is also often defined in economic terms – as a specific type of unofficial tax for both consumers and producers, which adds to the overall cost of doing business with the proceeds going to criminals, not the government. (U4, 2007; WB: Corruption, Growth, and Investment)

As the broad definition suggests, corruption takes on various forms and may range from everyday situations of common people to scandals involving politicians and vast sums of money. Based on the scope of corruption, Transparency International distinguishes among two types. *Grand corruption* occurs when high-ranking political leaders or bureaucrats abuse their power for their own gain, such as awarding public tenders in exchange for kick-backs. As an example, a former Slovak minister of construction is currently being investigated due to his involvement in a scandal, in which a €120 mil. contract was awarded to political friends without a public tender (NY Times, 2010) – and for services of significantly lower value. In Macedonia, politicians are suspected of having been paid off by Macedonian Telekom, owned by Magyar Telekom for delaying the opening of the telecoms market to competition. US courts have already found wrongdoing in the case and fined Deutsche Telekom, Magyar Telekom's owner, \$98 mil., as Magyar Telekom had been trading on the New York Stock Exchange at the given time. (Balkan Insight, 2012) On the other hand, *petty corruption* involves a more common or every-day abuse of power by low- and mid-level officials. This may mean offering, or being asked to pay bribes in schools, hospitals or police departments. (TI, 2009) As an example, a 2012 survey carried out for Transparency International Slovakia found that 21% respondents paid a bribe to a public official in Slovakia in the past 3 years, on average €20. (Focus, 2012) Grand corruption has the power to destroy the economy and impoverish nations. (U4, 2007) However, petty corruption inflicts significant costs on the poor and may have further political consequences, as will be discussed later.

Two parties always participate in corruption. However, who initiates it makes a difference. *Demand-side corruption* involves individuals asked to pay bribes in order to receive services which they are entitled to (i.e. extortion) such as health-care services or various types of stage registration or companies forced to pay kick-backs once they are awarded a public tender. *Supply-side corruption*, on the other hand, means that individuals or firms corrupt officials for their benefit, for example firms which bribe officials to circumvent regulation. (DFID, 2011)

As well as in size and origin, corruption varies in the form it takes. Individuals or firms, which twist and transgress existing rules and avoid punishment by bribing officials, obviously engage in corruption (this is so-called *administrative corruption*). However, perhaps less obviously, firms and individuals also corrupt officials in order to influence the way laws and regulations will be formed and ‘capture the state’, shaping it to their benefit. That is why this type of corruption is called *state capture*. (WB, 2000) As an example, a major Slovak political party has been accused of ‘selling’ parliamentary seats to business magnates for a particular set price prior to an important election. Other Slovak parties have been accused of and investigated for more general, but just as shady contributions to political parties.

2. MEASURING CORRUPTION

Corruption justly attracts a lot of attention from researchers, the public, businesses and governments. In order to support transparency and push for change, multiple international organizations have taken up measuring corruption. Among the most prominent are Transparency International, the World Economic Forum and the World Bank.

2.1.1. Transparency International: Corruption Perceptions Index¹

Since 1995, Transparency International² compiles an annual international ranking of countries worldwide, based on their level of corruption, as perceived by managers and academic experts. The Corruption Perceptions Index (CPI) is a so called “poll of polls;” it combines the findings of several surveys and assessments carried out by multiple organizations in individual countries. The surveys focus on issues such as kickbacks in public procurement, bribing public officials or embezzlement of funds by public officials. Countries are ranked based on scores on a scale from 1 to 10, where 10 stands for the lowest corruption. The CPI has become the most widely used source of data on corruption. (UNDP, 2008)

In 2011, TI measured the corruption in altogether 182 countries. Table 1 shows CPI data for 15 selected countries, including world leaders in transparency such as New Zealand, Denmark,

¹ <http://www.transparency.org/research/cpi>

² TI is funded by governments, international organizations such as the EU, EIB or EBRD as well as by businesses and private donors.

Finland, Sweden and Singapore as well as Macedonia and its fellow EU accession candidate countries Turkey, Serbia and Montenegro. On the scale from 1 to 10, Macedonia earned a score of 3.9 in 2011, ranking 69th out of 182 countries. The 5 global leaders in transparency earned scores above 9 points.

2.1.2. World Economic Forum: Global Competitiveness Report³

The World Economic Forum (WEF), an international non-profit organization, measures corruption around the world as a part of its Global Competitiveness Report (GCR).⁴ Its goal is to rank countries based on their competitiveness, corruption is measured as one of the indicators of a competitive business environment. GCR data on corruption are collected from firms around the world (for the report published in 2011⁵ on average 98 firms per country) with an Expert Opinion Survey, carried out by the WEF annually. In the survey, firms are asked about their opinion on the extent of bribery, costs of corruption or diversion of funds in their country, rating their country on a scale from 1 to 7. The resulting score is an average of those given.

The latest issue ranked 142 countries altogether. Table 1 shows corruption scores for the selected countries calculated from answers to survey questions on the prevalence of diversion of public funds, irregular payments and the business costs of corruption. The WEF ranking supports the findings of Transparency International, perhaps unsurprisingly, as TI also draws on WEF data when compiling its CPI. Nevertheless, the WEF approach to data is valuable, as it makes corruption an individual indicator of the quality of the business environment. As in the CPI ranking, the 5 leaders earn scores above 9 points. Macedonia earns a score of 5.4.

2.1.3. World Bank: Worldwide Governance Indicators⁶

The World Bank's (WB) Worldwide Governance Indicators (WGI), available since 1996, are another well known source of information on corruption worldwide.⁷ WGI are a database of aggregate indicators of good governance compiled by the World Bank from multiple surveys as well as from individual indicators drawn from experts. Indicators include political stability and the absence of violence, government effectiveness or the control of corruption; countries earn a percentile score for each of them.

³ <http://www.weforum.org/issues/global-competitiveness>

⁴ The WEF is funded by member companies, among them many global corporations. Its Report first appeared in 1979.

⁵ The Global Competitiveness Report 2011-2012

⁶ <http://info.worldbank.org/governance/wgi/index.asp>

⁷ The World Bank is an international financial institution dedicated to reducing poverty and promoting development, funded by governments around the world.

In 2010, the most recent year for which WGI are available, 210 countries were listed. In part, the World Bank finds similar results to the previous two institutions. The 5 corruption leaders remain at the top of the list, albeit in a different order. However, according to the World Bank, Macedonia earned a score of 5.6 while ranking 92nd in 2010.

Table 1: Transparency International, World Economic Forum and World Bank corruption rankings in 2011 (2010)

	TI CPI*		WEF GCR	WB WGI	
	Rank	Score	Score**	Score***	Rank
New Zealand	1	9.5	9.6	10.0	2
Denmark	2	9.4	9.4	10.0	1
Finland	3	9.4	9.1	9.8	5
Sweden	4	9.3	9.3	9.9	3
Singapore	5	9.2	9.3	9.9	4
Netherlands	7	8.9	8.7	9.8	6
Germany	14	8.0	8.3	9.3	15
France	25	7.0	7.6	9.3	24
Slovenia	35	5.9	5.9	8.1	52
Turkey	61	4.2	5	6.0	89
Slovakia	66	4.0	4.9	6.6	75
Croatia	66	4.0	4.8	5.8	86
Montenegro	66	4.0	6.3	5.0	111
Macedonia	69	3.9	5.4	5.6	92
Serbia	86	3.3	4.3	5.2	102

Source: *Corruption Perceptions Index 2011; The Worldwide Governance Indicators, 2011 Update; The Global Competitiveness Report 2011-2012*

*For all scores 1 = highest corruption, 10 = lowest corruption

**Adjusted from a 1-7 scale to a 1-10 scale

***2010 Score adjusted from a 1-100 scale to a 1-10 scale

The three examples of data sources on corruption show that measuring corruption is predominantly based on perceptions, in other words on the respondents' subjective judgement. Such data has been criticized, saying subjective data does not provide valid information, especially for international comparisons. Aggregate rankings (WGI, CPI) have also been criticized for using different data sources in individual countries and changing their

methodology, further complicating comparing individual countries. However, corruption perception data has proved a useful source of information, as finding objective data on corruption is difficult due to the fact that receiving and paying bribes is most often considered criminal behavior. Critics of the aggregate rankings may be convinced by single-survey data sources with unified methodologies across all countries, such as the WEF GCR.

3. COSTS OF CORRUPTION

But why does corruption receive so much attention, why do international organizations make an effort to measure it and why do governments and businesses pay them to do so?

The World Bank describes corruption as one of “the greatest obstacles to economic and social development. It undermines development by distorting the rule of law and weakening the institutional foundation on which economic growth depends.” (WB: FAQs: Fraud & Corruption) Transparency International states, rather dramatically, but not incorrectly, that corruption can in worst cases cost lives. More commonly, it costs people their freedom, health and money. (TI: What are the costs of corruption?)

TI illustrates the extent of the costs of corruption for a society by dividing them into four categories. Severe *political costs* may arise, as corruption has the power to undermine democracy and the rule of law. Whether it is petty corruption that people face in their everyday lives, or grand corruption committed by high-ranking officials, corruption weakens the belief that a country is governed by laws. Where officials abuse their office for personal gain, they lose legitimacy and democracy as a system is often challenged. A lack of trust in democracy opens up space for extremism and for calls for a change of the democratic system. A lack of stability in the political system, in turn has a negative impact on the economy. According to TI, political costs of corruption are even higher in emerging democracies. Albeit none of the countries involved were democracies, the Arab Spring movement is a recent example of the political costs corruption can inflict on a country. Across the region on-going unrest was sparked by protests in Tunisia, after a street vendor set himself on fire in protest of harassment and corruption.

Political costs are closely associated with *social costs* in the form of a lack of trust in the society. If rules do not apply the same way for everyone and some people bend them by means of corruption, people’s trust in the society, its rules, and in each other weaken. A lack of trust means lower social capital: if people don’t trust each other, they take precaution and dealing with each other becomes more costly. Thus, a lack of trust in the society has negative economic implications.

Indeed, corruption also means severe *economic costs* for the economy, as it depletes national wealth and slows down growth. It does not necessarily prevent high growth. The so-called Asian Tiger economies serve as an example of high-corruption, high-growth countries. But, if corruption were tamed, the countries' economies might have grown even faster. (U4, 2007) Corruption may negatively impact the economy by creating red tape in order to extort bribes. By favoring businesses which are willing to pay in public procurement, corruption distorts competition and leads to wastefulness in public funding. Governments may also shift public investment to certain sectors of the economy or particular projects by allocating funds based on bribes rather than need (e.g. investing in large-scale construction projects rather than in education and health care). Diverting public funds in turn pushes governments to provide poor quality services, further complicating the conditions for doing business. On the whole, corruption raises the overall costs of doing business and thus deters foreign investment, supports the informal market or tax evasion.

Finally, perhaps the most specific of the four are *environmental costs*, i.e. damaged environment. Environmental costs result from unregulated exploitation of natural resources due to corruption. Depleting or destroying natural resources such as water, woods or mineral resources may come at a high price for the economy.

3.1. Costs of Corruption in Figures

Quantifying the costs of corruption is yet trickier than measuring its scope. Experts warn against assuming a clear causality between the level of corruption and the health of the economy. (U4, 2007; GTZ, 2008; Mauro, 1995) Paolo Mauro, an economist with the International Monetary Fund and author of renowned studies on the costs of corruption, recognizes that the direction of causality is often blurred. (Mauro, 1995)

Nevertheless, research found a distinct negative correlation between a country's corruption levels and the health of its economy, as researchers attempted to prove some of the above mentioned costs of corruption. Established research includes studies on corruption's effects on investment, education, sovereign bond ratings or economic growth. These studies indicate that corruption comes at a significant cost for a country, its economy and businesses.

And what does the most recent data say about the impact of corruption on the economies around the world and in Macedonia? International business rankings such as the GCR or the Index of Economic Freedom of the Heritage Foundation also show a significant correlation between corruption and an economy's potential. This not only supports the research on the significant negative impact of corruption on countries and their economies. Rankings also serve as a source of information for businesses and may thus amplify their own findings, for example

by warning investors away from corrupt countries. Thus, international rankings also become a valuable tool when making an argument in the fight against corruption. Below main findings from the above mentioned studies on corruption are summarized and data from two international rankings are presented.

3.1.1. Corruption and Investment

Corruption deters investment. In economies with well-known and consistent high levels of corruption, bribes may be seen as a special type of an informal tax. If firms are aware they will be expected to pay bribes which will raise their costs of doing business, they may give up investing or in the case of foreign investors, invest elsewhere. In a well-known 1995 study Mauro finds a significant correlation between corruption in a country and its level of investment. Mauro draws on corruption data from the International Country Risk Guide and from Business International.⁸ The study finds, that if a country's corruption rating on a scale of 1 to 10 improves from 6 to 8, the country's investment/GDP ratio would rise by almost 4%. (Mauro, 1997)

Shang-Jin Wei, professor at Columbia University and an often-cited author on the issues of corruption costs, supports these findings in a study, which suggests that worsening a country's corruption score by one point on a scale⁹ of 1 to 10 is approximately equivalent to increasing the tax rate by 6%. (Wei, 2000) In Macedonia, this would mean a tax rate hike to 16% from today's 10%.

3.1.2. Corruption and Education

Mauro also investigates the effect of corruption on the composition of government spending, suggesting that corruption leads to higher investment in some sectors of the economy. Empirical research seems to suggest that in corrupt economies, public funds are shifted towards sectors, where more opportunities for corruption occur, such as construction, while sectors with fewer opportunities (e.g. education, health-care), suffer.

Mauro states that government education spending seems to be especially negatively influenced by corruption. His research suggests that an improvement in a corruption index with a scale of 1 to 10 from 6 to 8 could lead to a 0.5% rise in education investment as a proportion to GDP. Similarly, government healthcare expenditure seems to be negatively correlated with corruption.

⁸ Business International was a research and advisory company, which later became a subsidiary of the Economist Intelligence Unit

⁹ Wei uses corruption data from Business International

3.1.3. Corruption and Sovereign Bond Ratings

Corruption makes loans more expensive. In a 2003 study, Francisco Ciochini, an Argentinian researcher, along with his colleagues established a relation between a country's level of corruption and premiums paid when issuing sovereign bonds. The authors compared Transparency International data on corruption and data on the spread of bonds from 1990s emerging markets governments and firms, while controlling for other factors. The study found that an improvement on the corruption scale by one point lowers spreads by 18%: global investors require a substantially greater return on issued bonds in a more corrupt country, making borrowing more expensive and creating an obstacle to investment in corrupt countries. (Ciochini et al., 2003) This assumption suggests Macedonia would be able to borrow at 4.84%, rather than the 5.5% (MFRP, 2012) in April 2012, if it improved in corruption by one point.

3.1.4. Corruption and GDP Growth

Corruption slows down economic growth. Lower investment, poorer quality education as well as more expensive loans due to high corruption all have adverse effects on the economy and its growth. Indeed, in his cited study, Mauro presented empirical research showing a correlation between corruption and growth. If a country's corruption rating improved from 6 to 8 on a scale of 1 to 10, suggests Mauro, the country's growth would speed up by almost 0.5%. (Mauro, 1997) In such a case, Macedonia may have grown by 3.5% in 2011 and might grow by 2.2% in 2012, as opposed to 3% and 1.7% in 2011 and 2012 respectively. (Eurostat, 2012)

3.1.5. Corruption and Competitiveness

Corrupt countries are less competitive, suggest WEF Global Competitive Reports. The WEF defines competitiveness as "the set of institutions, policies, and factors that determine the level of productivity of a country." (WEF, 2011) According to WEF, productivity, in turn, determines how fast a country can grow and how prosperous it can become. (WEF, 2011) The WEF uses unique data on corruption collected through its Expert Opinion Survey. Corruption is one of the indicators measured for its impact on countries' competitiveness and thus affects the final competitiveness score of individual economies. However, its weight in the calculation is not large enough to significantly affect the ranking (the weight of 'ethics and corruption' scores amounts to 0.0375% of the overall competitiveness score), and thus may be examined in search of a correlation.

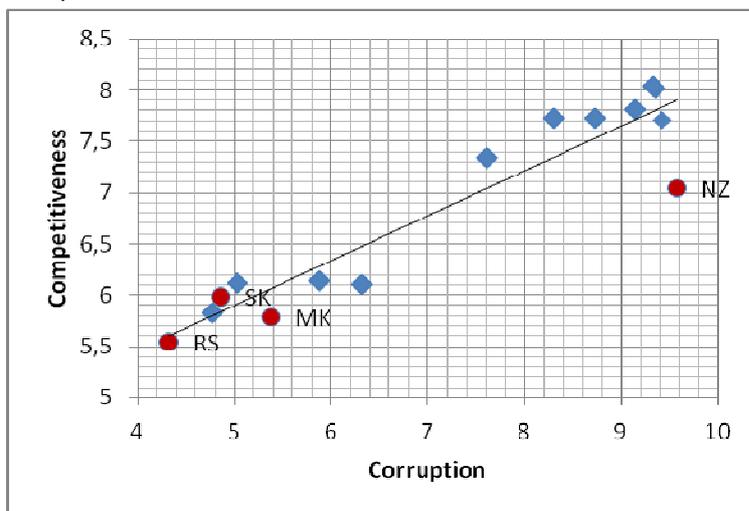
By examining GCR data on corruption and overall competitiveness scores a significant relationship is visible. In Chart 1, 2011 data for the 15 selected countries¹⁰ are plotted. The chart shows 7 countries with corruption levels above or close to 8 points on a scale of 1 to 10,¹¹

¹⁰ Croatia, Denmark, Finland, France, Germany, Macedonia, Montenegro, the Netherlands, New Zealand, Serbia, Singapore, Slovakia, Slovenia, Sweden and Turkey

¹¹ Adjusted from GCR scores on a scale of 1 to 7

Denmark, Finland, France, Germany, the Netherlands, New Zealand and Singapore. All 7 countries are highly competitive with a score over or close to 7. The lowest ranking country of the group in corruption, France, ranked 25th out of 142 countries covered in the report in corruption and 18th in overall competitiveness. Macedonia can be seen in a group of countries with significantly higher levels of corruption and lower competitiveness. With a corruption score of 5.4, it earned 4.05 in competitiveness.

Chart 1: WEF Global Competitiveness Report 2011-2012 shows corrupt countries are less competitive

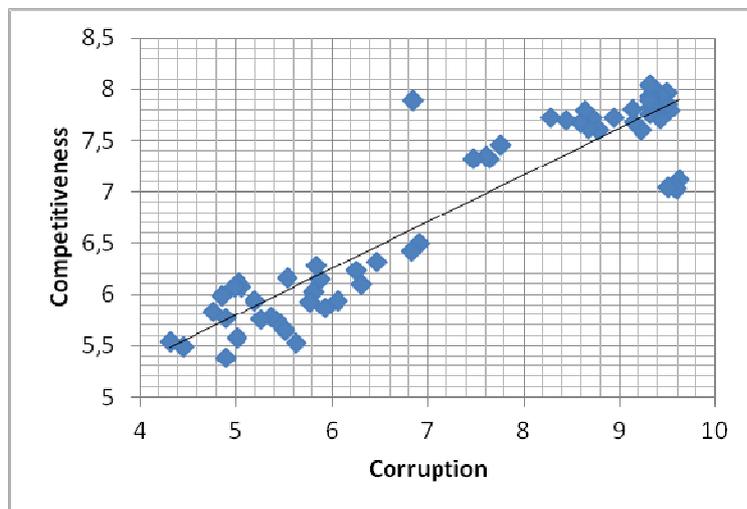


Source: GCR, 2011

MK – Macedonia, NZ – New Zealand, RS – Serbia, SK – Slovakia; on the corruption scale 10 stands for highest transparency

Chart 2, plotted with data for the same countries from 2008-09 to 2011-12 report, supports the finding over a longer period of time: countries with high corruption are less competitive than more transparent countries.

Chart 2: Using 2008-2011 WEF GCR data supports the correlation found in the previous chart



Source: GCR, 2008-2011

On the corruption scale 10 stands for highest transparency

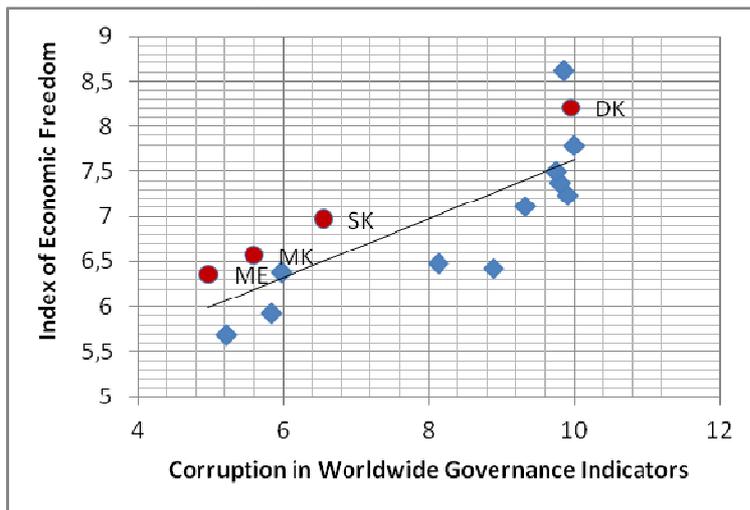
3.1.6. Corruption and Economic Freedom

Corrupt countries suffer from limited economic freedom, with negative implications for their democracy and economy, suggest Transparency International CPI data and the Index of Economic Freedom (IEF) compiled by the Heritage Foundation (HF). According to the Heritage Foundation, in an economically free society, the market functions freely, and governments refrain from interfering or coercing actors in the economy apart from interfering to maintain freedom itself. The Heritage Foundation argues that important relationships between economic freedom and “positive social and economic values such as per capita income, economic growth rates, human development, democracy, the elimination of poverty, and environmental protection“ have been demonstrated. (HF: Index: FAQs) The Heritage Foundation measures economic freedom based on 4 indicators, with data collected from surveys as well as hard data and assigns each country a score on a scale of 1 to 100. In 2012, 179 countries were ranked.

The IEF uses the Transparency International Corruption Perceptions Index as one of its indicators of economic freedom, namely freedom from corruption. As the weight of the corruption indicator in the index is not insignificant, it may affect the final score noticeably. However, Worldwide Governance Indicators figures are independent from the IEF. For the 15 examined countries, WGI data on corruption show a correlation with economic freedom, as measured by the IEF. More transparent countries are less burdened by regulation and state interference. Again, it would be tricky to establish the direction of causality. Transparency may add to the economic freedom of an economy by making do with lower taxes and government spending or easing the administrative burden of businesses. On the other hand – or at the same

time, high transparency may be the result of fewer regulations. Cutting back on regulation may reduce the scope of opportunities for corrupt behavior.

Chart 3: Heritage Foundation 2010 economic freedom data show corrupt countries suffer from less economic liberty



Source: Index of Economic Freedom, 2010

DK – Denmark, ME – Montenegro, MK – Macedonia, SK – Slovakia; on the corruption scale 10 stands for highest transparency

4. CONCLUSION

This paper presented data indicating that corrupt countries have lower investment rates and education or more expensive loans. Corruption may not prevent economic growth, but corrupt countries grow slower than those more transparent. International rankings, often cited by politicians, also support this claim: if corruption in a particular country spikes, it is likely its economic freedom and competitiveness will suffer.

EU candidate countries like Macedonia may face further negative consequences of high corruption, as fighting corruption has become a significant criterion of EU accession. Previous experience with corruption and EU standards suggests that failing to comply with EU anti-corruption requirements may have serious consequences for a candidate or even a member state. As an example, in 2010, Romania and Bulgaria's accession to the Schengen Treaty was delayed due to an inability to reform their judicial systems and curb corruption. Today, both countries are still waiting to join. In Macedonia, a 2011 EU accession progress report stated that 'corruption remains a serious concern.' (EC, 2011)

All of this presents a compelling case: corruption costs all of us, directly or indirectly. The widespread character of corruption, as well as the gains from lowering it, call for a joint effort by all parties concerned. This seems all the more relevant in a country with solid economic potential but high corruption, such as Macedonia.

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