

Governance, Moral and Economic Values

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Abstract As for all crimes, the cost of corruption to the perpetrator is a positive function of the probability of being detected and a negative function of the severity of the sanction. The uncertainty of the sanction and the growing importance of illegal practices in our society increases the benefits of operating illegally, while cost are reduced. This paper analyses the social costs of the activities of surveillance and sanction needed to circumvent corruption. The benefits of monitoring and sanctioning entail both decreasing and increasing costs. There will be an optimal level of such activities, in which corruption will not be eliminated. The use of real option theory suggests, contrary to the traditional theory of law and punishment that the power of politicians and men of law both depend on uncertainty. The greater the uncertainty and the value of penalty, the greater the power of the police or the magistrate. Given this perspective it may be considered desirable restoring the credibility of the judicial administration, such as providing somewhat prompt extra penalties, setting up anti-corruption boards, promoting transparency and openness in governmental activities. At the same time, these policies have limited power, since moral norms and standards are delicate mechanisms that rely on trust and commitment and ensure that citizens choose to act according to principles that would not necessarily increase their wellbeing.

1 Introduction

Ethics can be defined as the economics of behavior. For rational individuals, not governed by endogenous moral norms, an act is desirable if the expected cost (consisting of the product of the probability of being discovered for the sanction if

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any), is less than the expected benefit. If we are in the presence of relative moral norms (i.e. not “categorical”), the cost is added to an endogenous component that depends on the weight that the individual gives to the same standard. This may change the terms of the problem, since the moral cost may be positively or negatively correlated with the material cost.

In the case of corruption, it is likely that the moral cost is a positive function of the probability of being detected (if this is high, it increases the degree of cognitive dissonance of an infringement). The moral cost of corruption, on the other hand, can be negatively correlated with the severity of the sanction. From the cognitive point of view, in fact, that hardness is an alternative to the autonomous moral judgment and may therefore elicit a decreased motivation to behave in a clear and fair in business, as well as to obey the laws. If a higher strength of the sanction is accompanied, as is common for economic reasons, by a reduction in resources for repression, and thus a reduction in the probability of discovering the corrupt, obedience to the law for endogenous motivation (i.e. respect social norms) is further reduced.

More easily than for the other types of crime, a theory of illegality is generated on the basis of the idea that society can “tolerate” a certain degree of corruption, as is evident from the fact that only a small part of the corruptors and corrupted are punished. If this idea of tolerance level of 1 is generalized, the number of corrupt people tend to increase, further validating the theory. Level 2 tolerance follows and then tolerance of greater and greater degree, accompanied by a crescendo of lawlessness. Since the systematic misapplication of the rule creates uncertainty among citizens, lawlessness also receive increasing support from previously “honest” citizens.

The uncertainty of the sanction and the growing space occupied by corrupt practices, in fact, increase the benefits of operating illegally, while costs are reduced. But at this point, there being a large number of parties involved in corrupt practices, even those who have tried to behave honestly, or are guilty of marginal infringements will tend to support the corrupt people’s point of view. The campaigns against corruption, therefore, will not find any real support.

2 Measuring Corruption

The scientific literature has historically approached corruption as a complex phenomenon that is in large part matter of interpretation and is extremely difficult to define and measure (Wraith and Simpkins 1963). Both being immeasurable and not being measured are characteristics features of corruption that continue to represent a relevant obstacle to raising the awareness on this issue and to evaluating the effectiveness of the anti-corruption strategies adopted at the local, national and international levels.

However, the interest for the institutional aspects of development has prompted many international institutions (namely, the United Nation’s agencies and the World Bank), non profit organizations (Transparency International), and research

centres (Columbia University, Economist Intelligence Unit, PWC, etc.) to dedicate attention to this issue, by trying to look at it from a quantitative point of view and on a large scale.

Corruption is thus the current object of many international statistical and measurement efforts according to three main dimensions:

1. objective/subjective measurement;
2. object of measurement: level of corruption, its causes and effects;
3. level of aggregation/detail of the measure adopted.

With reference to the first point, the measurement of corruption can be classified in “objective” and “subjective” (e.g. Kaufmann et al. 2006; Sampford et al. 2006) measures. Objective measures are usually based on proxies such as large cash payments, judicial statistics, data on income elusion and evasion that are considered associated to corruption. Hence, even though they may be considered trustworthy, precise and relatively accurate according to circumstances, they have low validity (Duncan 2003) because they are essentially based on presumptions and correlations. Subjective measures are based on surveys or polls in which experts, local business people or citizens are asked to express their opinion on corruption levels in different fields and circumstances of every day life. Subjective measures may also concern the respondents’ perceptions or experience (see, for example Transparency International CPI and BPI indexes). Corruption measures may also address the whole extension of the phenomenon its causes or its consequences, especially in the economic impact, as for example its impact on economic development is often measured (Kaufmann et al. 2006; Mauro 1995). Measures may also be aggregate, by attributing a score for each country such as the CPI of Transparency International or the governance indicators of the World Bank, or disaggregated by distinguishing specific economic sectors or geographic areas (as for the statistics on criminality).

Clearly all these measures, which are of increasing popularity and use in today’s debate on economic development, present different ranges and operational significance. From the economic point of view, they are largely disconnected from economic theory and are often only loosely related to clear economic aggregates. Furthermore, existing measures are almost always subjective and while they may be useful from a moral and political standpoint for raising civil society and public opinion awareness on the phenomenon and for stimulating the debate, they do not provide policy indications to decision makers. The objective measures existing in Italy—mainly statistics on criminality levels and on the so called “black sector”—are incomplete and tend to confuse different phenomena such as corruption, criminality and tax evasion. In particular, again with reference to Italy, there are no well-developed instruments for measuring the economic impact of corruption (disaggregated per sector and/or territorial area), in spite of the fact that a few quantitative studies have been developed for phenomena related to corruption such as the so called *murky* sector and the organized crime (D’Antonio e Scarlato 1993; Scandizzo 2005a, Scarlato 2001).

3 Components of Corruption

From the economic point of view, corruption can be considered a contract in which two parties (the corrupter and the corrupted) agree to jointly derive a benefit from the default of another contract, to the detriment of the contractor (or contractors) of the latter not involved in the corrupt relationship. The most common context in which corruption unfolds is thus a form of contractual opportunism in which one of the main contractor—the agent, is unfaithful to the mandate received from the principal.

What are the tools to reduce corruption? The analysis of contractual opportunism has identified two main instruments of governance, which go under the name of monitoring (monitoring and sanctioning) and commitment (incentives and motivation), while the theory of crime and punishment has focused on the binomial probability-entirety of the penalty. We can, however, consider the problem of punishment essentially comparable to the problem of monitoring, which is to identify the most effective ways, from the point of view of costs, to detect and punish corrupt behavior. The possibility of extending the surveillance and supervision also to external parties to the contract (or the corrupters extortionist) is in fact provided just by the intervention of the judiciary, which in this sense, tries to complete the tasks of the principals (whether a private entity or the PA) to protect their interests.

The activities of surveillance and sanction (the monitoring), however, present intrinsic difficulties and potentially high social costs. In fact, they create a division in the communities, which tend to break up into two groups: “controllers” and “controlled”. The latter, even when they are not directly covered by the audit, may develop hostile and evasive behavior towards the controllers. This can be done both for solidarity with the other people controlled, and because the fact of belonging to the group of the “controlled” can lead to the conclusion that there is a positive probability of being subject to controls that are unjustified and harmful in the future. In more serious cases, such as, for example, those relating to a police state or a colonial occupation, the community developed an “anti-state” controlled sub-culture, which produced a specific cult of lawlessness.

Attempts to circumvent this reaction are based on indirect mechanisms, cultivating, for example, spying, further increasing the costs of monitoring. These attempts, in fact, although effective in the short term, produce, in the long term, further radicalization of the dualism controller—controlled and they foment the conflict, both through the growth of violent illegal activities, and through the multiplication of avoidance and retaliation activities.

The high costs of monitoring can also be seen, as in the literature on crime and punishment, in the dilemma posed by the binomial property of law enforcement. The literature has noted that the increase in the penalties is to be considered in the abstract more convenient from an economic standpoint, since it is able to increase the deterrent effect of law enforcement, without the expenditure of resources required by the increase in the probability of discovering the culprits. The harder penalty, however, creates indirect costs, due to the increases in the costs of

prosecution—judgement error and conviction of the innocent and, from the point of view of the perpetrator, it reduces the opportunity cost of the most serious illegality. In the case of corruption, in particular, because of the pervasiveness of the phenomenon, the growth of the punishment increases the likelihood of escalation of the opportunistic agent, who, faced with the possibility of civil or criminal sanction not commensurate with the quality of the crime, decides to defy the law, setting up commensurate scenarios of illicit gain. Corruption is followed, then, by fraud, scams or other types of corruption in contracts, which threaten to undermine all confidence in market transactions.

The rising cost of prosecution and conviction of the innocent, on the other hand, is an external effect of graver sanctions, accompanied by an increase of the capacity of discrimination. This cost can be very important, because it determines an expansion of the sphere of insecurity of the individual and poses a threat to the fundamental rights of the citizen based on freedom. Given a chance of being caught and punished, in fact, an increase in the penalty increases more than proportionally the uncertainty for the innocent as well as for the culprit.

This increase is greater, the greater is the inefficiency of the judicial system and leads to the result of a greater number of violations and, correspondingly, to a higher average value of the infringements. The so-called “legal certainty” will be threatened by an implicit collective agreement, so that a level of punishment that is not commensurate with the probability of application shall be equivalent to a much lower level of punishment with a higher probability of application. This phenomenon is due to a dual effect: on the one hand, the prospect of a more serious penalty will decrease the deterrence differential among crimes, because while it is possible to increase the penalties for minor offenses, it becomes increasingly difficult to increase the penalty for felonies.

On the other hand, the burden of generalized sanctions, with equal probability of application, discourages more than proportionately minor offenses than larger ones if, as it is likely, the price elasticity (i.e. the elasticity with respect to the penalty) grows with the expected benefits of the crime. For example, it is estimated that a 10 % increase in the penalty for the offenses of corruption that promises a gain of £100 million has a larger effect of discouragement, compared to an increase of the same percentage of the penalty for offenses that promise 200 million. This effect of adverse selection is analogous to what occurs in the world of credit, when trying to distribute the loans on the basis of willingness to pay higher interest rates. Who is willing to pay more, in fact, is the bearer of positions that are, at the same time, more profitable and more risky.

Similarly, the corrupt willing to pay more in the event of conviction expects a higher gain, even if this entails a greater risk. Increases in the penalty, thus resulting in an increase in the average price of crime, preferentially select those who are willing to pay more, namely those, who are willing to take greater risks in exchange for prospects to gain more in the end.

Since the degree of tolerance implicit in the application of the penalty will increase, this will be interpreted as a value judgment on the seriousness of the offense, with the result that the dishonest will become more confident to get away

and the “honest” less safe not to be unfairly prosecuted or for not having taken advantage of the circumstances to enrich the ranks of dishonest and achieve gains of uncertain illegality. The cost may increase further if the spread of the climate of impunity involves, as it seems likely, corruption in the law enforcement apparatus. Corruption, in this case, may lead to a process of degeneration of the entire system, whose institutions will be losing credibility and strength, and become “corrupt” to an increasing extent with the spread of illegal behavior in the social fabric.

The alternative to increasing the penalty is to increase the probability that it is applied appropriately. To achieve such an increase, it is first necessary to invest considerable resources, both in the investigating and in the judiciary apparatus. If this effort is carried out in an appropriate manner, the results are likely to increase the capacity for monitoring and sanctioning and, at the same time, for discriminating between the innocent and the guilty. Even in this case, however, we can expect difficulties and rising costs. Expanding the repressive apparatus, in fact, will multiply the possibilities of inefficiency: the so-called scale administrative diseconomies will make it increasingly difficult to coordinate and even control a large and pervasive bureaucracy, avoiding a logic different of its own self-assertion. A police state can also emerge that will ultimately threaten individual freedoms.

From this discussion it is evident that, since the benefits of monitoring and sanctioning entail both decreasing and increasing costs, there will generally be an optimal level of such activities, in which corruption will not be eliminated. There will be a level of “good” of corruption, that is a level below which it does not pay to reduce activity by direct repression.

4 Sanctions and Option Value

A financial option is the right, but not the obligation, to buy (in the case of so-called “call” option) or sell (for the so-called “put” option) an asset of uncertain value at a predetermined price. A real option is the analog counterpart of this definition to measure the opportunities and risks created by a “real” economic activity. Since some activities are at the same time, uncertain and irreversible, they give rise to temporary values, which depend on the particular events that may occur, the estimates of the economic operators and the degree of uncertainty (and Scandizzo 2005b). Any action or economic status can therefore be conceived as having an upstream option, since the mere possibility of undertaking it is a faculty but not an obligation. In this option, however, lies generally a contractual obligation, implied or explicit by an individual or collective counterpart. The economic freedom of a market economy, in particular, consists of a series of options that economic agents, as citizens and parties, possess. All of these options coincides with the rights that may be subject to attribution of value, exchange and detention by the individual and form the so-called “contingent wealth” of economic agents, i.e. wealth, the value of which is conditioned by the state of nature which, in turn, occurs.

An action is not, however, only subject to a contingent right that may or may not be exercised. Once implemented, every action itself tends to generate a set of options, that is, contingent rights depending on the economic origin of the action itself and on other economic agents. Some of these options are of the positive type: they represent additional opportunities for deployment of benefits to the originating agent. Others, however, are of a negative type, as they represent threats to the original agent, because of unfolding rights on the part of agents damaged by the initial actions, to obtain benefits at the expense of the original agent.

The creation of options of a negative type, or “liability options”, is particularly relevant in the case of corruption, for two main reasons. First, as we have seen, corruption is a case of opportunistic behavior, i.e. an agreement between corrupt and corrupting agents to take advantage of the incompleteness of a contract at the expense of the principal. The contract between principal and agent, in other words, creates a threat by the agent, to be unfaithful in favor of a third party (in the case of corruption) or of direct arrangements with third parties (in the case of bribery), to take advantage of the contract to the detriment of principal. If this option is not exercised, the agent is honest, and if it is exercised, it enters the realm of the moral unlawfulness and, depending on the applicable law, of illegality.

Once in this area, however, a further liability option is created, which is, in turn, a threat against the dishonest and possibly corrupting agent: the option to sanction. It is an option, because, for both the moral sanction that for the legal one, there is no certainty of its automatic application. Rather, the penalty is the possibility that any society, through either informal or formal proceedings may exercise its faculty to proceed against the unfaithful agents, given the information available. With all due respect of mandatory prosecution, in other words, even the legal sanction unfolds according to individual agents who hold the option, deem it appropriate to exercise their rights, and consider the related costs bearable and useful for the prosecution and the punishment of the guilty.

If we consider both the corruption and the sanction as liability options held by different economic agents, we can infer a set of logical consequences, at least in part, unexpected. First, since the value of an option is greater the greater the uncertainty of the value of the underlying asset, both the corruption and the penalty constitute two options whose value is greater the greater the uncertainty of the basic contract. In the case of politics, for example, in a democratic regime, the principal for the politician is the sovereign people, but the mandate is surrounded by uncertainties in both motivations and objectives. We must therefore expect high opportunities to elude and twist its terms for the benefit of agents (and any of their associates), i.e. high values of the option of corruption. Correspondingly, the value of the penalty will be the greater, the greater the uncertainty relating to its application, due to the difficulty of recognizing and detecting the offense, because of the difficulty of applying the penalty. Since laws are designed and approved by politicians, moreover, we can expect a reasonable concern, in good or bad faith, that the penalty is applied for non-legitimate purposes, or that it may involve innocent parties. Consequently, the costs, but also the uncertainty of the application, will be higher.

The economic value of an ordinary asset depends positively on the difference between the relevant benefits and costs, and negatively on the risk that the difference is less than expected or negative. In contrast, the value of an option is the greater, the greater the uncertainty surrounding the realization of a net benefit. The greater the uncertainty, in fact, the greater the value of maintaining the opportunity to take action, without running the risk of actually doing so until the information collected is not sufficient. "Holding" means having an option then retains the right to proceed without exposing oneself to the risk of doing it too soon or inappropriately. The option of being corrupt, therefore, does not corrupt and does not expose the agents of the company or sanction the action of the court, but increases the value of honesty. If corruption is rampant, on the other hand, the sanction option will assume a gradually increasing value, and this will be amplified by the uncertainty on the forms, methods and objects of the penalty. In contrast to the traditional theory, the greater the possible value of the penalty, the greater its arbitrariness and, as a consequence, because of the uncertainty of its application, the more menacing the option held in the hands of the magistrate or police officer. Much greater, therefore, the sum of the powers of these officers of the state.

To conclude, real option theory suggests, contrary to the traditional theory of law and punishment, that the power of politicians and men of law both depends on an elusive force: uncertainty. In the case of democracy, in particular, this force is the basis of the implicit contract between voters and elected officials, and the possibility that it can be violated by corrupt politicians. But it is also the basis of the option of intervention in the hands of the institutions responsible for the protection of the law. The greater the uncertainty of the intervention and the value of the penalty, the greater the power of the police or the magistrate. Paradoxically, this means that in some circumstances, it may be of objective interest of political power that there is the possibility of corruption, because it gives more power to the repressive hand of the state.

5 The Costs of Repression

Corruption is a crime that involves the middle classes, professions, politicians and the bureaucracy. As sanctions are painful and uncertain, and, as we have seen in the previous section, an implicit solidarity binds the corrupt and the holder of the sanction, its suppression tends to occur in a cyclic manner and in the form of a purifying bath of the collective type. It is difficult to trace the roots of the rational collective tendency to periodically invoke strong and immediate sanctions for crimes of corruption and participate with enthusiasm to the application of these provisions. There is no doubt, however, that a common experience of all civilized countries includes periods of execution fervor in which the conviction or acquittal on the part of the public tends to precede that of the courts both in substance and in rituals. In these periods, fortunately uncommon in Western countries, together with or even before the formal processes, collective processes are celebrated, which,

even in their spontaneity, have ritualistic elements: a discussion of the evidence, identification of the culprits, the contemplation of the possible penalties. Nowadays the media have come to expand social rituals on the different stages, which increasingly tend to become parallel and eventually converge with legal rituals.

In addition to ritualistic aspect, which may have common values of catharsis or reaffirmation and thus are necessarily cruel, since they assert the priority of the social over the individual, we must assume that the public expresses also instances of rational nature. In the crowd, individuals do not cease to respond to stimuli and beliefs that affect them even when they are not in the crowd: the desire for justice, for example, concerns the efficiency or honesty 'of the rulers, the fear of uncertainty and the future.

What legitimate feelings are hidden, for example, in the support for the measures of preventive detention, apparently so extensive in Italy, at least in some recent circumstances? It's not easy to say. The statistical data available clearly indicate a framework of systematic violation of human rights, which the pre-trial detention data make even more disturbing. Suffice it to cite a single alarming fact: in the last 10 years more than fifty per cent of those who were imprisoned before trial were found guilty, and this despite the fact that the use of preventive custody has received an acceleration in recent years, as a result, *inter alia*, of the approval of a new Code of Criminal Procedure and the opening of the front of the massive crimes against the public administration.

It should also be noted that the punitive value of preventive detention is 'far greater for uncensored citizens, whose activities' economy depends on the social reputation of honest behavior. In these cases, incarceration has the effect of irreversibly destroying a substantial amount of human capital, which can never be fully recovered by any declarations of innocence and that, in the Italian system, is substantially non-compensable. The distributional effect of preventive detention is therefore unfair and regressive, inequitable because the cost is higher for the innocent than for the guilty, regressive, because it is more expensive for those who have comparatively lower incomes.

That said, it is also fair to recognize and it can be assumed that, albeit in the absence of a clear cognitive awareness, that there are some benefits associated with preventive custody. The largest of these benefits could be that, under the current circumstances of Italy, preventive custody makes credible the prospect of a penalty that otherwise would not be. The length of the process and delays caused by claim to ensure all three levels of courts' judgement without adequate resources, create, as well as the permanent condition of injustice, an objective difference between the present values of benefits and costs of the criminal act. The remoteness in time and the slowness of criminal trials reduce the value and credibility of the threat of sanctions resulting in a more widespread lawlessness.

An insufficient amount of resources allocated to the administration of justice, thus creates a gap between the social rate of return and private rate of return of law. As a consequence, not only respect for the law is reduced, but because of the loss of credibility, penalties tend in turn to get worse, with an ensuing vicious cycle that can lead to a real system degeneration.

Given this perspective, we understand that it may be considered desirable to use a tool that somehow compensate the inefficiency of the judicial process by restoring, though improperly, the credibility of the judicial administration, such as providing somewhat prompt extra penalties. From the point of view of social welfare, however, the solution is not necessarily better than the previous one, since, in view of the reconstitution of the credibility one may create possibly higher costs, and certainly not comparable in terms of distribution, due to unrecoverable damages to the innocent unjustly imprisoned. From the point of view of justice, we risk creating a wound in the collective consciousness that is an even more serious loss of credibility of the ever delayed sanction. In addition to credibility, in fact, the penalty needs to be civil and moral dignity needs to be respected.

One can also rely, in line with our discussion on real options, that increased penalties, when they do not respond to the actual concerns of immediate protection of the community, result in a demonstration of repressive power, that does not solve the 'inherent uncertainty' of the situation, but simply restates the option of sanctioning, increasing its value through the expansion of its uncertainty of application. The penalty becomes a sword of Damocles in the hands of the authority vested with the power of sanction, which may dramatically extend its power, especially against the innocent and the weak, which are more exposed to this threat while the corrupt may engage more easily in eluding it.

Instead of relying on increased repression, a number of measures have been recommended to contain and minimize corruption (Theobald 1990; UN 1990). These include: setting up of anti-corruption boards, commissions and the like, campaign for moral regeneration or moral re-armament, strengthening controls on abuse of power and the enhancement of accountability systems, promoting transparency and openness in governmental activities, developing positive social attitudes, enforcing a code of public ethics, supporting the role of media, improving educational procedures.

To reduce corruption drastically, a number of more fundamental changes have also been advocated. These include: reducing the opportunities for corrupt transactions by cutting back state's activities; letting new centres of power emerge outside the bureaucracy; implementing far-reaching administrative reform measures that affect policy, institutional and process levels; strengthening prevention structures (Theobald 1990; UN 1990).

6 Motivations and Incentives

Greed is not the only spring for individual action. Economic theory has long identified some of the motivation mechanisms (the so-called mechanisms of commitment), which ensure that citizens choose to act according to principles that would not necessarily increase their well-being, but are beneficial to the community. Moral norms and social standards are at the origin of the most important of these mechanisms. It was, for example, suggested that investment in schools and

churches is partly justified by the positive impact that these institutions have on motivations to obey the rules. In the case of corruption, we are faced, however, with rules that often are characterized by a substantial margin of ambiguity. A first ambiguity arises from a contrast typical of the production of public goods, which is the distinction between the benefit the public good offers to its users and the willingness to pay for it to be offered.

This phenomenon, which goes under the name of free riding, often means that there is a subtle distinction between the verbal support that the individual is willing to offer the dismissal or prosecution of corrupt practices and what she is willing to pay, in concrete cases that come her way, to give up the advantage that would result from corrupt transactions. The latter, in fact, often occur in the form of relatively small infractions to the rules of a very general nature, and just as the unpaid ticket by the free rider, they can be interpreted as small exceptions that are ultimately irrelevant to honest behavior. This is true at least until the escalation of individual or collective corruption does not make it impossible to continue to hold self-beliefs of honesty, even by exercising sophisticated techniques of self-deception.

A second ambiguity appears as a consequence of the fact that compliance with a moral standard is based on mechanisms of self-motivation. These, in turn, are based on the assumption that, to gain the respect of morality on the part of law-abiding citizens, there is no need to threaten more or less stringent sanctions. As many experimental psychology trials have demonstrated, a tightening of the repressive action weakens the endogenous mechanism to support the standard. In turn, this loses its endogenous support, in the sense that the individual tends to classify related behavior in the class where the burden for correct behavior is borne by society rather than the individual.

A third ambiguity, finally, depends on the elusive nature of the standard. This elusiveness is a consequence of the fact that the rule is generally supported by a common feeling (see, for example, “the common decency”), which, in turn, translates into a minimum standard, rather than in an absolute rule. This “required minimum level of honesty” varies with the level of economic development and the degree of freedom of each individual company, in the same way of other living standards such as poverty, piety, decency etc.

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