

Corruption: concepts, types, causes and consequences

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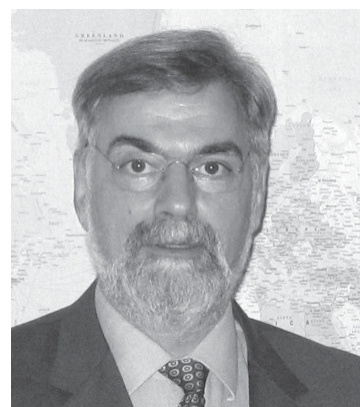
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Bibliography

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Definition of Corruption

What is corruption? There are several answers to this question. Analytically speaking, the most promising answer is the one made by Vito Tanzi: “Corruption is the intentional non-compliance with the arm’s-length principle aimed at deriving some advantage for oneself or for related individuals from this behavior.” There are three basic elements of this definition. The first element deals with the arm’s-length principle as it requires that personal or other relationships should play no part in the economic decisions that involve more than one party. Equal treatment of all economic agents is essential for a well-working market economy. Bias towards particular economic agents definitely violates the arm’s-length principle and fulfills a necessary condition for corruption. If there is no bias, there is no corruption.

There are two additional necessary conditions for corruption, or rather conditions that must be fulfilled for observed bias (“non-compliance with the arm’s-length principle”) to be specified as corruption. The first condition is that the bias must be intentional – accidental violation of the arm’s-length principle because of, for example, imperfect information, does not represent corruption. Second, there must be some advantage for the individual who commits a violation of the arm’s-length principle; otherwise, there is no corruption. Violating impartiality may sometimes represent racism, but it is not corruption.

Deriving some advantage, or seizing some benefit for the corrupted economic agent, can have different forms. It is a rather widespread notion that corruption is receiving money (this form of corruption is most often called bribery), but similar gain can imply expensive gifts or various favors returned. Giving expensive jewelry to the wife of the person who violated the arm’s-length principle and providing a well paid job (with little work) for his son is definitely corruption.

Seizing some benefit or deriving some advantage can be carried out simultaneously with a violation of the arm’s-length principle, but those two actions can be taken at different times. Namely, biased behavior of the one who is corrupted makes an informal, but sometimes binding obligation of the corruptor to return or repay the favor, and that obligation does not grow obsolete, so that seizing the benefits from the one who is corrupted moves into the future. If the returned favor is a well-paid job for the son, and the son has just started college, it is obvious that there is a time gap between the two actions. Furthermore, in formulating the corruption contract, the returned favor is sometimes not even specified, but the obligation is assumed.

There is an alternative definition of corruption frequently used by the World Bank that specifies corruption as “the abuse of public office for private gain.” This definition considers

the cause of corruption in public authority and its abuse, and links corruption to the state, its activities, state intervention on the market and the existence of the public sector. In other words, the use of this definition excludes the possibility of corruption in the private sector, and it focuses exclusively on corruption in the public sector. This definition is consistent with the beliefs of Nobel Prize laureate Gary Becker that “if we abolish the state, we abolish corruption.”

The problem with the alternative definition is that not all abuses of public office are corruption. Some of them are straightforward theft, fraud, embezzlement, or similar activities, but definitely not corruption. If a senior governmental official simply illegally appropriates a sum of money from the budget without providing any service or favor to anyone, that is not corruption – it is a crime, but of another kind. It is socially unacceptable, but it is still not corruption, i.e. corruption is not the only thing that is socially unacceptable and illegal. In addition, extortion is something that provides intentional non-compliance with the arm’s-length principle, but since there is no advantage for the victim of extortion (a judge or a prosecutor, for example) a violation of this kind is not corruption. It is important to distinguish between corruption and other illegal activities because factors of corruption and policies to fight corruption usually are or can be quite distinctive from factors and policies against other types of illegal activities.

From the enforcement point of view, corruption is a contract. It is an informal contract because it is illegal – no court in the world will uphold it if there is a problem with its enforcement. On the contrary, a properly operating court would process corruption as a criminal offense. This very specific feature of corruption as an illegal contract generates its substantial transaction costs, the most important of which are: finding the counterpart, formulating the contract (particularly taking into account all foreseeable and unforeseeable contingencies), monitoring the contract, and enforcing the contract. This is not to say that standard legal contracts are free of transaction costs. This is to say that due to the illegal nature of the corruption contract, its transactions costs are multiplied. The transaction cost feature of corruption is of great relevance and must be taken into account when the consequences of corruption are analyzed.

From the point of view of its source, corruption is in most cases, the consequence of rent appropriation. Rent is a factor’s income that is above the competitive returns of the factor. Competitive returns are those achieved on the competitive market; hence in the world of perfectly competitive markets, there will be no rents. Corruption is just a form of rent appropriation and its dissipation, i.e. a situation in which economic agents are willing to pay a bribe to be included in the rent appropriation scheme – they are

paying to earn some rent. This origin of corruption should always be taken into account when discussing the factors of corruption. The factors that create rent are the ones that create fertile ground for corruption.

A few words on the ethical aspects in defining corruption should be added. For an overwhelming majority of people corruption is something morally unacceptable; it is the evil that should be fought because its very existence is against basic moral principles. The analysis of corruption which follows is morally neutral. The issue of morality is irrelevant to the considerations in this document. In that sense Tanzi's definition of corruption is morally neutral.

Basic Types of Corruption

The types of corruption are strictly linked to the theoretical view on corruption. Economic theory has developed two basic views of corruption. One view is set within the framework of the principle-agent theory. This approach is based on the assumption that there is an asymmetry of information between principals (politicians or decision makers) and agents (civil servants or bureaucracy). Accordingly, benevolent politicians are not informed about the misdemeanors of their subordinates. This approach is analytically very clear, it is very well developed, and the models of theoretical models of corruption based on this approach are analytically rich, as they can explain a wide range of behavior of civil servants, including administrative corruption. However, this approach cannot explain political corruption. According to the main assumption, the state is benevolent, so there is no possibility for political corruption. Only administrative corruption (corruption of civil servants) can be explained and predicted. Since the list of corrupted politicians and associated political scandals is lengthy in virtually all countries of the world, it seems that not only are the assumptions of the model unrealistic, but also its predictions regarding political corruption are wrong. Political corruption simply cannot be explained within this methodological framework.

The crucial feature of this approach is that corruption is exogenous to the political process; hence principal-agent relations (and the scale and scope of asymmetry of information) are not as influenced by the political process and political constellations as by the outcomes of that process. In other words, corruption is not institutionalized.

Nonetheless, if corruption is considered endogenous to the political process, corruption is institutionalized and its level and pattern depend on the political constellation, i.e. the political regime in the country. Corruption is nothing but a consequence of the political process. The methodological breakthrough of that kind has been recently achieved by Charap and Harms. The methodological approach is based

on the recent contributions to literature on the economics of conflict and appropriation, the economics of organized crime, and the political economy of dictatorship.

Within such a framework, corruption is considered as a form of rent appropriation by the ruler. Corruption is the answer to the problem of internal cohesion of predatory teams. Corrupt civil servants are created to satisfy ruler desire to foster loyalty through patronage. Corrupt civil service is nothing but the extension of efficient rent appropriation by the ruler. The rent is extracted through sales of a limited number of permits and licenses for economic activity. Furthermore, endowing only a few civil servants with the power to grant licenses enables the diversion of the licensing proceeds from the budget towards private gain. Finally, civil servants are cooperative because they have their share in the spoils. Corruption serves as a hostage mechanism to minimize the probability of defection or insurrection by lower level insiders of corrupted civil servants; they are effectively constrained, due to their own participation, from turning to the public to denounce the system. Dictators can, when and if necessary, find a reason why an uncooperative civil servant is found guilty of corruption. Hence, there is both the carrot and the stick to strengthen loyalty.

This approach is tempting because it provides grounds for understanding and explaining the relationship between corruption and the political process. Nonetheless, this methodological approach does not provide a clear analytical framework for consideration, given the level and structure of corruption. The main problem is that the structure of incentives to the political decision makers and the change of that structure are not explained, hence we have no information on the driving force of the change, although the model provides information on the structure of incentives for rent appropriation.

In general, within one or the other theoretical views, three basic types of corruption are identified. The first one is corruption for achieving or speeding-up materialization of some specific right that the citizen or legal entity is entitled to – corruption without theft, as suggested by Shleifer and Vishney. If a person bribes a civil servant in charge of issuing a passport that a briber/corruptor is entitled to, i.e. there is no legal barrier for his passport to be issued, that is exactly the first type of corruption. Its specific and more aggressive version is bribing officials for jumping the queue for providing the service that is thoroughly legal. In other words, civil servants are corrupted to do their job or to do it more quickly than they usually do, instead of not doing it. The frequency of this type of corruption is a good indicator of the capacity and effectiveness of a country's administration, i.e. its poor administrative capacities or poor supply of administrative services. One should bear in mind that the shortage of supply

of administrative services can be deliberately produced, aimed at creating the rent and its redistribution via corruption.

The second type of corruption is a corruption that violates the legal rules, or a very biased enforcement of the rules. This is administrative corruption and is the most modelled type of corruption – the vast majority of theoretical contributions in the field are about administrative corruption. This is due to very clear motives and incentives for each economic agent and very clear relations between them. This type of corruption corresponds to the principle-agent model of corruption, as the total supply of corruption (demand for the bribe for violating the rules) is provided by the civil servants. The most significant direct consequence of this type of corruption is that legislation and public policies are not justly enforced. A cynical approach to the issue within countries with widespread corruption is that some public policies are so bad, it is actually better for the society that they are not enforced. Accordingly, corruption is considered to be the second best solution. It would be better if these policies were not enforced at all. Nonetheless, since the political process resulted in bad policies (and no alternatives to that political process are feasible in the foreseeable future), corruption is seen as a solution for bad public policies, whatever the source of these bad public policies. Nonetheless, one should take into account the costs of corruption as such, particularly the costs of corruption as a method for circumventing bad public policies.

Finally, there is “state capture” – corruption that is aimed at changing the rules and regulations into rules and regulations that favor the interests of the corruptor. The concept of state capture was developed by the World Bank primarily for explaining the reality of political life in transitional economies. The underlying assumption is that legislation and public policies are decisively influenced by the bribing of legislators by a few oligarchs – very powerful business people. In other words, public policies are inevitably formulated to favor the oligarchs, not the public. Although there is no doubt that such a process exists, and that this type of corruption can explain some elements of public policy in many countries (not only transitional ones), the concept of “state capture” lacks analytical clarity. The main problem is that interest groups influence legislators’ decision making in all countries. Strong lobbying is an entirely legal and legitimate activity in mature democracies. The crucial analytical problem of the “state capture” concept is specifying a cut-off line between legitimate political lobbying and “state capture” created by corruption. The state can be captured both by aggressive lobbying and by effective corruption. Subsequently, the crucial question is to what extent are the outcomes regarding public policies from legitimate lobbying and illegal corruption different, and more specifically are the public policies designed by lobbying superior to the ones designed through

corruption? Additionally, the question is whether the social costs (in terms of the opportunity costs of resources used) of lobbying are greater or less compared with the social costs of corruption. In brief, although the type of corruption that influences public policy is very important to consider, the analytical framework of “state capture” should be substantially improved in order to better explain its mechanisms and for an enhanced understanding of the process.

The other important distinction in the case of corruption is its industrial organization, as Shleifer and Vishney thoroughly analyzed the phenomenon, emphasizing centralized (monopolized) vs. decentralized patterns of corruption. The crucial prerequisite for centralized corruption is the ability to enforce joint profit in bribe collection. It is closely related to the problem of enforcing collusion in oligopoly. It has been pointed out that when governments have an effective policing machine to monitor the action of civil servants, such as the KGB in the former Soviet Union, corruption in the country is centralized. Within the methodological framework of a benevolent state, the analysis of industrial organization cannot answer why some (benevolent) governments are equipped with agencies like the KGB while others are not. Apart from the prerequisites for distinctive industrial organization of corruption, the crucial distinction is the one of transaction costs. In decentralized corruption, a single corruptor is dealing with multiple, rather than single, corruption contracts (transactions), hence the transaction costs are multiplied. In other words, a monopolized corruption pattern is superior to a decentralized one regarding the scale of transaction costs.

Basic Causes of Corruption

All economic agents are maximizing their individual utility, i.e. personal welfare (wealth). Accordingly, selfish interests of economic agents are the basic motive for economic transactions between them. Resources are allocated to the activities that provide the greatest returns on investment (an allocation decision). In short, people in all conceivable conditions behave economically rationally.

As described earlier, rent is a factor of income above the competitive returns (opportunity costs) of the factor. Because of that, i.e. because rent appropriations will maximize individual utility (welfare), economic agents are engaged in the rent-seeking process, the process of creation and distribution (appropriation) of rent. Theoretically speaking, rent can be created in a few distinctive ways, but in reality the most significant rent generator is government intervention, i.e. violation of free market operations. A frequently used synonym for this type of government intervention is regulation. In other words, instead of enabling the free market to regulate relations and transactions among

economic agents on the market, the government, whatever the motives may be, steps in and regulates these relations in a hands-on manner.

The majority of government intervention on the market is prohibitive, i.e. economic agents are precluded from doing something, unless the government explicitly empowers some of them to do so. A typical regulation of this kind is import licensing. Only the firms that obtain import licenses are allowed to import certain goods and only the quantity specified in the license. That will inevitably create a shortage in the market; supply will not be formulated according to the marginal costs of the producer/importer, but by the administratively specified quantity. At that specified quantity, the price commanded by demand (i.e. the amount of money consumers are prepared to pay for an additional unit of the good) will be substantially higher than the costs of its production/import. That difference is economic rent which will be distributed, i.e. appropriated, at the end of the day. By paying a bribe to get an import license, a portion of the rent is appropriated by the corruptor and the remaining portion is appropriated (in the form of bribe) by the corrupted. Needless to say, without introducing import license regulation there would be no rent and there would be no corruption. There are some cases of corruption not linked to rent, but the most significant, most common, and consequentially dangerous forms of corruption are linked to rent-seeking behavior.

Accordingly, more government regulation *ceteris paribus* (all other things being equal), results in fewer free-market operations, and therefore more corruption. Nonetheless, apart from the content of legislation that introduces government regulation, it is very important how these rule and the process of the enforcement are specified. As to the specification of the rules, for efficient enforcement the rules should be simple, clear, and easily understandable by anyone. The more complicated, unclear, and ambiguous the rules, the more opportunity there is for corruption. A typical example of this occurs with a large variety of customs tariff rates in general and for rather similar products in particular. If the customs tariff rate for one product is 3% and for another similar product is 30%, there are strong incentives for corruption aimed at misclassification of the goods and illegally reducing the levy by applying the lower rate.

Furthermore, procedural legislation, which are rules regarding enforcement of rules and regulations, is very important for corruption. The complicated and non-transparent legislation specifying slow procedure (procedures with unspecified time limits or no binding deadlines), at the discretion of civil servants in the enforcement process, creates a tremendous opportunity for corruption. Not only does such legislation create incentives for corruption, but it also

decreases the probability of detection, making threats to the corruptors and corrupted less credible.

The analysis of corruption factors is a prerequisite for an effective strategy for fighting corruption, as the strategy should take into account and address the main sources of corruption. Taking into account that rent is the most important source of corruption and the government intervention that creates rent is the most important factor of corruption, the crucial element for any effective strategy for fighting corruption is deregulation. Deregulation means abolishing government intervention that is prohibitive, thus allowing market forces to function effectively. Market forces on the free market will drive all the factors' returns to their competitive level and there will be no rent due to government intervention, hence there will be no source of corruption of that kind. There will be no shortage on the market, no queues for goods whose supply is limited, no black market and no rent generated and appropriated from long queues and the black market.

From another perspective, deregulation will decrease and in some cases eliminate corruption due to the lack of discretionary power of civil servants. Then there will be no incentive for private parties to bribe civil servants, because civil servants will not be in a position to offer any favor to the corruptor. For example, there will be no import licenses because anyone can import whatever she likes in the quantity that she considers profitable or good for the business. There will be no barriers to entry that must be circumvented by a certificate issued by a civil servant, etc. Civil servants will lose their power to decisively influence the fortune of business people and citizens.

Deregulation and decreasing the role of the government has its limits. The basic reason for the government to exist is to provide the rule of law. For economic agents the most important aspect of the rule of law is protection of private property rights through efficient contract enforcement. In the case of rule of law, government power should not be diminished, on the contrary it should be enhanced – there is no room for the government to withdraw from this area as a key element of anticorruption strategy. On the contrary, strict rule of law is one of the elements of an effective strategy for fighting corruption. Accordingly, all measures that improve the rule of law will definitely contribute to the fight against corruption. One of the crucial elements of strengthening the rule of law is the creation of simple, clear, and transparent rules that are understood by all concerned parties. Such rules of the game – and the name of the game is market competition – will minimize disputes regarding their enforcement which will minimize the uncertainty of economic agents and substantially decrease any room for corruption.

Streamlining procedural legislation and making it simple and transparent is also very important because it minimizes the uncertainty of economic agents, reduces the discretionary power of civil servants, and increases the visibility of corruption cases, i.e. situations in which procedural legislation is violated. Such a framework increases the probability of detecting corruption misdeeds and apprehending corrupted civil servants. The increased probability of apprehension and punishment creates a deterrent for civil servants to accept bribes, therefore decreasing incentives for corruption.

Increasing wages of civil servants is another important segment of the strategy for fighting corruption. Nonetheless, this element of the strategy should be considered within the framework of the deterrent, i.e. punishment. Part of the punishment for corruption should be expulsion of the civil servant from the job that provides higher wages than those on the labor market, i.e. wages in the private sector. In this sense, high wages of civil servants (higher than in the private sector) can provide incentive to not accept bribes only if there is a substantial risk of apprehension and punishment that includes a decrease in their future (expected) incomes. Accordingly, the wage scheme as a segment of an anticorruption strategy should always be considered along with the probability of apprehension. Furthermore, excessively high wages in the public sector can have an adverse effect on the allocation of the labor force as talent is moved away from the private, value-adding sector.

Nonetheless, the most important prerequisite for effective anticorruption strategies is strong and unconstrained political will. Such a will can be generated by identifying the most significant consequences of corruption. If such a will exists, government must send an unequivocal and credible signal to all concerned parties that it is committed to fighting corruption. Strong words are necessary, but not sufficient, for credibility. These words must be followed by actions and accomplishments in the area of policy and institutional reform along the suggested lines as well as action in the area of the criminal prosecution of corruption.

Consequences of Corruption

As to the consequences of corruption, it should be recognized that the bribe itself is nothing but a redistribution of income. In other words, the bribe itself is not a welfare loss – the scale of social welfare does not change, only its distribution. Although strictly speaking this is true, emphasizing only distributional aspects of corruption is one of the major fallacies of corruption research.

The first reason is the existence of huge transaction costs from corruption. As it has been pointed out, corruption is an illegal contract, and therefore its transaction costs are massive. And transaction costs are real costs: the opportunity

costs of resources engaged in transaction activities. According to some estimates (Tanzi), senior managers in countries with widespread corruption spend about 20% of their working time negotiating corruption and enforcing corruption contracts; this is the amount of transaction costs in terms of the opportunity costs of highly skilled labor.

There is a rather widespread notion that the corruption income of corrupted civil servants provides compensation for their lower wages. Hence there is no need for a wage increase and no need for increasing the tax burden. In other words, the corruption burden is its own kind of a “tax burden” that, according to this approach, enables the proper tax burden to be decreased. However, proper taxation (together with efficient tax administration) decreases uncertainty and transaction costs. Hence, corruption “taxation” is inferior in terms of economic efficiency.

Furthermore, it was demonstrated that rent-seeking activities are closely related to corruption. The origin of rent-seeking is public policies that boost government intervention and disable free market operation. These public policies can be deliberately pursued specifically because they create rent, i.e. these policies can be influenced (irrespective of whether it is done by legitimate lobbying or illegitimate “state capture” corruption) by interest groups with a vested interest in creating and appropriating rents. Although these public policies are in favor of these interest groups, they are completely wrong regarding maximization of economic efficiency and social welfare, i.e. they are not in favor of the public interest.

Corruption violates the rule of law, and the rule of law is a prerequisite for the market economy. If there is no rule of law, there is no protection of private property rights and no contract enforcement. There is poor exchange between agents because there are no incentives for exchange due to poor protection of property rights and inadequate support of contract enforcement. Because of the poor exchange between firms, all firms produce the majority of inputs internally, instead of the purchasing these inputs on the market. In other words, there is no social division of labor and no prerequisite for specialization. Since there is no specialization, a significant source of increasing economic efficiency is absent. This is the indirect way in which corruption diminishes economic efficiency and consequently social welfare.

Corruption increases basic business uncertainty, particularly regarding protection of property rights. This kind of uncertainty decreases the expected profit rate for potential investors. Investors, making their decisions based on expected profit rate (returns), are less likely to invest when lower returns are expected. This is particularly true for the

foreign direct investors who compare expected returns, i.e. expected cash flow for investments in various countries and decide to invest their capital in the country with the highest expected returns. Since corruption decreases expected returns, corrupt countries receive less foreign direct investment and consequently record lower growth rates.

There is another reason that countries with widespread corruption cannot expect high growth rates that is directly related to entrepreneurship and innovations. As suggested by Baumol, entrepreneurship is a resource that can be alternatively allocated to productive activities or to unproductive and destructive activities. It will go to the activity that enables the entrepreneur the highest possible returns on his activity. Corruption is definitely an unproductive, and sometimes even a destructive, activity. If corruption is widespread, i.e. if the highest possible returns are in the area

of corruption, entrepreneurs, instead of focusing on productive, wealth creating activities will focus on corruption, redistributing activities and allocating their talents to it. As a consequence, other resources will be also be allocated to redistributive activities. Innovations that are a result of entrepreneurship will be allocated to redistribution and corruption. New methods of corruption will be introduced instead of new products and new methods of production.

This is a crucial dilemma for every nation: will the available resources be engaged in creating wealth or merely in its redistribution? Widespread corruption is a symptom of a severely ill society with a majority of resources and innovation allocated to the area of redistribution. Corruption is not about an amount of money changing hands or about “grease in the wheels of business.” It is about the future of the nation. And it is the nation that must make some difficult decisions regarding it.

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MISSION

The Center for the Opening and Development of Latin America (CADAL), with headquarters in Buenos Aires, Argentina, was created as a Foundation on February 26, 2003 with the aim of promoting the strengthening of democracy, rule of law and economic liberties in the countries of the region. For this purpose, CADAL organizes activities related to analysis, research and promotion by means of two special projects and various programs pertaining to four areas: Latin American Politics, Democratic Strengthening, Economy and Rule of Law, and Institutional Development and Communications.

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The interpretation of the Argentine crisis of 2001/2002 and its regional impact, institutional weaknesses in several countries and, in general terms, the anti-market public opinion in Latin America after the economic reforms of the 80s and 90s, were some of the motives that led to the creation of the Center for the Opening and Development of Latin America. Another reason was the need for a pro-democracy and market-oriented NGO that worked to combine analysis, research and promotion of political and economic issues from a regional perspective.

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