

**“Getting the Country Back: Popular Demand, Institutional Change and Corruption
in the Paraguay of the Nineties^{*}”**

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Introduction

Paraguay has seen many changes in the nineties. In 1989 a coup d'état overthrew Alfredo Stroessner from power, to see the end of one of the longest, most cruel and corrupt dictatorships of the twentieth century. This coup signified the first opportunity for the Paraguayan people to undertake a structural reform that will affect generations to come. The break of the equilibrium attained during the dictatorship provided the foundations to structure major fundamental changes that will affect most institutions in the country. The instability generated by the coup gave the alternative to initiate a series of changes in the rules of the game aiming for a new equilibrium. This process has been a constant in the Paraguayan society in this decade. In this paper, we focus on the consequences of these changes on corruption. Corruption was a central institution in the Stroessner years, since "reciprocal ties of material support and obligation, provided the basis for personal loyalty to the ruler" (Nickson, A. R.: 1994: 2). The incentives set up for members of the public sector, rapidly spread to affect the whole society.

However, what is corruption? Throughout this paper, corruption will be understood as the principal-agent problem in which payments are made by a customer to an agent to try to influence his behavior. The scope of the study is reduced to include just the cases that affect the administration of the public sector and this relation between public officials and their supervisors¹. Consequently, supervisors or politicians will be the principals of lower ranked public bureaucrats. Although, there are references to other forms of crime towards the property of the state, such as contraband, drug trafficking and the like, the focus will be on the effect of reforms on the problem stated above. Neither we will be interested in introducing an opinion on the debate on the effects of corruption. Most of the theoretical literature of corruption in economics that deals with the issue seems to be agreeing on the pervasive effects of this reality². On a more pragmatic level, the effects of this problem are evident in the country of study. Unequal income distribution, large fractions of the population in informal activities, poverty, black markets, Mafias and crime are only some of the externalities from corruption observable in the Paraguay of today.

The paper presents an account of the influence of the major forces and strategies of the Paraguayan society and its political institutions to reduce corruption in the years of the transition. Based on the belief that there is always some level of corruption, we study how the different variables that determine the stability for corrupt systems were affected by institutional change in the period under scrutiny. The first section of the paper contains a brief summary of the relevant theoretical literature under consideration, while the following sections present a detailed account of changes in the relevant variables.

¹ This relation is inclusive because it considers not just the relation of the lower class public bureaucrats, but also refers to higher stages of corruption that include not just the government as a whole, but also the relation of accountability between the public and their rulers.

² For a complete interpretation of the effects of corruption, see Rose Ackerman (1978), Rose Ackerman (1996), Alam (1989), Schleifer and Vishny (1993) and Mauro (1995).

Identifying the Variables: A Brief Review of the Theory

Several articles that study the problem of corruption in economics consider the existence of multiple equilibria. Under this hypothesis, the same socioeconomic structure gives rise or could give rise to different levels of corruption. These models, by recognizing one of the few stylized facts about corruption, namely, that its incidence varies strongly across countries, try to explain corruption in specific settings. The existence of a system of multiple equilibria allows for the possibility of affecting certain variable to reduce corruption. Andvig and Moene (1990) recognize this fact and develop a model where they link the profitability of corruption to its frequency. They describe a system of supply and demand of corrupt services where suppliers are public officials, while private firms and individuals search for and demand these corrupt services. The demand and supply functions can be understood as describing best response functions also under the circumstances of perfect information, or by assuming that bureaucrats can observe last period's corruption level and update their behavior consequently with this information. A system of multiple equilibria at high and low levels of corruption is achieved in the model.

Several variables affect the equilibrium level of corruption in the model. The authors consider that all stable supply side equilibria can be improved by a salary increase. Cutting real wages of public servants more than those in the private sector when cutting public spending as a cure to balance of payments problems, should lead to increased corruption in countries without serious political corruption. In countries with high levels of corruption, a cut in public spending without affecting real wages may in fact reduce the overall level of corruption. The effect of a change in the discount rate is also important in determining the outcomes of the model. Increases in the discount rate imply that people value less the future, making bureaucrats more inclined to be corrupt. Anticipated changes in regime in a system with high job turnover will increase the level of corruption, since bureaucrats will be eager to capture rents before their contracts are terminated. It is clear that in countries with democratic regimes where elections are held after a certain period of time, and where a career for public servants is not in place, bureaucrats may expect changes with the same frequency.

Cadot (1987) considers the case of bargaining between bureaucrats and customers in a public office. He imagines a situation where there are several applicants for a license. In order to acquire it, the applicants should pass a test and afterwards face a public official in a bilateral bargaining setting. If the applicant has no right to pass, he/she has to bribe or fail. A passing candidate could also face either an honest or a corrupt official. When facing a corrupt official the applicant may or may not accept to bribe him. In the latter case, he reports the official to his superior. This is done at the cost of losing the good for a period. The problem for the official is to ask for a low enough bribe such that it does not pay to the applicant to report him. However, the official faces another problem: he has to deal with his superior. An interesting aspect of the model is that allows the superiors to behave corruptly as well.

Given this basic setup, Cadot evaluates different cases. First, he considers the problem between the official and the applicant. He proposes solutions for the cases of perfect information, asymmetric information and imperfect information on both sides. In all these cases, the superiors are assumed to be honest. The next step consists of

investigating the relation of the public official with his superior, while the assumption of the latter being honest is dropped.

Although the story behind is somewhat unrealistic, Cadot manages to obtain quite interesting results in its applications. He assumes that from the bargaining problem described above, the official will obtain a bribe that he will try to maximize. The first variable affecting the bribe size is again the discount rate of the official. Raises in the discount rate imply that the official values less the future, such that these increases will have positive effects on the bribe size. If officials do not have much to lose when losing their job in the following periods, then they will be willing to ask for higher bribes. A particular feature of this model is that the degree of absolute risk aversion enters the official's objective function³. A large enough income level, which implies that the official is more risk-averse, will make him ask for a smaller bribe. As in the other case, he also considers the effect of a higher salary in the size of the bribe. A higher wage will increase the opportunity cost of the official, inducing him to take less. This last result is concomitant with the observed reality. Empirical studies confirm that highly corrupt administrations are usually characterized by low salaries (see Broadus (1976) and Mauro (1995)).

In an ongoing work, I propose a principal-agent model of corruption in which, following Rose-Ackerman (1996), a bribe, and more extensively corruption, is understood as the principal agent problem where "payments are made to agents by people who are not their principals in return for a well-understood [explicit] *quid-pro-quo*" (Rose-Ackerman, Susan, 1996: 6). This work models a principal-agent problem with two players: workers and supervisors, where workers have the opportunity of obtaining a bribe from a third party at a certain cost. Given the level of supervision, the workers will choose their level of corruption to maximize their expected income. In equilibrium, this level of corruption chosen by the worker will be the same as the population level. From the solution of the worker's and the supervisor's problem two best response functions are obtained, that determine a system of multiple equilibria. This model, besides telling a more general and feasible problem and starting from the most acknowledged definition of corruption, presents new modeling features. As before, raises in wages and in the discount rate have negative and positive effects on the level of corruption, respectively. The fallback position for the worker is included, that is, his next best alternative, as well as the level of supervision in the system. Bribes are determined by the general level of corruption, giving agents little room for negotiation. Increases in the fallback position reduce the wage differential of the worker, who will have to search elsewhere to compensate for this loss, making him more corruption prone⁴. The inclusion of the fallback position allows to relate the problem of corruption to the general conditions in the economy. The inability of writing complete contracts, a common feature of labor relations, is captured by the modeling of the level of supervision. Since complete contracts that are enforceable in a court of law are impossible to write, supervisors have to incur in monitoring and

³ The usual measure used in Economics and in this particular model is the Arrow-Pratt measure of risk-aversion. For more information see Varian (1992).

⁴ This result is even stronger under the assumption that jobs elsewhere are difficult to find or that income in the informal sector is too low.

incentives to extract performance and honesty from their workers⁵. Increases in the level of supervision reduce corruption, since it is assumed that a worker caught transgressing will be dismissed with probability one. However, since there are increasing marginal costs to detection technologies, the level of supervision will not rise high enough to eliminate the existence of bribery, that is, there will always be some level of bribery.

Basu *et al* (1992) presents a model of the bargaining situation between a public bureaucrat and a briber. They focus specifically on repressive policies to deter corruption. Although this model has neither a principal-agent setting nor has multiple equilibria, it is interesting in what studies the efficiency of third party enforcement in solving the problem. Modeling the bargaining situation is equivalent to saying that both parties in the exchange are the unique forces determining the size of the bribe. The model is constructed by setting up a Nash Bargaining Problem, and studies the efficiency and effectiveness of several measures to control corruption. The result is a bribe size that is a function of a particular level of penalty. Thus, this penalty works as an instrument to curb corruption. However, this instrument is less efficient than originally supposed, but an instrument all the same: although the agreed contract can be renegotiated away in the future, it influences the fallback of the new negotiation. Another important policy discussed is the creation of a special elite of civil servants that is highly paid and trained to block corruption. The existence of two different types of elite is discussed: a hierarchical elite and a mingling one. The former is a civil servant in the hierarchical chain of the organization, while the latter are civil servants that are randomly and uniformly distributed at different levels of the organization. The first strategy blocks corruption after the round where the honest civil servant is encountered, but leaves the structure of bribery unchanged in earlier stages. The efficiency of the second strategy will depend on the monitoring costs of the government.

In summary, the variables that affect corruption according to this body of literature are: wages in the public sector, the existence of a career in public service, the level of income of the informal sector, the existence of a black market, an informal sector and barriers to trade, and the overall efficiency of the monitoring institutions of the public sector. In the following sections, we provide an account of the evolution of these variables for the case of Paraguay in the post-Stroessner period. The very nature of this phenomenon makes it difficult to be measured, and as a result any quantitative comparison of its evolution over time becomes troublesome⁶. Due to this fact, this paper will focus on the qualitative aspects of the different policies.

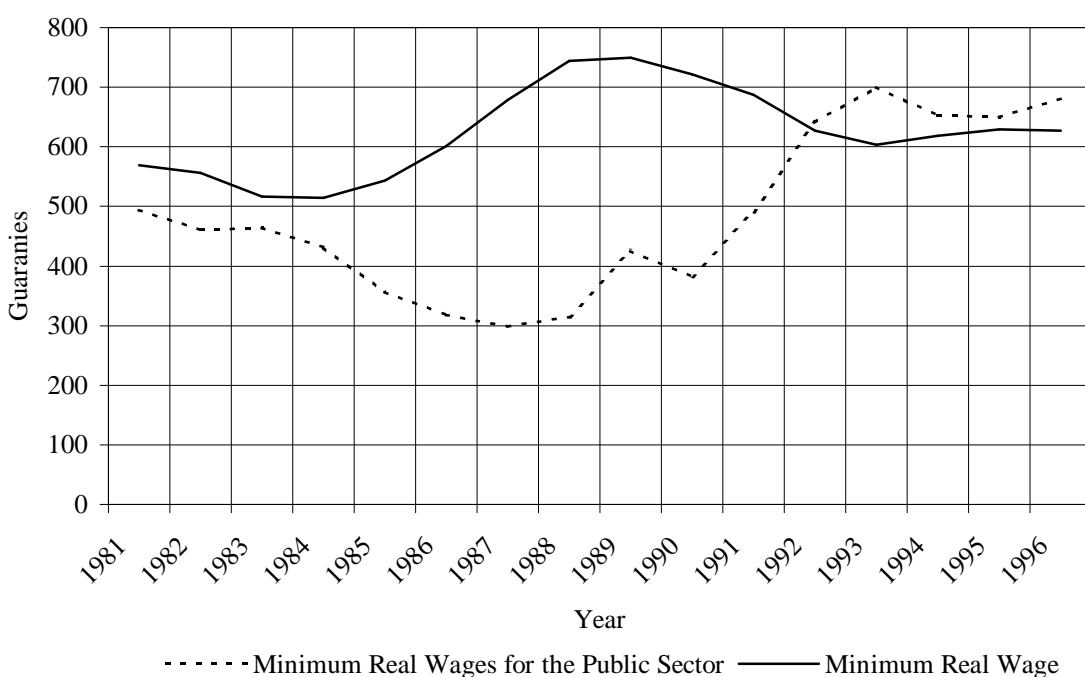
⁵ For a complete account of incentive strategies for workers, see Bowles and Gintis (1990).

⁶ However, an initial solution to this problem already exists. Transparency International has now an Internet version of their Internet Corruption Ranking (<http://www.GWDG.DE/~uwvw/icr.htm>). This ranking, a survey of surveys, gives a rate of corruption to some 69 countries. However, the ranking has only 2 years, which make it impossible to make comparisons of structural change. Paraguay is not yet included in this survey.

Variations of Salaries in the Public Sector

In this decade, the effect of wages has been acknowledged in the policies of the government towards (at least petty) corruption deterrence. Real wages have been increasing in the public sector since 1989. This increase, however, has had a peak in 1993 (an election year) and has decline since then. The minimum wage for a state employee has been consistently under the value of the minimum salary until 1992 (see Chart 1). Two parallel forces account for this change in sign of the wage differentials of public employees. On the one hand, wages in the public sector suffer an increase of 60.25% by 1996. This increase was basically pushed from below, since democracy was a boost to the

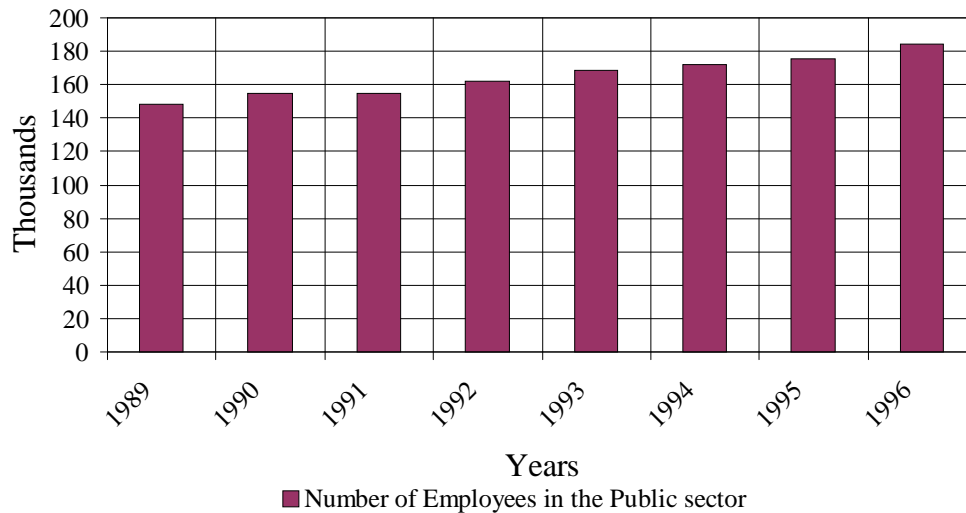
Chart 1: Wage Differentials



level of unionization of workers in general and especially in the public sector, since all public institutions constituted a labor union where before were none. On the other hand, in the same period there has been a reduction of 16.35% in the purchasing power of the workers in the private sector. Therefore, wage differentials for public bureaucrats have been negative in that period. The number of labor hours in the public sector is less than in private business, which allows public employees to work extra hours in another job. However, due to the recession that the Paraguayan economy has been suffering in the past decade and the large migration from the countryside, getting jobs have been quite hard. On the contrary, negative wage differentials acted as a major force in pushing employees to be more corrupt. The other alternative that many bureaucrats adopted was to enter the informal sector, where income is consistently lower than in the formal sector, but employment is always available. Although wage differentials have been positive for a while now, corruption does not seem to have been declining in the country. This could be due to

several causes. First, the period of negative wage differentials has been long enough to

Chart 2: Employees in the Public Sector

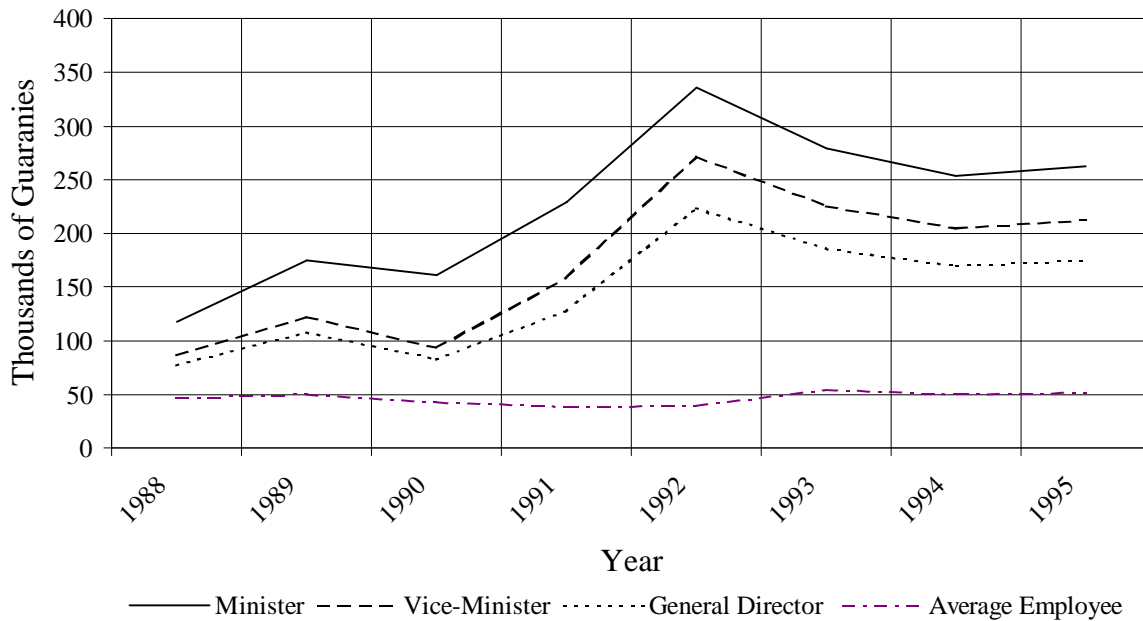


create a habit for corruption in the public sector that influences the long run endogenous preferences of public officials⁷. This implies that there might be a need of a new process of habit formation to overcome this habit of corruption in the bureaucracy. A second hypothesis is that the increase in wages of public officials, although important compared to the minimum wage in the private sector, is not enough to live on. Therefore, bureaucrats still have to search for new sources of income. The first explanation is the most compelling since it gives room for the fact that corruption seems to present long-run stability in the system. However, both seem to be strong causes for the stability of the system.

A legacy from the Keynesian policies of the Import substitution days, is the use of the state as a substitute for the overall inefficiency of the economy to create jobs. Moreover, in Paraguay a problem inherited from the dictatorship is that the state has been used as spoils of war by the group in office. Whoever was (or is) in power will include its partisans in the payroll of the state as a way of financing political campaigns. The problem has not only increased with the transition but it has been made worse over the years, as it is possible to notice in Chart 2. The number of employees in the state, despite the supposed policies toward reducing the state has been increasing in alarming numbers. The total increase in the state employees is up by 24.16%.

⁷ For a complete discussion of the theory of endogenous preferences and habit formation, see Becker (1996), Seabright (1996).

Chart 2: Changes in Wages of the Public Sector by Category



Although raises in wages were important in providing incentives for corruption deterrence, the distribution of these wages has not reach the lower levels of the organization. As we can observe in Chart 3, at higher levels of the organization the increment in wages have been higher. This increase, however, had its peak in 1992 and since then, the trend has been decreasing. Increases in wages in supervising positions are important since it increases the opportunity cost of higher-ranking officials of transgressing, and make them more risk-averse. However, a similar policy should exist at lower levels as well. Petty corruption in public administration can, not only increases the level of corruption in society as a whole, but can also influence behavior of supervisors. This is especially true in the case of Paraguay where, as we will see, supervisors lack power over their subordinates.

Other illegal activities affect corruption. Smuggled goods in the country have fundamentally two sources of demand, both of them foster corruption in the public sector. The first is the external market. Through “selling points” these goods are distributed to neighboring countries (see discussion below). Since imports are heavily taxed, to be competitive these goods have to avoid this process. Public officials enter the game her providing the necessary services to avoid controls and taxes. Most of the goods commercialized in this way are high-tech and luxury goods. The other market is in the informal sector. Many distributors of merchandise sell their products to informal street vendors. They demand mostly consumption goods for low-income groups. Since these products are obtained through bribery in the public sector, increased sales of products in the informal sector or increased income in this sector, imply increased black market activities, that has a support from bribery in the public sector. From this general equilibrium perspective, exogenous forces such as migration may increase the level of

corruption in a system. Assuming that the income level of the informal sector is low enough such that it is at the subsistence level, increases in the size of the labor market in this sector does not affect marginal income of members, which tend to be constant⁸.

Institutional Rules that Favor Corruption

The Law 200

In this section, we reduce our study to those aspects of regulations of work within the public sector that affect not just performance in the working place, but also foster corruption. The main rule we will be referring to is the law 200 that regulates the relations between the state and its employees and sets up the conditions for the existence of public servant careers. This law was sanctioned in 1970 and was not changed with the military coup in 1989⁹.

According to this law, any official would be appointed provisionally for 4 months, and after this period, will automatically be tenured. A concordant article, points out that the sanctions for typified corruption cases¹⁰ will only be applied by the authority that made the appointment, after an administrative indictment. The direct supervisor has no authority to impose sanctions on their subordinate employees in corruption cases. There are several problems with this law:

- The fact that the worker acquires stability and cannot be summarily dismissed reduces power of the supervisor and the politicians in charge. Although the objective of this article was to give stability to the careers of public servants, the attained outcomes are harmful. Honesty, an essential ingredient to high levels of administrative efficiency within the state, cannot be specified in a contract enforceable in a court of law -in this case, an administrative indictment-, but at very high costs for the administration. Therefore, other types of enforcement strategies must be used. Usually this strategy is reflected in the use of performance-based wages and the power of supervisors to dismiss officials in a summary procedure. This law takes that power away from the supervisor, while wages are fixed in the government budget.
- The only one with power to dismiss a corrupt official is the head of the administrative office. In many cases, and considering the size of the Paraguayan state, one government section is composed by several tens of thousands of members. One important case is the Ministry of Finance, which has under its power several units, including the customs and the Internal revenue section, in charge of collecting taxes. These two sections represent more than 60% of the revenues of the public sector and are the places where more cases of corruption could be found. The ministry has

⁸ For a detailed presentation of this hypothesis regarding income in the informal sector, see Fields (1990).

⁹ Moreover, although its obsolete nature in terms of the provision of incentives, the law started being applied after the coup in 1989. In the Stroessner years, the appointment was made by the dictator himself or someone in his political entourage. For a complete account on the Stroessner years, see Nickson (1994).

¹⁰ Among these, only three cases are contemplated: to receive any kind of advantage because of the position the official is holding, to have “moral aptitude” to carry out the duties inherent to the position and to embezzle government funds.

thousands of employees all over the country and the only one with power to dismiss them is the Minister, that is, the one who appointed them.

- The procedures for dismissing an employee on corruption charges are long and inefficient. The statute that rules each section regulates these procedures. A typical procedure will be the following:
 - An employee is detected in a corrupt act.
 - The direct supervisor sends a letter to the head of the section asking for an indictment to this person.
 - The head of the office approves the petition and derives it to a secondary official in charge of putting together an indictment committee. In all cases, a committee has to be appointed for each case.
 - When the committee is formed -usually composed by five officials of the section-, the head of the section will contacts the supervisor in writing to inform him of this matter. A committee has to be formed for each case.
 - The committee starts functioning and all the proofs have to be presented in writing to it.
 - After evaluating all the material, the committee advances a verdict on the issue.
 - With this verdict, the head of office will determine whether to fire or not the accused individual.

This whole procedure would normally take months, discouraging any supervisor to follow it. Usually honest supervisors will avoid it. They will move the reputedly dishonest individuals to second level posts or to those posts where getting a bribe is more difficult, and hire new workers for those positions. As may be noted, this procedure is one of the causes of a growing public sector with increased corruption. Furthermore, committees are hardly independent when making decisions on these issues, and since they belong to the same sections as the indicted, their identities are known. Both problems attempt against the capacity of committees of producing impartial verdicts. The problem of the inefficiency of internal enforcement mechanisms is a serious one for economic performance. North (1990) emphasizes their importance as a crucial determinant of economic performance. Cumbersome and dishonest bureaucracies may delay the distribution of permits and licenses, slowing down the process of economic innovation. This same argument could be applied to external mechanisms, as is pointed out below.

- The only specified form of payment of public servants is monthly salaries. There is no other way in which efficient wages can be set up to provide the necessary incentives to avoid corruption and increase performance of workers. The only exception to this rule is the case of foreign experts. Neither there are any forms of collective action measures that could set up ways to solve coordination failures in the provision of the public goods by the state.

The supervisor does not have the power of setting the wages of their employees, since these wages are determined on a yearly basis through the fiscal budget. Moreover,

with law 200, supervisors lose the power of dismissing corrupt workers. This impossibility by supervisors of setting neither the participation nor the incentive compatibility constraints of public officials is one of the explanations of the inefficiency and corruption within the public sector¹¹, and an important cause of decreased economic performance. Many realities in the public sector only make matters worse. Job descriptions do not exist, evaluations of performance are unknown and there is no systematic training. In 1990, a public service directorate was created to implement law 200, but has had little impact.

The Career as a Public Servant

Law 200 attempted to be instrumental in defining the rules public bureaucrats have to follow to have a career in the public sector. This is an important issue in the struggle against corruption. If public sector employees do not have the perception that they will remain in office with a change in government the consequences can be disastrous. Tenured positions insure officials against changes in government. However, if this protection does not exist, and they can foresee changes, this will foster corruption in the public sector. In Paraguay, it has been common that the ruling party (the Colorado Party) would publicly threaten state employees with losing their jobs if they did not vote for their candidate¹². Most elected candidates have promised –and fulfilled this particular promise- that everybody will keep their jobs when they get into office. However, as we can notice from the above exposition, such policy just derived into an increased government structure, where efficiency is not a paradigm.

For the first time, with the application of law 200, the government recognized the need for an institutionalized career for public officials. However, there is the need for a more modern form for this law. A bureaucratic career should be done on the basis of merits and aptitudes for civil service. However, the law is favoring tenure to anybody that could get a position and until now there is no selection process for higher positions within the organization. If we add to this the fact that labor unions of public servants have been struggling for increased wages and reduced dismissal of their associates, the level and efficiency of public offices will be greatly damaged.

Several institutional measures can be taken to foster desirable careers in public office. Providing performance-based incentives is the most important one. Wages, where possible, should be based on reliable measures of accomplishment of the objectives of the organization. Tenure should be acquired gradually and competition for higher posts based on merits, experience and aptitude should be the rule. It is also necessary to identify the dishonest officials. This is an easy task since information on reputation is easy to acquire. Offices should be gradually but consistently purged of these individuals. The process of reducing the size of the state must be slow in what number of employees, since a drastic reduction could affect the level of employment. Both internal and external monitoring systems must be put to work. Collective action is both a low cost and efficient way of

¹¹ For more information on the subject, see Rasmussen (1990), Fudenberg, and Tirole (1990).

¹² The last such threat was made not more than a week ago by the current Minister of the Interior, Atilio Fernandez, who said that everybody have to vote for the candidate of the official fraction of the Colorado Party, and that he was going to guarantee that happening (ABC, April 9, 1997).

solving coordination problems. This implies a change in the conception of the state in the administrative spheres. In the following section we study the measures that have been put in practice in Paraguay.

The Reform: Improving the monitoring capabilities of the State

i) The General Controller's Office

In 1992, the new constitution established a General Controller's office (Contraloría General del Estado), in charge of ensuring accountability of the public sector. However, the first mandate of the General Controller was not successful in undertaking disciplinary measures to deter corruption. One possible problem was the fact that the head of office was provisionally appointed by the President. In 1994, for the first time, the head of the General Controller's office -a secretary and a sub-secretary- was elected by the Parliament. Before this date, these posts were filled by direct appointment from the President. The Office of the Controller undertook a direct monitoring over other sections of the government by two direct and simple means. First, they started a series of auditing procedures in most government offices. In the process of selecting which offices to audit, preference was given to those allegedly corrupt as denounced in press reports. Second, they started a control of vehicle property of the state at night, to ensure drivers has the required permit to use them. These two policies were effective in different aspects. The first is a real control that makes a detailed study of the situation of the accounts of a particular public institution, affecting real variables such as government expenditure. The second one is designed mostly to affect expectations of bureaucrats, since the officials that stopped a car has little authority to fire the corrupt person caught using the public vehicle. However, both are perceived by the public as effective ways of externally controlling corruption in the public sector. The same effect is obtained from the public since they can anonymously report acts of corruption to the controller's office. This fact is important because it gives public officials a feeling of being monitored by a powerful institution. In a country like Paraguay, where during the whole Stroessner's period incentives were set up to raise the level of corruption, new measures of control are a necessity.

ii) Economic Policy

A first step in the economic reconstruction of the country after Stroessner was the liberalization of the exchange rate. The existing fixed exchange rates did not follow at all its market value, providing incentives for imports that were cheap and disincentives to exports that were relatively expensive and thus affecting production. Moreover, 60% of the values of exports had to be exchanged into national currency at the fixed rate. This encouraged not only bureaucratic corruption in the country but also related activities like contraband.

The signing of the Treaty of Asunción by the Paraguayan authorities to formally incorporate the country to MERCOSUR can have major effects in the system of corruption that exists in the country today. Barriers to trade generate rents that foster non-productive rent-seeking activities from agents in the economy. These rent-seeking

activities are mostly performed in illegality, surrounded by a high degree of secrecy. Secrecy is obtained by restricting access to transactions to unknown individuals. In most cases, the size of bribes determines the size of these rents. Countries in MERCOSUR, specially Brazil and Argentina, are the major commercial partners of Paraguay. The lifting of trade barriers will imply the dissipation of these rents and the resulting activities. However, the problem does not end when barriers are lifted. In the public sector, bureaucracy is another impediment. Bureaucrats collude in creating barriers to transactions relevant to international commerce (delays, excessive amount of paperwork, etc.) to be able to extract bribes from customers that want to speed up these processes. Therefore, contrary to the popular belief, as long as the bureaucratic and administrative regime is not modernize the sole inclusion of the country in the trade agreement could have little impact on the reduction of corruption.

On the other hand, Paraguay has been in the past few decades a major smuggler of industrialized products from third countries into the area. As of today, Ciudad del Este a bordering city with Brazil and Argentina in the Iguazú falls region has been acting as a duty free zone for the whole area. Brazilian authorities, specifically the Internal Revenue office of that country, estimated that illegal business in this city reached the incredible sum of 12 billion dollars, almost twice the size of Paraguay's legal GDP (ABC, October 25, 1995). Lifting barriers for trade would legalize just the sales of these goods to the free zone, but not the introduction of smuggled goods into Paraguay. Collusion between businessmen and public officials to capture the emerging rents are and will still be a reality. Addressing the problem of corruption in Paraguay within MERCOSUR, became a matter of not just national but regional concern. In 1995, Brazilian officials imposed restrictions on the value of the goods that could be introduced from Ciudad del Este to Brazil by Brazilians, lowering it from \$250 to \$150 (ABC, September 29, 1995). The estimated losses for businesses in Ciudad del Este from this measure reached 6 billion dollars (ABC, August 25, 1996). Herken (1995) proposes the re-conversion of activities in the sub-region from commercial to industrial, in order to provide the adequate comparative advantages for the country to compete. In this process, however, it is important to consider the influence that this will generate on the urban poor. The state is the biggest employer in the country and the provision of anti-corruption incentives implies increased wages of public officials with the consequent reduction in size of the state. Such reduction could imply growth of the informal sector, that along with the reduction of contraband could also reduce total income in the sector. The provision of incentives for the formation of new community enterprises directed towards solving the collective action problems of these informals, might be a feasible alternative policy for the sector to accompany these measures.

iii) The Congress

The first Parliament elected in May 1989 had the historic duty of starting the reform of the state and the setting up of new democratic institutions. This was a major task in a hardly legalized country with a repressive state. The repressive machine of the dictatorship was partially dismantled, especially with the derogation of laws 209 and 294 of "Defense of Public Peace and People's Freedom". Congress assumed the functions of

both public attorney and judicial system, scrutinizing activities that affected not only the public but of the private sector as well. In 1990, the Bicameral Commission for the Investigation of Felonies (Comisión Bicameral de Investigación de Ilícitos) was established to start functioning as a Committee in charge of scrutiny of public expenditure and investigation of corruption. Nevertheless, in the last years the commission has seen his reputation diminish. The excessive amount of irrelevant hearings and unproved imputations restricted credit from the public as an important institution.

iv) Judicial Reform

Under Stroessner, all members of the judicial branch of the government belonged necessarily to his party: the Colorado Party. Moreover, all judges, even the supreme court ones were appointed by the executive branch, i.e., the dictator himself. This had two consequences on the development of corruption. The lack of independence of the judicial system from the executive branch destroyed any possibility of control. Even an honest judge could not survive in his post if he wanted to control the behavior of the public sector in general. This lack of control coexisted with the influencing decisions of judges by a systematic system of bribery.

The Constitutional Reform in 1992 established a Committee that would be in charge of appointment of new judges. The newly instituted Consejo de la Magistratura (Council of the Magistracy) was in charge of appointing new Supreme Court members, judges and magistrates. Furthermore, the 1992 Constitution guaranteed the judicial system a 3% of all national budget expenditures. Finally, the Constitution also established a “Jurado de Enjuiciamiento de Magistrados” (Jury for the Judgement of Magistrates). This Jury is independent of the Supreme Court and can dismiss judges on charges of corruption.

Despite all these changes, the judicial system is still not working well. This constitutes a problem because even when complete contracts can be written, such that they might be enforced in a court of law, the weakness of third party enforcement mechanisms makes contracts useless. Although a large number of the judges that were in office before have been changed, people do still not trust the judiciary. This perception of the public is reinforced by the existence of groups outside the state that are functioning as third party enforcers. The problem of the weakness of the judicial system and the existence of corruption in Paraguay, are largely determined by the possession of certain groups of the capacity of inflicting costs on other individuals and groups, which are not interested and blocking change. These costs could take sometimes the form of violence¹³ but most times are translated into power in market relations, where powerful economic groups by dominating the system are capable of appropriating large fractions of the GDP through collusion and monopoly.

¹³ The assassination of the journalist Santiago Leguizamón in Pedro Juan Caballero a neighboring city with Brazil and ruled by Mafia groups in 1991, and the recent attempt to murder journalist Héctor Guerin in Ciudad del Este, account as two examples of the implementation of violence as a means for imposing costs.

Conclusions

The reduction of the state in highly corrupt countries like Paraguay is a necessity. After more than 35 years of ruling of a highly corrupt government, there is the need for a smaller, more efficient and thus, stronger state in the economic sphere. A large part of the debate on privatization in Paraguay wanders around distributional issues. The state is assumed more egalitarian than the private sector when managing the so-called strategic sectors of the economy. However, at high levels of corruption this is not true anymore. The Paraguayan ruling class is largely connected to corruption and other illegal activities. The scale of operations undertaken by these former and current public officials attained incredible figures. Wealth distribution was therefore significantly affected by corruption. The effect is even larger if sister activities are taken into account. The distribution of resources has also been affected through money laundering and capital flight in financial markets and distribution of land that affected the land tenure system.

The spirit of a reform trying to reduce corruption should include incentives for honesty, not only in the public sector, but in the whole economy as well. The central objective to be considered when elaborating such policies should be the achievement of social optima with improved income distribution. With this consideration in mind, the debate should center on the efficiency of one particular institution over the other in achieving that goal. The impact of communities should also be considered as a major provider of public goods. Communities as collective action enterprises can be more efficient in solving coordination problems when monitoring is costly and contracts are incomplete. It is important that certain aspects are considered when elaborating anti-corruption policies. Although market mechanisms are efficient in allocating goods, market failures are common especially in developing countries like Paraguay. The state should be ready to provide the hard and soft infrastructure necessary to achieve the social goal. Communities, on the other hand, can be more efficient than the state in providing goods especially when coordination failures arise in small groups¹⁴.

In the struggle against corruption, mere privatization could give rise to concentrated ownership of assets; increasing the already unequal income distribution and giving rise to new and equally pervasive inefficiencies. Such outcomes in a developing country like Paraguay could boost the informal and the black markets, de-institutionalizing even more an already highly non-institutionalized society. Anti-corruption policies should be careful in providing the right incentives to include most of the population within the boundaries of legitimacy and law. Identifying the main aspects of the corruption enterprise within the public sector, and devising strategies that could result in attenuating the existing coordination failures must be the central purpose of such strategies. At the same time, these policies imply a wider range of issues that include the whole economy. Asset redistribution that attacks concentrated ownership where perverse incentives and costly enforcement strategies exist should accompany these anti-corruption policies. One such policy might be worker ownership of firms. Such a policy has started to be implemented in Paraguay, with the recent selling of the government steel factory (ACEPAR) to the workers through their labor union. Although this policy is interesting is undertaken in a

¹⁴ For a complete discussion on efficient redistribution of assets, see Bowles and Gintis (1996)

sector that does not seem to be technically competitive in the region. The results are yet to be seen.

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