

CORRUPTION AND ECONOMIC DEVELOPMENT: THE CASE OF CROATIA

Predrag Bejaković⁴

Abstract

Many surveys have conclusively shown that countries with higher and more widespread corruption tend to have slower economic development and lower growth income per capita. Corruption is the most important obstacle to exiting the vicious circle of poverty, economic inequality, illiteracy and ineffective investment. Countries with much corruption badly use or altogether neglect their available human and natural resources. Corruption is a serious threat to foreign direct investments, and significantly contributes to political instability and widespread disbelief in governmental institutions and state bodies. Corruption jeopardizes public revenues and endangers existing social belief or enables its creation. Unclear and often changing laws that provide public officials with huge discretionary powers are fertile preconditions for widespread corruption. This causes insecurity in business activities, encourages suboptimal decisions and makes impossible, or at least hinders, the realization of economic development and poverty reduction. Widespread corruption and the intermingling of government and organized crime are especially dangerous in transitional countries, where the privatizing process includes huge assets that are the result of work of many previous generations.

The goal of this paper is to extend this analysis by further exploring the institutional settings and practical experiences of policies towards combatting corruption and tax evasion in Croatia. The overall purpose of this analysis is to understand the complex mechanism underlying the persistence causes of corruption, since a clear understanding of the mechanism will enable assessment of the strengths and weaknesses of current anti-corruption measures in Croatia. In general, when people consider the government corrupt and believe that the country is headed in the wrong direction this negatively effects social solidarity as expressed in trust in others, and reduces trust in the bodies and decisions of the authorities. Laws must be clear and durable, leaving the least possible room for discretionary action, while decisions must be made on the basis of clear criteria, and be transparent and accessible to the public.

Key words: corruption, economic development, Croatia, public policy, public revenues

⁴ Institute of Public Finance, 10000 Zagreb, Croatia, Smiciklasova 21, predrag@ijf.hr. This Paper is an output of the European Commission's Framework 7 Industry-Academia Partnerships Programme (IAPP) grant no. 611259 entitled 'Out of the shadows: developing capacities and capabilities for tackling undeclared work in Bulgaria, Croatia and FYR Macedonia' (GREY). The author would like to thank the funders for providing the financial support to enable the research and writing of this paper. The usual disclaimers apply.

Introduction

Causal explanations of corruption and governance proliferate, as do studies of the effects of different political institutional arrangements on important outcomes such as economic growth, social equality and political stability. Yet relatively little attention has been paid to the theoretical and empirical links between corruption and governance, on the one hand, and political institutions, on the other. Many authors (Rose-Ackerman, 1999, della Porta and Vannucci, 2016) and institutions, like Transparency International, have conclusively shown that countries with higher and more widespread corruption tend to have slower economic development and lower growth income per capita. Corruption is the most important obstacle to exiting the vicious circle of poverty, economic inequality, illiteracy and ineffective investment.

Countries with widespread and deeply rooted corruption badly use or altogether neglect their available human and natural resources. Corruption is a severe threat to foreign direct investments, and contributes to political instability and widespread disbelief in governmental institutions and state bodies. Corruption threatens public revenues and endangers existing social belief or enables its creation. Corruption activities divert the resources of all citizens into the hands of a select few, and mostly from poor to rich. The lack of financial resources causes low quality of public services and/or enables their provision. This causes higher infant and child mortality rates, a lower quality of child nutrition and higher school drop-out rates.

Unclear and often changing laws that provide public officials with huge discretionary powers are fertile preconditions for widespread corruption. This causes insecurity in business activities, encourages suboptimal decisions and makes impossible, or at least hinders, the realization of economic development and poverty reduction. Pervasive corruption and the intermingling of government and organized crime are especially dangerous in post- transitional countries, where the privatizing process includes huge assets that are the result of work of many previous generations.

According to Budak (2006) corruption is categorized among the major challenges faced by the South-East European (SEE) countries. Despite most of these countries' positive efforts towards establishing regulatory and institutional bases for fighting corruption, including specialized anti-corruption agencies, significant problems persist, especially with regard to the practical implementation of existing legal frameworks and institutional enforcement. Although it is hard to generalize in the context of the different SEE countries given their varying national historical and institutional environments, there seem to be several basic common problems throughout the region which draw a distinct picture of the major corruption difficulties in the region. They are primarily linked to limited institutional independence and capacity resulting in slow implementation of anti-corruption policies (Čaldarović et al, 2009).

One of these countries, Croatia, is a relatively small country with a population of 4.3 million inhabitants. The start of formal EU accession negotiations in 2005, marked a turning point regarding the fight against corruption, since the Croatian government was under foreign and domestic pressure to make tangible progress against corruption, particularly against the high-level corruption that had proliferated since Croatia's independence. Croatia became a European Union member state in June 2013. Although

the government has expressed a determined obligation to undertake measures against corruption, still there are opinions that the fight against this social evil hasn't been given the needed political acceptance and respect. One can estimate that in Croatia there are different laws and institutions in charge of reducing the corruption, but a serious problem exists, there is a low level of law enforcement.

After these introduction notes, the second part contains a short theoretical framework and literature review. The third is dedicated to the recent history of Croatia and its fight against corruption. Part four deals with level of law enforcement, while the last chapter contains conclusion remarks. The main purpose of this analysis is to understand the complex mechanism underlying the persistence of causes of corruption, since a clear understanding of the mechanism will enable assessment of the strengths and weaknesses of current anti-corruption measures in Croatia.

Theoretical framework and literature review

Generally, one can define corruption as an act that *subverts the public good for private or particularistic gain*. This broad definition condenses most extant definitions and usages of the term in contemporary social science and in practical politics. According to Philp (1997), corruption 'is rooted in the sense of a thing being changed from its naturally sound condition, into something unsound, impure, debased, infected, tainted, adulterated, depraved, perverted, et cetera.' If the public good (or public interest) is the contemporary manner of expressing the 'naturally sound condition' of a polity, then there is an important link between this minimal definition and the history of this key concept of modern political and economic Western thought (Gerring and Thacker, 2004).

Rothstein (2001) described the relationship between the rule of law, institutions, corruption and faith in others. In civilized society, institutions of law and order play a very important role: to detect and punish *traitors*, those who violate agreements, steal, kill and commit similar acts that harm society, which makes it impossible to trust them. So if citizens deem that certain institutions are doing what they are supposed to in a just and efficient manner, that people will refrain from treasonous behaviour, and in such circumstances think that most people can be trusted.

According to Dreher et al (2007, 2009), corruption threatens public revenues and disrupts existing trust or prevents it altogether. Corrupt practices redirect the funds of all citizens into the hands narrow select elite, from the poor majority to the wealthy. A shortage of money impinges upon the quality of and/or prevents the rendering of public services. Bejaković (2004) underlines that a government prone to corruption will not select the top bidder, nor will it permit the advancement of capable and professional public officials. It will instead spend public funds at its own whims to suit its own needs and reduce the salaries of public officials, who will in turn orient their efforts to extorting corruption from the citizens they serve. Stated concisely, corruption leads to (or enhances) governmental inefficiency and hinders or blocks economic growth and competitiveness.

Greater and longer lasting non-observance of laws means destruction of the entire social fabric and undermining of achievements made over the long run. This is fertile

ground for the emergence of corruption, which disrupts economic flows, creates its own “rules and laws”, accepts unlawful behaviour as normal, creates new centres of power and dissolves any trust in existing institutions and authorities. Lack of respect for laws makes countries uninteresting to foreign investors, and it hinders or reorients economic growth, which in turn prompts illegal business. All of this prevents or at the very least retards the building of new institutions that are so necessary to achieving competitiveness, and overall economic and social development.

In general, when people consider the government corrupt and believe that the country is headed in the wrong direction; this obliterates social solidarity as expressed in trust in others, and reduces trust in the bodies and decisions of the authorities. In post-transition countries and/or post-war society under conditions of relatively low social capital and mutual trust, accompanied by simultaneously arduous and long-term reforms, this can lead to an increased desire to halt reforms, reduce market competition and increase egalitarianism.

Although institutions are a favoured topic in contemporary political science and economics, and although formal, theoretical work on this topic is quite common, there have been few attempts to study the relationships between basic-level institutions and political corruption in an empirical, national setting. In the further text the situation in Croatia is explained. The goal is to extend the analysis by further exploring the institutional settings and practical experiences of policies towards combatting corruption in Croatia.

The short recent history of Croatia and its fight against corruption

The general elections of December 2003 were won by the Croatian Democratic Union (HDZ) which formed a government with three other parties and some national minority members of parliament. The HDZ remained in government until losing the parliamentary elections in 2011 when it was replaced by a coalition of four parties lead by the SDP (Social-Democratic Party). At the end of 2015 on Parliamentary elections, HDZ and SDP won very similar number of votes, but HDZ formed the Government with the party of independent representatives Most (Bridge). Non-party member Tihomir Orešković, a businessman raised in Canada, was elected as the Prime Minister by the Croatian parliament on the 22nd January 2016. His appointment was welcomed by business community in a hope that the government would curb corruption, but also by the trade unions that complained about the bad relationship with the previous government. Orešković’s key priorities were to reform the public sector and reduce corruption, stabilize the budget deficit, and aggressively work on foreign investment and viable business opportunities to stimulate growth and employment.

On the 16th of June 2016, the Croatian Parliament gave a vote of non-confidence to the Prime Minister Orešković and his Government. While addressing the Parliament before his impeachment, the PM explained that he did it because of the ex-First Deputy PM and the leader of the HDZ Tomislav Karamarko's possible conflict of interest became too heavy a burden for the incumbent government. Croatia now has the technical Government until the Parliamentary election in September 2016. This situation has an important adverse influence on structural reforms and measures for improvement of

fight against corruption, which now are halted. A new election could cost Croatia €1 billion to 2 billion in lost EU development funds.

Almost 15 years ago, even before the Croatia's negotiations over EU accession had begun, the government had appointed a group of independent experts and representatives of the Ministry of Justice to prepare a National Anti-Corruption Program entitled the *Anti-Corruption Action Plan*, accepted in Parliament (OG 34/2002). Tasks are directed towards realizing the rule of law and its effectiveness, the establishment of a specific body specializing in the prosecution of cases of corruption, raising the efficiency of the criminal prosecution of corruption, organizational measures in the administrative system, decentralization, financial responsibility measures and other economic measures, international activity and the stimulation of political and civil responsibility. According to the plan, corruption should be tackled without delay. Furthermore, in April 2010, after being constantly blamed for not reacting to the economic crisis, the HDZ government announced an Economic Recovery Program. This incorporated several goals: the state's withdrawal from the economy, the implementation of necessary structural reforms, public administration rationalization and efficiency improvement, budget expenditure reduction, tax system simplification, state aid system reform and even a fiscal responsibility law.

Despite the HDZ's nominal commitment to eradicating corruption, however, many cases of corruption involving politicians and businessmen were raised by journalists during its government, although other than media intrusion, those suspected of corruption or being involved in organized crime faced no further consequences for their alleged wrongdoings. Perhaps relatedly, throughout this period the Croatian public was becoming increasingly concerned about corruption. Transparency International surveys in 2003 and 2005 found that 85.9% and 89% of Croatians, respectively, considered corruption to be widespread (Budak, 2006). A government-financed survey in 2004 found that 72% of Croatians believed that most civil servants were involved in corruption (Sekulić, 2010).

Government determination to combat corruption and abuse of position in the highest governing structures has further increased since the change in government at the end of 2011. The coalition led by the SDP overturned a HDZ government that had led the country for two uninterrupted electoral periods (totalling eight years). Only at the end of his term, former Prime Minister Mr. Ivo Sanader was investigated following various allegations of corruption, and later sentenced to eleven years of prison with the possibility of appeal. Following this critical election ending the tenure of its once-powerful political leaders, Croatia has moved towards a more competitive and democratic system.

The SDP-led government was particularly active in the fight against corruption, primarily through various documents and activities. It expressed the determination to undertake measures against corruption, with changes that are not only being seen in programmes but also through tangible results. Furthermore, this government took a more positive and decisive approach towards European integration and adoption of new corruption measures, primarily through developing and implementing a comprehensive anti-corruption programme announcing sweeping reforms in public administration, and proposing freer access to state information.

A part of successful fight against corruption is systematic analysis of this phenomenon. There have been some valuable publications on corruption in Croatia from authors such as Kregar (2000), Derenčinović (2001) and Štulhofer (2004). Their works have stated that there was a widespread public belief in Croatia that corruption could be found almost everywhere in society – from the top to the bottom. Fragmentary research data and anecdotal evidence also suggest that tolerance towards petty or low-level corruption is much higher than towards high-level corruption. All sources conclude that further progress is needed to practically implement the adopted legislation. The implementing structures still have to be further strengthened because there is still a significant implementation gap. Despite progress in economic and administrative reforms, problems remain, including a judiciary plagued by case backlogs and complex bureaucracy. These authors underline that in order to reduce corruption it will be necessary to concentrate on making more precise legislation, and coordinating laws and regulations, giving the courts greater independence and making them better equipped and finally, improving the organization, efficiency, professionalism of and cooperation among bodies of the state.

Due to a process of democratization that has been slower than many other post-communist countries and a lack of rule of law, principally as the result of the war of independence, Croatia has experienced resistant corruption, particularly at the highest political level. It can be related to the weak system of law enforcement in Croatia.

Law enforcement

Article 20 of the Council of Europe Criminal Law Convention on Corruption (accepted by Croatia and published in Croatian, OG, International Agreements, 11/00) stipulates the following responsibility on the Croatian state: "Each Party shall adopt such measures as may be necessary to ensure that the persons or entities are specialized in the fight against corruption. They shall have the necessary independence in accordance with the fundamental principles of the legal system...". As an attempt to fulfil such responsibility the specialized State Office for Combating Corruption and Organized Crime (*Ured za suzbijanje korupcije i organiziranog kriminala - USKOK*) had been established. USKOK was envisaged as a division of the state attorney's office, but with broader powers. This office has preventive, intelligence and investigative functions and is composed of a multidisciplinary team including specialized prosecutors, investigators, and accountants. USKOK coordinates the work of agencies at a national level and will play an important role in the international exchange of information from investigations relating to corruption and organized crime. Additionally, it coordinates the operation of existing state bodies that can help in the struggle against organized crime: Internal Revenue and Customs Services, the Bureau for Preventing Money Laundering and the police. Furthermore, a special police unit under the direct command of USKOK has been formed, as well as of a special service to safeguard USKOK agents, protect witnesses and "whistle-blowers". The USKOK project has already received substantial aid from Europe, but its efficiency primarily depends on the quality and knowledge of its staff, as well as on public and media perception of its functioning. USKOK will need to secure support, build capacity, and launch high-powered investigations without skimping on preventive efforts. However, the fight against

corruption is more complex and demanding if there are many social and economic sources of this phenomenon.

Closely related to the corruption and unsuccessful law enforcement is the issue of privatization. The most common method of privatization in Croatia has been the management-employee buyout, with the second method being voucher privatization. At least three institutional and legislative framework factors have proved to be decisive in the process of privatization in Croatia (Čučković, 1997). The first is the concept of privatization favoured by government, which resulted in the Law on Ownership Transformation of Socially-Owned Property from 1991. This mainly set out methods of selling on case-by-case principle, with preferential treatment for formerly and currently employed persons. Unfortunately, the inherited economic system with its deep structural flaws and the initial 'transitional depression,' later enhanced by the war, were not particularly facilitative of this preferred concept of selling. As time passed, management-employee buyouts proved more and more unrealistic with regard both to the income realized and the extent to which it brought about privatization. Within the time limit laid down in the law, insufficient interest was shown in the purchase of parts of socially owned capital, except by employees and managers. As a result of the war, interest from foreign investors was almost non-existent. Consequently, the greater part of socially-owned capital finished up as a state-owned property because no one with sufficient capital came forward to buy it. A number of serious economic analyses had very clearly and correctly foreseen this, considering a privatization policy based only on selling highly questionable. According to the legislation, all the unsold property of the socially-owned enterprises were transferred without any compensation into the ownership of three public funds: The Croatian Development Fund (two thirds) and two pension funds (one third). The same failings happened with regard to the assets of companies that failed to apply for ownership transformation within the authorized time limit. Non-privatized socially-owned property thus formally became state-owned property and the citizens who had participated in creating that property in the first place were now represented by state institutions.

The chosen model of privatization, with its forms of preferential sale, had at least three negative consequences: a) centralization at the level of the state administration of all decisions concerning ownership transformation and privatization; b) state takeover of a significant part of socially-owned capital; c) selection of large buyers according to political loyalty (for example, one should be a member of, or at least close to, a ruling party to be taken seriously as a buyer in many cases of privatization).

The second important factor that contributed to the increase of irregularities was the concentration of decision making in the hands of a state agency which was also in charge of its implementation. The central role of the state in managing the entire process of privatization in Croatia had a series of undesirable side effects. According to the Law on Ownership Transformation of Socially-Owned Enterprises (1991), although all firms and companies were guaranteed the right to suggest their preferred mode of privatization, the final decision on the privatization of a particular company was made by the Agency for Restructuring and Development (ARD, later to become the Croatian Privatization Fund, CPF). This in practice meant that it was the agency that had the final say on who to sell to and at what price, although the companies themselves had

the right to propose privatization methods and the potential buyers that best suited them.

The third factor influencing the interconnection between the ‘formal’ and the ‘informal’ economy on one hand, and corruption on the other, was the fact that the initial legal solution left many important practical issues undefined and unregulated, leaving them to be solved in practice. This is the reason why the initial legislation had to be constantly amended in order to legalize some challenges that had developed during the implementation of the Law on the Transformation of Socially-Owned Enterprises. For example, the preferential treatment of the employees and managers in purchasing a company as laid down in the original law had a discriminatory effect on other interested buyers. Not until the beginning of 1993 was a special government decree passed which restricted the right of preferential treatment to 50% of total company value. The other 50% had to be sold to the best potential investor in soliciting for tenders by the Croatian Privatization Fund.

The frequent changes and amendments of the original text put the new owners in an unequal position because it produced feelings of legal insecurity and created favourable conditions for many forms of grey economy activities. The original Law on Ownership Transformation of Socially-Owned Enterprises (1991) was subject to six amendments. The majority of these amendments adopted by parliament were aimed at the protection of small shareholders in the privatization process. Their participation was extremely important for the government because the government wanted to encourage broad public support for privatization, which had lost a great deal of its vitality and strength during the first two years of its implementation.

The slow privatization process favouring insiders, the lack of transparency surrounding some privatization transactions with the privileged treatment of individuals (tycoons) well connected to the political elite, and increasing reports of corruption, raised the concerns of potential investors, and angered the public – although this backlash came later as the policy’s bad economic outcomes became known during the following decade. There is no doubt that the privatization process of the 1990s underpinned the growth of the informal economy and the expansion of large scale corruption. Most of the informal economy in the first half of the 1990s, not only corruption and bribery, but also misdeeds such as the nurturing of political clients, fictional additional capitalization, failure to show or appropriation of the profits of firms, asset stripping, deliberate bankruptcies and the abuse of official positions occurred in the second half of the 1990s, with the new phenomena of irregularity in the privatization of the banking sector and voucher privatization. Because of the absence of any political will, the non-existence of an effective and independent judiciary and the inefficient public control, the informal economy was maintained in privatization during the long period.

A large number of companies were bought on the instalment plan which did not, however, affect their new owners’ rights to immediate management. A little more than a year ago an intensive trend was observed in connection with some of these companies. Unable to fulfil their obligations towards the Croatian Privatization Fund they began being returned to state ownership. Their adverse financial positions could be explained by the fact that a significant part of their resources had gone “private” (asset

stripping). These failures very much affected the state, the taxpayer-creditors and the banks that extended loans to these companies (Faulend and Šošić, 1999).

According to Čučković *et al* (2011), many corruption cases during the 2000s were related to the privatization of public utilities. It has been the most controversial component of the privatization process because such enterprises were often natural monopolies which provided universal services, and public enterprises in these sectors were usually the most valuable parts of the state portfolio. While privatization in other economic sectors has been based on a significant process of liberalization and deregulation intended to introduce contestable markets, the *visible hand* of the regulatory state was needed for sectors that were traditionally characterized by market failure. This has been principally needed for sectors where competition is limited or non-existing (such as electricity, telecommunications, postal services, and gas and water supply) and where regulation should support a necessary degree of competition.

Conclusion

What could be done to reduce corruption? Corruption arises as an overlapping of the public and private sectors: a public official makes a discretionary decision on whether an individual will exercise a certain right. Therefore, laws must be clear and durable, leaving the least possible room for discretionary action, while decisions must be made on the basis of clear criteria, and be transparent and accessible to the public. It is necessary to go ahead consistently with structural reforms because transitional countries that have made more progress on structural reform and realized decentralization tend to be less corrupt. It is also important to work hard on achieving a skilful and independent judiciary, creating acceptance of unambiguous and lasting laws, clearly delineating authority and responsibility of governmental bodies, and reducing discretionary powers of public officials. It is necessary to respect existing laws, and to improve the co-ordination of state bodies. State bodies and highest public functionaries should serve as a positive example. It is important to draw attention to what is perhaps the most important step – sensitizing the domestic public to the existence of a problem. This would be greatly helped by a high quality media campaign, which should include incentives for skilful, independent and persistent journalism. Surely this is not an easy and simple task; one that can be done overnight, but experiences from many countries, some much poorer and less developed than Croatia, show that it is possible.

Croatia needs an overhaul of the chronically inefficient and corrupt legal system, along with a reform of local government. These two reforms are essential in the fight against corruption and in attracting new investments. Furthermore, cutting red tape and curtailing the vast inefficiency of the public administration are also important factors in reinvigorating domestic businesses climate. Finally, there is a need to stop the practice of constantly changing laws, regulations and provisions that make it difficult to start and operate a business in Croatia. That also endangers the necessary legal stability and so provides a fertile ground for corruption.

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