

Transparency International Anti-Corruption Helpdesk Answer

State capture in Asia Pacific

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State capture in the Asia Pacific region is linked to long lasting relations between governments and the business sector. Countries in East Asia in particular, share similar political-economic models characterised by highly interventionist states, robust and closed corporations and economic decision making based more on relationships than on market principles. Even if empirical evidence of capture is scarce in the literature, the interconnections between the political elite and the business class consolidated in systems with a long tradition create clear opportunities for the capture to happen. The Asian experience offers an opportunity to advance the definition of state capture, its possible solutions as well as on where the border lies between what is considered a legitimate or not legitimate influence in a given society.

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Query

Please provide an overview of state capture and regulatory capture in Asia Pacific with some examples, lessons and possible solutions.

Contents

1. Introduction: Understanding state capture
2. Opportunities for state capture in Asia Pacific
3. Examples of government and business partnerships
4. Anti-capture measures
5. References

Introduction: Understanding state capture

State capture refers to situations where powerful individuals, institutions, companies or groups within or outside a country use corruption to influence a nation's policies, legal environment and economy to benefit their own private interests (Transparency International no date). According to Hellman et al. (2000), state capture occurs when the ruling elite or the business sector manipulate policymaking and influence the formation of the rules of the game (laws, rules, regulations) to their own advantage.

In some contexts, the intertwined character of the relationship between business and political elites makes it difficult to establish a clear distinction between the captor and the captured. In contrast to other forms of legal or legitimate influence, such as lobbying, the capture involves some sort of corruption. In essence, state capture refers to a deviant form of the relationship between the state,

Main points

- Contrary to other forms of undue influence, state capture involves change in the rules of the game, which then affect the whole society.
- The economic driving forces in several Asian countries are determined by strong links between interventionist states and robust corporations.
- Effective anti-capture approaches should address the problem from different angles: motivation, form and context.

the business sector and the political class (Center for the Study of Democracy 2016).

The exact nature of state capture depends on what is considered an ideal or legitimate relationship between the political elite and the business class in a given society. That consideration, in turn, will indicate when there is capture because the relationship has been corrupted and the collective good has been compromised.

State capture is not the only possible form of deviant relationship between political and economic actors. There are other forms of undue influence, such as favouritism, nepotism and cronyism with a shared objective: to divert official

decision making from the public good to benefit private interests. What distinguishes state capture from those types of undue influence is the scope of those decisions. In the case of state capture, the influence does not only affect how or if a law is implemented in a specific situation – which can be achieved through bribery, for example – instead, the capture might involve a complete change of the law or the creation of regulations, which will then affect the whole society directly.

According to some authors (Carpenter and Moss 2014; OECD 2017), state capture meets three criteria: i) a policy goal must be defined; ii) the captor must intend to extract rents; iii) the policymaking process, including laws and regulations, must have shifted away from the goal in the public interest towards the captor's interest. Moreover, the capture involves systematic corruption in a particular way. Rather than simply being widespread corruption, the corruption instrumental to state capture is performed by networks of corrupt actors that cluster around sectors of the state, allowing them to act collectively on their private interest (Fazekas and Tóth 2016). Thus, the corruption indicative of state capture is characterised by its distribution rather than by its amount. Depending on its distribution, the capture can be local, when only a particular government organisation is captured, or global, when multiple public organisations are captured (Fazekas and Tóth 2016).

The specialised literature identifies three types of capture: state capture, policy capture and regulatory capture (OECD 2017). State capture refers to situations where the central government is captured on a large scale. Policy capture refers to the capture of decisions throughout a policy cycle. It occurs especially during agenda setting, policy development and policy adoption, and to a lesser extent during policy implementation or policy evaluation related to revising the rules. Regulatory capture implies capture of a regulator, regulatory agency or regulatory process (OECD 2017).

The form state capture acquires in a given context is determined by the motivation for the capture. This can vary depending on the economic model in place and, in particular, on the extent of the intervention of the government in the economy. Hellman et al. (2000) show that, in economies in transition where large firms with formal ties with the state inherit influence as legacy of the past, new economic players use state capture to compensate for weaknesses in the legal and regulatory framework. In this case, the purpose of the capture is to reduce the inequality among economic players. In a liberalised economy, the motivation for the capture can be to reduce competition by influencing regulations to obtain “legal” protection while excluding others (OECD 2017). In other cases, governments aiming to control the economy might trigger the business sector to protect themselves from government intervention by capturing government decision making.

Opportunities for state capture in Asia Pacific

The literature on state capture in Asia Pacific is considerably scarce and, therefore, so is the evidence on how state capture occurs in the region. In addition, Asia Pacific offers a great diversity of political and economic realities that can be difficult to grasp or make generalisations from. Nevertheless, similar documented relationships between the state and the business sector in several countries in East Asia offer significant opportunities for capture to occur and offer examples to learn from. That relationship is characterised by closed ties and exchanges between big business networks and the political elite. The significant presence of these interconnections has led analysts to define the situation in Asia as crony capitalism (Vighneswaran and Gomez 2014; Chang 2000; Kang 2003).

Chang (2000) describes crony capitalism as the situation when personal connections and political patronage, rather than entrepreneurial ability,

determine who gets access to government generated rents, bank credit and other lucrative economic resources. In a crony system, decisions are not made based on market principles but on personal connections, patron-client relations, corruption and nepotism (Kang 2003).

The relationship between governments and the business class has been the driving force of several Asian economies (Vithiatharan and Gomez 2014). Centralised states, big corporations and banks are the main actors in this relationship. Large and politically connected corporations are, often, the result of the participation of states that are highly interventionist in the economy. According to some authors, a company is well connected when at least one of its large shareholders or top officers is a member of parliament, a minister or is closely related to a top politician or party (Faccio 2006) or when a politician or close relative is the company's director or a large shareholder (Vithiatharan and Gomez 2014). At the same time, the state's political intervention in the economy is facilitated by the close links between the government and the corporate and banking sectors, and it is manifested through state-directed loan policies, lack of competition and lack of prudential regulations (Vithiatharan and Gomez 2014).

Mutual support and dependency are behind the relationships expressed in different ways in different countries. In Thailand, South Korea, Indonesia and the Philippines, businesspeople can become prominent political figures. In other cases, such as Malaysia and Indonesia, it is the establishment of a dependent relationship between the business class and political elites (Vithiatharan and Gomez 2014). On the one hand, the new business class depend heavily on political elites for access to government resources, like infrastructure projects, licences and rents, while on the other hand, political elites require campaign funding from the business class during elections (Vithiatharan and Gomez 2014).

The creation of large share-owned corporations by national governments is intended to protect national economies by reducing external and internal competition and to prevent others from taking over economic control. States justified this interventionist model with the need for a rapid industrialisation and to ensure that government-sponsored industries were able to catch up with their Western counterparts (Vithiatharan and Gomez 2014). Thus, government intervention was presented as necessary for the survival and competitiveness of national economic players. Even if this model brought the rapid industrialisation of the region, it was made with several irregularities that were exposed during the Asian financial crisis of 1997. Among those irregularities were poor bureaucratic and regulatory oversight of those companies and irresponsible use of state-generated bank loans, as well as unproductive business activities, such as reverse takeovers and mergers (Vithiatharan and Gomez 2014). The crisis in 1997 resulted in the collapse of a high number of those conglomerates. Few of them were sustained through rescue packages (Gomez 2004).

In some Asian societies, the legitimacy of these relationships and the existence of these big conglomerates is based on the importance of social bonds and networks. Networks are recognised as the institutional foundation of economic organisation in East Asian capitalist economies. Authors distinguish between three types of business networks: interpersonal, intercorporate and political (Nolan, Rowley and Wamer 2017).

Interpersonal networks respond to a collectivist approach present in many Asian societies and are expressed in personal bonds to particular in-groups, respect for age seniority and hierarchical positions. Intercorporate networks refer to firm-to-firm horizontal networking and take the form of groups of firms with multiple ties to achieve mutually beneficial objectives. These intercorporate ties might respond to ownership

structure, state economic policy or social networks, such as family or friends. Political and elite networks are based on interpersonal reciprocity relations, which may lead, for example, to favouritism in recruitment and promotion within an organisation to licensing agreements (Nolan, Rowley and Wamer 2017).

Examples of government and business partnerships

This section gives examples of business models based on close ties with governments and whose activities involve some level of control over the regulations within a sector or economic area. The acceptance of the legitimacy of these models, sometimes based more on tradition than on the integrity of the model, raises questions not only about the legality of forms of influence but also about what kind of influence is considered legitimate and publicly acceptable in a given society.

Keiretsu and cartels in Japan

A *keiretsu* is a conglomerate of companies with shared business activities and cross-ownership participation. Member companies own small numbers of shares in each other's companies, creating a robust interconnected group where companies are protected from external risks such as market fluctuations. All the companies in a *keiretsu* are centred around a bank that lends money to the companies and holds their equity. Interlocking relationships and the control of the *keiretsu* bank over the companies limits competition within the *keiretsu* and prevents company takeovers by outsiders (Twomey 2018).

This system originated as part of the reconstruction of Japan after the World War II and dominated the Japanese economy until the 1990s. *Keiretsu* are legal structures supported by the government. From a social point of view they respond to the Japanese focus on social relations and collectivist understanding of society, and from

an economic perspective they were justified as a way to protect the Japanese economy.

In the early 1990s it was estimated that these networks owned or controlled around 12,000 companies, representing a third of Japan's business capital (Cutt 1992). They stem from the old practice of *zaibatsu* based on tradition and relationships created in the 1600s and propelled in 1866 with the industrial revolution. At present they still exist though are less centralised than before. Mitsubishi and Toyota are contemporary examples of *keiretsu*.

After a brief elimination of *zaibatsu* during the American occupation of Japan, the Japanese government promoted the creation of robust corporations that could resist the pressure of external and internal trade competition.

The Asian financial crisis of 1997 revealed *keiretsu*'s weaknesses of limited competition, increased debts due to easy access to capital and the difficulties of these big corporations to quickly adapt to the market. That forced Japanese companies to compete for price and quality and to use market-based strategies rather than relational arrangements (Twomey 2018).

In addition to *keiretsu*, cartels are also economic and political key players in Japan. According to Cutt (1992), "cartels are a way of life and *keiretsu* a structural vehicle that ensures their continued success". It is considered that this web of informal cartels – in the form of family groups with business interests, government and political parties – structure the society in a way that maintains the security of the country, provides full employment and distributes the risks (Cutt 1992). Some cartel's activities are considered illegal, such as price-fixing within an industry, but others are legally permitted and even supervised by the government, like setting prices, rationalising industries and responding to depressed markets (Cutt 1992).

An example of the controlling power of the cartels comes from the agricultural cartel organised under the Nokyo group (Japan Agricultural Cooperatives) (Cutt 1992). Originally created by the government, Nokyo turned into a powerful agricultural lobby, able to control the link between the price of rice, the agricultural industry and the Japanese ruling Liberal Democratic Party (LDP), in power since 1955. In the 1990s, the price of home-grown rice in Japan was at least five times more expensive than other countries (Cutt 1992). Rice is a basic product in Japan, and its demand is constant despite the price, which implies a great benefit to Nokyo as the sole wholesaler of agricultural products. At the same time, the price was set on the basis of production costs incurred by farmers, who also benefited Nokyo as the sole wholesaler of agricultural supplies like fertiliser, pesticides and machinery. Moreover, Nokyo's political power was behind the national refusal to accept rice imports, forcing the Japanese population to buy the expensive national rice. Likewise, Nokyo administered national farm subsidy programmes, which kept rural conservatives voting for the LDP, closing the circle between setting the rice market rules to increasing their own benefit while maintaining government support (Cutt 1992). Nevertheless, in 2014, the government undertook reforms that reduced the power of Nokyo, and in 2015 Japan worked towards reducing trade barriers to foreign agricultural products.

Chaebol in South Korea

In South Korea, *chaebol* is a business conglomerate, composed of a large number of diversified affiliate companies run by an “emperor-like owner chairman” or family, whose power exceeds legal authority (Jung 2004). Their origin dates back to the Japanese occupation before the end of the World War II, and were inspired by the Japanese *zaibatsu* (Albert 2018). Originally, as in Japan, *chaebols* responded to an export-driven strategy and protected against competition.

Chaebols, as fundamental pillars of the South Korean economy, hold extraordinary power over politics. The South Korean government has supported these conglomerates since the 1960s, and the latter have relied in their close relationship with the government for their success. Subsidies, loans and tax incentives helped them to become the dominating forces of the South Korean economy (Albert 2018). The top five of the 40 recognised *chaebols* represent around half of the South Korean stock market's value (Albert 2018). Nowadays, Samsung and Hyundai are among the strongest and biggest *chaebols*.

During the 1997 Asian financial crisis, 15 of the top 30 *chaebols* went to bankruptcy. That led to reforms intended to reduce the *chaebols*' power, such as including corporate transparency measures and cuts to government subsidies (Albert 2018). Nevertheless, the South Korean government and *chaebols* continue to have close ties. Politicians turn to *chaebols* to fund their campaigns, and *chaebols* lobby for favourable legislation and policy (Albert 2018).

Critics say the relationship between the government and *chaebols* fosters corruption, embezzlement, bribery and tax evasion (Albert 2018). In fact, in the last few years, high-level corruption scandals have involved leaders of strong *chaebols*. For example, in August 2017, a court convicted Lee Jae-Yong, the acting chairman of Samsung, for bribery, embezzlement, hiding assets overseas and perjury (BBC 2018). He was accused of making donations of more than US\$37 million to foundations run by a friend of the former South Korean president Park Geun-hye in exchange for political favours (BBC 2018). Among those favours was to protect a controversial Samsung merger that paved the way for Lee to become the head of the conglomerate, and for which support from the government-run national pension fund was necessary (BBC 2018).

Lately, despite increasing efforts to prosecute the corrupt, many of the accused pay only high fines,

with their time in jail is suspended, or they receive presidential pardons (Albert 2018), as with Lee Jae-Yong. In February 2018, his sentence was halved, and the Seoul High Court decided to suspend the time in prison, setting him free.

Network-based economy in Vietnam

The Vietnamese economy is characterised by the supreme role of the Communist Party of Vietnam (CPV), in power since 1976, and a market economy with a socialist orientation (Truong 2015). In turn, the CPV has maintained its political dominance and influence in the economy through its controlled networks of mass organisations and trade unions, and providing protection, privileges and monopolies to political and economic organisations associated with the party, in particular the state-owned enterprises (SOEs) (Truong 2015). SOEs became the “pillars” of the Vietnamese economy.

An alliance of multi-channelled networks of interests spreads vertically from the top of the party at the state level to the authorities at the local level, and horizontally between ministers, SOEs and connected private businesspeople (Truong 2015). This system has generated the personal enrichment of party officials, their families and friends. Stock exchange, banking, real estate, construction and development projects have been especially profitable areas for CPV leaders.

In the absence of an effective legal system, good governance and social control norms, the network-based system in Vietnam has evolved into a “culture of envelopes” and distributing favours based on nepotism and cronyism, resulting in widespread corruption (Truong 2015). According to some authors, current developments in the network-based economy resembles a rent-seeking state (Vuvinh 2013). Some authors have identified signs of capture in the land sector, where economic decisions and regulations regarding collective ownership and land management are intended to support the illegal appropriation of communal land or state property for private benefit (Truong 2015).

Thus, the alliance between the state and the business sector dominated by the CPV has led to poor quality policy implementation due to favouritism, cronyism, red tape and corruption (Truong and Rowley 2014), allowing the privileged elites to control the economy and amass billions of dollars in personal wealth. An example of this is the rise of the Vingroup, defined as a Vietnamese corporate empire (Reed 2019). The group expanded its activities from real estate, to convenience stores, schools, healthcare, smartphones and, recently, cars.

In Vietnam, there are concerns about national policy-makers being used by Vingroup or similar companies (Reed 2019). Those fears stem from certain facts. In 2018, for instance, the government introduced new restrictions on foreign car imports, a measure that benefits VinFast, part of Vingroup, a company lauded in 2017 by the Communist Party general secretary Nguyen Phu Trong when he defined Vingroup as “pioneer in building a national car brand” (Reed 2019). The government also announced plans to take polluting motorbikes off the road in the biggest cities, a decision that, according to many Vietnamese, helps VinFast’s electric scooters and its recently founded electric bus division, VinBus (Reed 2019).

Since 2007, there have been efforts in Vietnam to focus on reducing the role of the state in the economy, promote the private sector and improve the quality of public services. Part of the reform was to reduce the number of SOEs by privatising the ineffective ones. Nevertheless, those remaining, instead of becoming more competitive, further consolidated their monopolistic positions and expanded their areas of influence to non-core business such as hotel, import/export, financing and telecoms, among others (Truong 2015).

Despite these intentions to open the economic space to other players, the way in which the party/state/business monolithic system operates and makes decisions does not facilitate the smooth implementation of the reforms. Decision

making is based on consensus, and checks and balances occur horizontally (between ministries and departments), vertically (between central and local governments) and geographically (among all the regions of the country) (Truong 2015). Under this system, decisions require long negotiations, compromises and networks to satisfy the interests of stakeholders (Truong and Rowley 2014). The reform process also implied a certain level of decentralisation that resulted in the creation of “para-state” entities at the local level, which meant the replication of cronyism and favour distribution at the local level.

Anti-capture measures

Given the complexity of the phenomenon of state capture, there are no simple solutions to prevent it. Rather, reducing the risks of state capture requires addressing the problem from different angles: the motivation for the capture, how it happens and the characteristics of the governance environment that might increase the opportunities for the capture to occur. Hellman (no date), states that, reforms to deal with the problem of state capture need to target the buyers of influence (mostly firms), the sellers of influence (public officials) and the structure of the market in which they interact (the policymaking process). Some anti-capture measures are:

Increase competition in the market

This is particularly important in sectors dominated by monopolies or powerful incumbents (Hellman no date). Ways to increase competition include restructuring key monopolies, promoting entry through liberalisation, removing anti-competitive advantages and enhancing the provision of public goods to improve the investment climate. As Hellman (no date) points out, it is not only about increasing the number of competitors but about promoting different forms of interest representation that widens the scope of actors whose interests are represented, including the interests of the less

powerful. Business associations that channel influence activities away from individualised relationships between firms and public officials to the representation of collective interests at the sectoral or regional level can play an important role in this sense.

Open the policymaking process to wider consultation in the formulation, review and decisions on laws and regulations

This implies increasing access and transparency of policymaking procedures. Specific measures in this regard require a deep understanding of policymaking procedures in each country. According to Hellman (no date), possible concrete reforms are:

- the introduction of mandatory public hearings to discuss draft laws and regulations
- the development of corruption impact assessment procedures for draft regulations
- publication of minutes at specified stages of the policymaking process
- implementation of freedom of information legislation to allow access to documents related to policymaking
- government mechanisms to encourage public consultation on draft laws and regulations
- strengthen individual accountability mechanisms
- mandatory disclosure of parliamentary votes and judicial decisions

Increase the mandate of judicial control over capture

This idea stems from the limitations that judicial controls have in detecting and preventing capture. One of those limitations is that it is a reactive control since it can only be activated when they are presented with a case (Magill 2014). Other situations in which judicial controls are limited are when there is inaction from a governmental

agency to prevent the capture, or a certain action is considered to be “committed to agency discretion” (Magill 2014). In this last case, it is exceedingly difficult to attack an agency’s general administration and operational system.

Create consumer empowerment programmes

Creating consumer empowerment programmes brings the consumer perspective into the process of regulatory decision making (Schwarcz 2014). These programmes gained some popularity in the last years, and there are two types. One is proxy advocacy that relies on independent government institutions with the role of representing the public interest in designated regulatory proceedings. The second type is tripartite consumer empowerment programmes that amplify the voice of non-government public interest groups otherwise unrepresented.

Create legitimate forms of influence

The creation of lobby regulations can help to clarify doubts about the line between due or undue influence and provide legal grounds to reports of capture.

Address the interaction between state capture and administrative corruption

Administrative corruption is often the tool used to achieve state capture. For this reason, it is important to design strategies that respond to the interaction of state capture and other forms of corruption (World Bank 2000a; Bhargava 2004). Moreover, the importance of looking at their interaction is that strategies and tools to combat administrative corruption may be compromised by state capture and vice versa (Bhargava 2004).

Strengthen meritocratic and independent and accountable institutions

Measures to prevent administrative corruption include merit-based recruitment processes and institutional reforms to reduce bureaucratic discretion. Adequate systems for monitoring the boundaries between money and politics, strong

budget management, strong procedures and technology systems in tax and customs administrations and the decentralisation of service delivery with increased accountability are considered good practices to reduce the administrative corruption that might contribute to state capture (Hellman 2002).

Meritocracy in public recruitment can be achieved by including requirements such as entry-level exams, minimum levels of education and work experience, and the existence of values such as integrity, honesty and work ethics (Chêne 2015). Objective criteria in performance evaluation and the integration of ethical behaviour indicators into the performance review process can also help (Chêne 2015).

Other measures to counterbalance undue influence from dominant groups proposed by the World Bank (2017) are:

- appropriate design of incentives within public agencies
- checks and balances between agencies
- mechanisms that extend accountability to a broad group of firms and individuals.

Finally, effective preventive measures should be tailored to each case and context.

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