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Corruption - Correspondence - Volume 1

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O F F I C E M E M O R A N D U M

DATE: July 2, 1997 05:36pm

TO: MARK MALLOCH BROWN
TO: Jane Armitage

(MARK MALLOCH BROWN@A1@WBWASH)
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FROM: Masood Ahmed - IECDR, IECDR

(MASOOD AHMED@A1@WBHQB)

EXT.: 33800

Sent By: Leonila Castillo

SUBJECT: Corruption Report Dissemination

As you know, EDs will be discussing the corruption report in a Board seminar on July 15. Sven is anxious that a published version, cleared by the Board, be available for distribution at the Annual Meetings in Hongkong. Given the impact of the President's Annual Meetings speech last year, there will be considerable interest in any remarks Jim may have this year, and what generally the Bank has to say on the subject of corruption.

Can we meet as soon as convenient next week to share ideas on how dissemination can best be handled? There have already been preliminary discussions between Mike Stevens, Carol Rosen and Phil Hay on printing and handling press inquiries. However, I would value your advice on overall strategy.

Currently, we are planning to edit the CAPWG Report into a "Development in Practice" series publication in time for Hongkong. We will strip out the internal Bank discussion and recommendations, and reconfigure the material under a title like: "Corruption and Development: How the World Bank can Help". It would address such questions as the costs of corruption, why countries should be concerned, what external agencies and the Bank in particular can do to assist them address corruption. It would draw principally from the CAPWG Report, while at the same time complement WDR messages.

Sven is anxious that the Board should see the draft and approve it, so we will be working on a tight timetable, aiming to have a draft ready for distribution to EDs by 25 July on a no objections basis, for printing in August and shipment to Hongkong by mid-September.

Our preliminary thinking is a press conference in Hongkong, using it to convey a set of basic messages how the Bank can help countries, and to distribute the publication. Another opportunity might be the module on governance and corruption in the seminar series.

However, on all of the above, we want to be guided by

your sense of what is best.

Best regards,

Masood

CC: Cheryl Gray

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Addressing Corruption:

~~The World Bank's Role~~

Report of the

Corruption Action Plan Working Group

Helping Countries To
Combat Corruption:
the role of the
World Bank Group

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CHAPTER 1

INTRODUCTION AND KEY MESSAGES

1.1 Worldwide attention to the issue of corruption has intensified in recent years. In his Annual Meetings speech in October 1996, the President of the World Bank, Mr. James D. Wolfensohn, offered the Bank Group's assistance to member governments to implement national programs to discourage corrupt practices and pledged support for international efforts. His remarks received worldwide attention.

1.2 The establishment of the Corruption Action Plan Working Group (CAPWG) in 1996 is the latest in a series of recent moves by the Bank to address governance and corruption.¹ The CAPWG's mandate includes the following: (1) to develop a strategic framework for the Bank's work on corruption; (2) to identify actions that the Bank might take to assist countries to implement national measures; (3) to suggest how the Bank should contribute to international efforts to control corruption; (4) to identify actions that the Bank should take to strengthen the control of fraud and corruption within Bank-financed projects and to ensure their compatibility with country efforts; and (5) to look at internal controls and the use of the Bank's own administrative budget resources. The first four tasks are covered in this Report. While the Report is quite specific in some areas, the overriding objective has been to develop a framework within which Bank staff and management can address the issue. Staff from across the World Bank Group contributed to the analysis and recommendations. Summaries of approaches of IFC and MIGA to ensure corruption risks are minimized in their operations with private sector partners are given in Annex B. NB

1.3 We believe such a framework is needed to guide Bank management and staff in activities at four levels:

- (i) Ensuring against fraud and corruption within Bank-financed projects;

¹ The Bank has long been concerned with controlling fraud and corruption in its own projects. In 1995, a report by the Controller highlighted the need to review controls against fraud and corruption in Bank loans and to strengthen borrower accountability. The Bank's procurement and disbursement procedures have been progressively refined to minimize the risks for both lender and borrower. Corruption as an issue of development was highlighted in the Bank's two governance reports, "Governance and Development" in 1992 and "Governance: The World Bank's Experience" in 1994, and in several Bank reports on Africa. In some countries, the Bank has registered its concern about corruption in high level meetings with government leaders – for example, when governments have persisted with unviable and costly public investment projects. The Bank has curtailed lending, sometimes drastically, where systemic corruption and other manifestations of poor governance has affected Bank projects.

- (ii) Assisting countries that request Bank support in their efforts to strengthen institutions and reduce corruption;
- (iii) Taking the impact of corruption more explicitly into account in CAS's, country lending considerations, in the policy dialogue, in ESW, and in the design of projects.
- (iv) Communicating to a global audience the costs of corruption and participating in international efforts against corruption;

The first level has long been a concern of the Bank, and procurement and loan disbursement policies have been progressively refined to ensure efficient use of Bank resources. The report supports current initiatives to streamline procurement and disbursement processes, and to promote borrower accountability. The second level is partly familiar territory, partly new. While the Bank has helped countries strengthen public institutions for many years, involvement in explicit anti-corruption strategies is novel. In the past year a small but growing number of countries have approached the Bank for assistance. The third level is more difficult terrain, but unavoidable if the Bank is to confront corruption squarely as a development issue. The fourth level is a new area for the Bank, but one in which a strong lead has been given by the President, and where prospects for collective action are good.

1.4 There is no intention to link Bank lending in some formalistic way to either explicit or implicit measures of corruption in borrower countries. Rather the Bank's concern in addressing corruption should be to protect the integrity of projects it finances and to lessen the negative impact of corruption on a country's development prospects more generally. At the same time, the Working Group recognizes that this is a complex and sensitive topic, and management and staff will need careful guidance on how to approach it in the country dialogue, in considering the lending program, and in carrying out ESW.

1.5 The key messages of this Report can be summarized as follows:

- (i) *Corruption is a global problem (Chapter 2).* It exists in all countries in varying degrees. It is systemic in many of the countries that borrow from the Bank and in some industrialized countries. And corruption has significant transnational dimensions the Bank must pay attention to. Current efforts by OECD countries to criminalize foreign bribery and end its tax deductibility are strongly welcomed.
- (ii) *Sustainable development requires the control of corruption. (Chapter 2).* A growing body of empirical evidence supports what Bank staff and many others have long sensed – that the social and economic costs of corruption are high and fall disproportionately on the poor. Corruption also burdens the private sector, deters foreign investors, and harms the environment. It undermines the credibility of government and diminishes the effectiveness of public policy. It thus interferes

with the outcomes the Bank seeks to support in its interventions at the country level.

- (iii) *Corruption is a governance issue, and can be addressed by the Bank within the framework established for governance (Chapter 2).* The Bank can take many actions under its Articles of Agreement to help countries fight corruption. However, the Bank must be concerned only with the economic and social development implications of corruption, and must refrain from intervening in countries' political affairs.
- (iv) *Tackling corruption is neither easy nor quick (Chapter 3).* Corruption is a symptom of deeper-seated factors. The causes of corruption are complex and the means to control it are not fully understood. Corruption thrives when economic policies are poorly designed, education levels are low, civil society is underdeveloped, and the accountability of public institutions is weak – conditions that exist in many settings but are particularly prevalent in developing countries. It has an important political dimension and to a large extent reflects the way power is exercised in a society. Like others working in this area, Bank staff must address the issue with humility, realizing that we all have as much to learn as to offer. Solutions that work in one setting can have unintended consequences in another.
- (v) *The Bank should address the problem of corruption more explicitly than in the past, but in ways that reflect its mandate and its comparative advantage (Chapter 3).* The Bank has been reluctant hitherto to confront the issue openly because of its political sensitivity and the lack of demand for assistance from borrowers. The Working Group believes a window of opportunity has opened to address corruption in a more comprehensive way. Bank staff, other donors, and many in borrowing countries strongly support such efforts. There is another reason why the Bank should confront the issue more directly. Corruption undermines the effectiveness of aid and in turn threatens its political support.

1.6 Despite the complexity and sensitivity of the issue of corruption, there are some things the Bank can do to make inroads into the problem:

- (i) *The Bank can increase the profile of this issue in its dialogue with borrowers (Chapter 3).* Where corruption is widespread, affects the country's development objectives and Bank-financed projects, the Bank should raise the issue with borrowers and seek ways to help governments and civil society address it.
- (ii) *The Bank should stand ready to help countries if they seek the Bank's assistance in the design and execution of anti-corruption strategies (Chapter 3).* With its long experience in helping countries with economic reform and strengthening institutions, central pillars in the fight against corruption, the Bank is well placed to support national efforts. For governments intent on reform, sustained control of

corruption is largely about getting the basics of public policy and management right.

- (iii) *The Bank can pay more attention to corruption in designing and assessing programs of economic reform (Chapter 4).* Although most of the Bank's economic policy recommendations clearly reduce opportunities for corruption, there are some areas – including tax policy, expenditure reductions, privatization of natural monopolies, and environmental regulation – where closer attention is needed to the capacity of governments to implement policy reform. If such capacity is lacking, policy change may inadvertently increase rather than decrease the risk of corruption. The answer is not to forego reform, but to consider and help strengthen institutional capacity in tandem with policy design.
 - (iv) *The Bank can put additional emphasis on strengthening public sector management and governance (Chapter 5).* Although many of the Bank's existing activities help to build public institutions, a greater focus on this goal is warranted. Well-performing public sectors are characterized by a professional civil service, strong financial management, accountable organizations, and a capacity for effective policy making. Fighting corruption also means strengthening the rule of law through clear legislation, effective enforcement capacity, alert statutory watchdog bodies, an independent judiciary, and an engaged civil society.
 - (v) *The Bank can participate more actively in international efforts to deal with corruption (Chapter 6).* The Bank should play an active role as a partner in multilateral efforts to control corruption and reduce transnational bribery. One important example is the current initiative, led by the OECD, to coordinate the criminalization of transnational bribery and elimination of tax deductibility by member governments.
- 1.7 To play a more active role in these areas, the Bank should (Chapter 7):
- (i) *Build knowledge*, by dedicating more resources to understanding better how some countries have successfully reduced corruption, disseminating such knowledge, and applying such learning actively in its own work.
 - (ii) *Address corruption and its economic effects more explicitly in CAS's, in ESW, in the design of projects, and in research.* In the past, management and staff reluctance to acknowledge the effects of corruption on policy and on projects may have diminished the relevance of some Bank efforts and caused the Bank to undervalue the contribution of well-functioning institutions. If the Bank is to have a constructive dialogue with governments on the control of corruption, it needs to be able to identify and analyze its costs, understand its impacts, and discuss them openly with governments.

- (iii) *Continue to build working relationships with partners*, both in borrowing countries (including local NGOs and the private sector) and on a regional or global basis (including bilateral donors, NGOs, and international organizations). This will help focus the Bank's efforts where it has comparative advantage.
- (iv) *Fill critical skill gaps* – particularly in financial management, procurement, and public sector management.
- (vi) *Ensure that the projects it supports and its own internal operations set an example of best practice, while taking into account their impact on borrowing countries.* Bank projects must not be seen in isolation, since they are invariably affected by the overall system of public management and governance in borrowing countries. Moreover, in countries which depend heavily on aid inflows for financing their development projects, the lending operations and policies of the Bank and other donors may also affect overall public management. One implication of this for the area of procurement and disbursement is that the Bank generally should move away from an enclave approach and progressively place more emphasis on borrower accountability, thereby contributing to stronger government financial management systems.
- (vii) *Be alert to the inherent security risks that Bank staff, consultants, and their counterparts may face in addressing corruption issues.* The Bank must respond quickly if staff are threatened.

CHAPTER 2

CORRUPTION AND ECONOMIC DEVELOPMENT

How Do We Define Corruption?

2.1 Corruption covers a broad range of human actions. To understand its impact on an economy or a political system, it helps to unbundle the term by identifying specific types of activities or transactions that might fall within it. The Working Group sought a usable definition of corruption and a taxonomy of the different forms corruption could take consistent with that definition. We settled on a straightforward definition – the *abuse of public office for private gain*. This is both simple and sufficiently embracing to cover most aspects of corruption that the Bank encounters, and it is a definition widely found in the literature. Bribery can occur entirely in the private sector, but bribery in the public sector, offered or extracted, should be the chief concern of the Bank, since the Bank lends primarily to governments and supports government policies, programs and projects. Public office is abused for private gain when an official accepts, solicits or extorts a payment. Public office may be abused for personal benefit even if no bribery occurs, by patronage and nepotism, the theft of state assets, or the diversion of state revenues.

2.2 **Bribery.** Bribes are a principal instrument of corruption. They can be used by private parties to "buy" many things provided by central or local government, and officials may seek bribes in supplying them.

- *Government Contracts.* Bribes can influence the government's choice of firms to supply goods, services and works, and the exact terms of those contracts. Firms may bribe to win a contract or have sub-standard work accepted.
- *Government Benefits.* Bribes can influence the allocation of government benefits, whether monetary benefits (such as subsidies to enterprises or individuals or access to pensions or unemployment insurance) or in-kind benefits (such as access to certain schools, medical care, or stakes in enterprises being privatized).
- *Lower Taxes.* Bribes can be used to reduce the amount of taxes or other fees collected by government from private parties. Such bribes may be proposed by the tax collector or the taxpayer. In many countries the tax bill is negotiable.
- *Licenses.* Bribes may be demanded or offered for the issue of licenses which convey an exclusive right, such as a land development concession or the exploitation of a natural resource. Sometimes politicians and bureaucrats deliberately put in place policies that create control rights which they profit by selling.

- *Time.* Bribes may be offered to speed up the government's granting of permission to carry out legal activities, such as company registration or the granting of construction permits. Bribes may be extorted by the threat of inaction or delay.
- *Legal Outcomes.* Bribes can change the outcome of the legal process as it applies to private parties, by inducing the government either to ignore illegal activities (such as drug dealing or pollution) or to favor one party over another in court cases or other legal proceedings.

2.3 Not only are the government benefits purchased by bribes quite varied in type, but they can also be different in size. Contracts and other benefits can be enormous ("grand corruption") or very small ("petty or retail corruption"), and reinterpretation of laws can be dramatic or only minor in its impact. Grand corruption is often associated with international business transactions. Petty corruption may be pervasive throughout the public sector and firms and individuals regularly experience it when they seek a license or a service from government. The sums involved in grand corruption may make newspaper headlines around the world, but in aggregate the costs of petty corruption may be as great if not greater.

2.4 ***Theft.*** *Theft of state assets* by those in official positions charged with stewardship is also corruption. An extreme form is the large scale "spontaneous privatization" of state assets by enterprise managers and other officials in some transition countries. At the other end of the scale is petty theft of items such as office equipment and stationery, vehicles and fuel. The perpetrators are usually middle and lower level officials, compensating, in some cases, for inadequate public service salaries. Typically, asset control systems are weak or non-existent, as is the institutional capacity to detect and punish the wrongdoers.

2.5 *Theft of government financial resources* is another form of corruption. Officials may pocket tax revenues or fees (often with the collusion of the payer, in effect combining theft with bribery), steal cash from treasuries, extend advances to themselves that are never repaid, or draw pay for fictitious "ghost workers." In such cases financial control systems have typically broken down or are neglected by managers. Theft of state assets and revenues may take place with or without the payment of bribes, with differing economic consequences (Chapter 3).

2.6 ***Political versus Bureaucratic Corruption.*** Corruption within government can take place at both the political and the bureaucratic levels. The first may be independent of the second, or there may be collusion. At one level, controlling political corruption involves election laws, campaign finance regulation, and conflict of interest rules for parliamentarians. These types of laws and regulations lie beyond the mandate and expertise of the Bank.² At another level, corruption may be intrinsic to the way power is

² Participants in EDI's "integrity workshops" may discuss such matters, as part of the "integrity infrastructure" required to control corruption. "Integrity infrastructure" is a term coined by

exercised and cannot be changed through law making alone. In the extreme case, state organs may be infiltrated by criminal elements.

2.7 *Isolated versus Systemic Corruption.* Not only is there great diversity in the types and sizes of corruption, but the extent of corruption in a society can be rare or widespread. If it is rare, consisting of a few individual acts, it is straightforward (though seldom easy) to detect and punish. In such cases non-corrupt behavior is the norm, and institutions in both the public and private sectors support integrity in public life. In contrast, corruption is "systemic" (pervasive or entrenched) where bribery, large or small scale, is routine in dealings between the public sector and firms or individuals. Where systemic corruption exists, formal and informal rules are at odds with one another; bribery may be illegal but is understood by everyone to be routine in transactions with government. And there may be different degrees of coordination between those taking bribes, ranging from uncontrolled extortion by multiple officials to highly organized bribe collection and distribution systems. While the Working Group found no countries lacking anti-bribery laws, there are many where bribery characterizes the "rules of the game" in private/public interactions. Systemic corruption may occur uniformly across the public sector, or it may be confined to particular agencies – such as customs or tax authorities or public works or other ministries, or particular levels of government.³

2.8 *Corruption in the Private Sector.* Fraud can also take place in the private sector with costly results. Unregulated financial systems can undermine savings and deter foreign investment. Popular support for privatization or the deepening of financial markets can be eroded if poor regulation leads to small shareholders withdrawing when confronted by insider dealing and the enrichment of managers. And when corruption is systemic in the public sector, firms that do business with government agencies can seldom escape participating in bribery.

2.9 While noting the existence of fraud and corruption in the private sector and the importance of controlling it, the Working Group decided to confine itself to corruption in the public sector. Nevertheless, Bank activities can also promote the control of bribery within the private sector by helping countries strengthen the legal framework to support a market economy and by encouraging the growth of professional bodies that set standards in areas like accounting and auditing.

Transparency International to describe the full range of values, processes and organizations within and outside the public sector that contribute to accountable, transparent and honest government. See TI's "National Integrity Source Book," published in 1996 and used by EDI in anti-corruption workshops.

³ Once it is widespread, or "systemic," the likelihood of detection and punishment falls in any individual case. As the expected "cost" of corruption falls for the public official, the incidence rises still further. This pattern of initially rising but then falling "cost" can lead to multiple equilibria. One equilibrium is a society relatively free from corruption; the other is one where corruption is widespread and systemic. Moving from the latter to the former is much harder than merely reducing corruption at the margin within either one.

What are the Effects of Corruption on Development?

2.10 While it would be simple to take a moral view that all corruption is bad, the Bank must base its policies on evidence and analysis of development impact. The political sensitivity surrounding issues of governance underscores the need for such a foundation. We therefore examined the evidence of the effects of corruption on development, compiled by outside researchers and within the Bank.

2.11 When surveying existing evidence or planning new projects, research, or economic and sector work, it is important to keep in mind that corruption is an exceedingly difficult phenomenon to measure, because the perpetrators have an obvious incentive to hide it from the public eye. Even if it were clearly visible, corruption is correlated with many other attributes of weak governance, and isolating its impact on development can be tricky. This is not a reason to avoid the subject altogether, but we need to appreciate the limits to measurement and monitoring as future research and anti-corruption initiatives are planned.

2.12 *Economic research.* The body of research that addresses the economic impact of corruption has grown significantly in recent years. The research is both macroeconomic and microeconomic, theoretical and empirical. The conclusions reached depend in part on what the researcher views as the bottom line: (i) short-term economic efficiency in private markets, (ii) longer-run dynamic efficiency and economic growth, (iii) equity and fairness, or (iv) political legitimacy.

2.13 One strand of literature explores, primarily from a theoretical perspective, the likely economic impact of particular forms of corruption.⁴ While it is possible to define conditions in which corruption may not harm, and theoretically could improve, efficiency, the impact of corruption tends to be far more negative when longer-term effects are taken into account.

2.14 First, the argument is made that corruption may not distort the short-run efficiency of an economy if it entails merely a transfer of economic "rents" from a private party to a government official. The problem with this line of reasoning is that it fails to take into account any objectives other than short-term efficiency. In the longer run, expectations of bribery may distort the number and types of contracts put up for bid, the method used to award contracts, or the speed or efficiency with which public officials do their work in the absence of bribes. In addition, the gains from such bribery may be inequitably distributed (accessible only to certain firms and public officials). Widespread bribery will undermine the public's trust in government and prevent the emergence of a well-performing bureaucracy capable of implementing policy in the public interest.

⁴ S. Rose-Ackerman provides an excellent overview of this literature in "When is Corruption Harmful," a background paper for the 1997 World Development Report, August 1996. Also see P. Bardhan, "The Economics of Corruption in Less Developed Countries: A Review of Issues," Center for International and Development Economics Research Working Paper C76-064, February 1996.

2.15 Second, bribes can theoretically increase economic efficiency if they allow firms to avoid overly-restrictive regulations or confiscatory tax rates. There may be some validity to this argument, particularly in the short run. The counterargument is that such bribery defuses pressure for broader reform, and it invites firms to evade good regulations as well as bad. Furthermore, the costs of such a system may fall disproportionately on smaller firms.⁵ Policy based on many legal restrictions and widespread bribery to avoid them is like a highly regressive tax system on the private sector, and few would argue for the latter in developing countries. And in some transition countries such restrictions have proliferated in an uncontrolled way with the express purpose of extracting rents.

2.16 To summarize, models purporting to show that corruption can have positive economic impacts are usually looking only at static effects in the short-run. In the longer-run, opportunities for bribery are likely to lead public officials to change the underlying rules of the game or their own behavior in the absence of bribes, and the results are likely to be costly in terms of economic efficiency, political legitimacy, and basic fairness.

2.17 Another strand of literature⁶ looks at the links between investment and/or economic growth and the quality of government institutions. It finds that weak public institutions, as evidenced by unreliable contract enforcement and property rights, unpredictable policies, inefficient public administration, corruption, and other indicators, significantly reduce private sector investment and lead to slower growth. While very useful in highlighting the broad economic impacts of institutional deficiency, much of the literature is unable to separate the impact of corruption *per se* from other dimensions of government quality. However, this is now changing, and some conclusions are now being drawn from empirical analysis on the effects of corruption alone on economic performance.

2.18 A survey of 3,600 firms in 69 countries carried out for the 1997 World Development Report provides further evidence of the widespread existence and negative impact of corruption. As noted in the Report:

"The survey confirmed that corruption was an important – and widespread – problem for investors. Overall, more than 40 percent of entrepreneurs reported having to pay bribes to get things done as a matter of course Further, more than half the respondents worldwide thought that paying a bribe was not a guarantee that the service would actually be delivered as

⁵ For examples of such regressive impact, see S. Rose-Ackerman and A. Stone, "The Costs of Corruption for Private Business: Evidence from World Bank Surveys," mimeo, May, 1996.

⁶ S. Borner, A. Brunetti, and B. Weder; Political Credibility and Economic Development, New York: St. Martin's Press, 1994; P. Mauro, "Corruption and Growth," Quarterly Journal of Economics, August 1995; P. Keefer and S. Knack; "Why Don't Poor Countries Catch Up? A Cross-national Test of an Institutional Explanation," IRIS Working Paper, University of Maryland; survey for World Development Report 1997; Shang-Jin Wei, "How Taxing is Corruption on International Investors?," National Bureau of Economic Research, Working Paper 6030, 1997.

agreed, and many lived in fear that they would simply be asked for more by another official The consequences of corruption often do not end with paying off officials and getting on with business. Government arbitrariness entangles firms in a web of time-consuming and economically unproductive relations..."⁷

The survey also confirmed the negative correlation between the level of corruption (as perceived by business people) and the level of investment in an economy.

2.19 While few would disagree that the impact of corruption in Africa or the former Soviet Union has been very damaging, the juxtaposition of high growth and systemic corruption in some Asian countries challenges those who believe that corruption is always economically harmful. Several explanations have been suggested. First, perhaps predictability is what matters, and some governments reliably deliver what is "bought" with bribes while other governments do not.⁸ Second, some others view highly-concentrated corruption at the top of the political system (cited as more the model in some Asian settings) as less distortionary than uncontrolled corruption at lower levels (as, for example, in parts of the FSU).⁹ Third, if political systems are stable and the rules of the game are well-known, the transaction costs of rent-seeking may be less costly than in a more unstable, uncertain environment. Fourth, corruption may be imposing environmental and social costs not captured in national accounts data. The reality is that we do not know, and even within Asia, country experience differs widely. Nobody, however, argues that corruption is *good* for development, and recent research suggests that, corruption may be harming growth even in Asia.¹⁰

2.20 **Political science.** Political scientists look beyond the visible signs of corruption to the broader setting in which it occurs. They see corruption in relation to the legitimacy of the state, the patterns of political power, and the engagement of civil society. One approach is to look at corruption as a manifestation of the way political power is contested and exercised. To the political leadership, corruption may serve several purposes: rewarding supporters, buying off opponents, or accumulating resources to fight elections. To obtain these resources, the political leadership may forge alliances with business groups or in other ways extract rents through the bureaucratic apparatus. The resulting policies may favour or discourage private investment and economic growth, depending on the nature of the alliances struck.¹¹ While some countries have laws that

⁷ "The State in a Changing World," World Development Report 1997, forthcoming.

⁸ The importance of predictability is stressed in the 1997 World Development Report, "The State in a Changing World."

⁹ A. Schleifer and R. Vishny, "Corruption," *Quarterly Journal of Economics*, 1993, pp. 108, 599-617.

¹⁰ See Daniel Kaufmann, "Corruption: The Facts," in *Foreign Policy*, June 1997.

¹¹ Mushtaq Khan, "Corruption in South Asia: Patterns of Development and Change," SOAS, University of London.

provide public funds for political parties which pass a voting threshold, in most countries politics is a public good society expects to be privately financed.

2.21 Another approach is historical. Over time, most industrialized countries have evolved merit-based bureaucratic values, institutionalized competitive politics, established transparent government processes, and developed an active media and an informed civil society. These constrain political and bureaucratic corruption, making it the exception rather than the norm. In developing countries, by contrast, government institutions are weaker, civil society less engaged, and political and bureaucratic processes less accountable and transparent. An effective state apparatus and capacity for law enforcement may be virtually non-existent. In such settings, sustained progress in building an honest and effective state apparatus requires addressing the mix of factors in state and society which give rise to both corruption and weak social and economic performance. This is an exceedingly complex and long-term effort.¹²

2.22 **Public management.** The public management view of corruption is very clear cut. Systemic corruption, in the form of graft and patronage and the inefficiencies that accompanied it, spurred the nineteenth century reforms in Europe and North America that created the modern bureaucratic state. Corruption opposes the bureaucratic values of equity, efficiency, transparency, and honesty. It thus weakens the ethical fabric of the public service and prevents the emergence of well-performing government, capable of developing and implementing public policies that promote social welfare. The machinery of modern government, as it evolved in the industrialized world and has been transferred to developing countries, includes systems that protect public organizations from corruption and promote accountability, such as a meritocratic civil service, and watchdogs like the supreme audit institution, the ombudsman, and the public service commission. These should not be neglected. Though some OECD countries seeking to improve government performance through "New Public Management" reforms are developing "risk management" perspectives on corruption, they do so within a framework of strong financial management control systems, and a renewed emphasis on the ethical values of public service. While economies may still grow in countries where corruption is entrenched in the public sector, the public management view is that successive stages of economic and social development will be harder if not impossible to achieve without well-performing government. Ultimately, countries need to create durable institutions to foster and protect integrity in public life if public policy is to achieve the social objectives (such as poverty reduction and environmental protection) that the Bank promotes.

2.23 **Bank economic and sector work.** We looked at Bank economic and sector work (ESW) to see what light it could shed on corruption and its causes and costs. Generally Bank ESW has not directly addressed the topic of corruption. However, a small but growing number of Public Expenditure Reviews (PERs) have drawn attention to the

¹² See Michael Johnston "What Can Be Done About Entrenched Corruption?", Colgate University. Paper presented at the Annual Bank Conference on Development Economics, April 1997.

problem, and survey data gathered in the course of Private Sector Assessments (PSAs) are beginning to illuminate the costs of bribery to entrepreneurs. By drawing on the ESW that does address the topic, tapping informal country knowledge within the institution, and by trawling the Bank's vast store of country reports for examples where the influence of corruption can be inferred (even if the term is seldom used), the following picture emerges of the many ways in which corruption imposes costs on our borrowers.

- (i) *Macroeconomic stability* may be undermined by loss of government revenue and excessive expenditure. This can happen through corruption in tax and customs departments; through debt incurred when the scrutiny of finance ministries and central banks is by-passed; through awarding contracts to higher cost bidders or without competitive bidding and colluding with the supplier to charge a higher than market price; and through the general erosion of expenditure control. Excessive debt may be incurred through "white elephant" investment projects that owe their origin, in part, to bribes. Macroeconomic stability may also be threatened by debt guarantees and other off-budget contingent liabilities agreed to in corrupt transactions without public scrutiny. In transition countries, and in many developing countries,¹³ corruption may reduce revenue collection by driving firms (or their most profitable activities) out of the formal sector and by providing a moral justification for widespread tax evasion. The costs of macroeconomic instability are borne by all elements in society, but especially the poor.
- (ii) *Foreign direct investment* may still flow to countries where corruption is systemic, but only if bribery is affordable and the results are predictable. Even so, corruption may well have a negative effect on foreign investment. Where corruption is systemic and large, investment may be concentrated in extractive industries where operations can be enclaved, or in light manufacturing or trading operations, which can be relocated if corruption costs become unbearable. Or foreign investors may shun the country altogether. For most foreign firms, corruption is a cost of doing business to be recouped from revenues. If the costs become too high or unpredictable, they will disengage unless global marketing or sourcing considerations require a presence to be maintained in that country. Very high levels of corruption add to the risk of a country being marginalized in the international economy.
- (iii) *Small entrepreneurs* may be affected in many developing and transition countries. Evidence from Private Sector Assessments (PSAs) suggests that corruption

¹³ See for example Hernando de Soto's description of the informal sector in Peru, in "The Other Path," 1989.

increases the costs of doing business, that small firms bear a disproportionately large cost, and that bribes can prevent firms from growing.¹⁴

- (iv) *The environment* may be endangered. Many countries have enacted laws to protect the environment and have created special agencies to enforce the laws, but there is too often a "disconnect" between policy and its implementation. Complying with environmental regulations imposes costs on firms that can be avoided by bribery. There are huge rents to be earned from activities, such as logging in tropical rain forests, where permits are obtained corruptly or where inspectors can be bribed to ignore illegal logging. The environmental costs of corruption may take the form of ground water and air pollution, soil erosion, or climate change, and can be global and intergenerational in their reach.
- (v) The *poor* suffer. While Poverty Assessments have focused more on measuring poverty than explaining it,¹⁵ anecdotal and survey evidence reveal the cost of petty corruption on the poor. When access to public goods and services requires a bribe, the poor are excluded. Furthermore, when corruption results in shoddy services, the poor lack the resources to pursue "exit" options such as private schooling, health care or private power generation.¹⁶

2.24 *The views of Bank staff.* To augment the evidence from research and ESW, the Working Group carried out informal interviews of Bank staff to discover their views and insights. Common patterns emerged, but there were important regional differences – most notably regarding the economic impact of corruption in East Asia. Raising the topic tapped into deep and strongly held beliefs among the Bank's task managers. From the responses we drew the following conclusions:

- Bank staff are concerned that corruption is widespread. They believe it is growing in most countries, either in amount or in visibility, in response to the weakness of institutions, and to the special conditions of the post-socialist transition economies.

¹⁴ See Susan Rose-Ackerman and Andrew Stone, "The Costs of Corruption for Private Business: Evidence from World Bank Surveys." See also Daniel Kaufmann, "The Missing Pillar of a Growth Strategy for Ukraine: Institutional and Policy Reforms for Private Sector Development" (in *Ukraine: Accelerating the Transition to Market*, ed. P. Cornelius and P. Lenain, IMF, January 1997). And also "Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies: A Framework of Analysis and Evidence," (with A. Kaliberda), (Chapter 4 in *Economic Transition in the Newly Independent States*, ed. B. Kaminski, Armon, NY: M.E. Sharpe, 1996).

¹⁵ This is now changing with Participatory Poverty Assessments which seek to tap the experiences of the poor directly.

¹⁶ Pioneering work in this area has been done by the Public Affairs Centre in Bangalore, which found in five Indian cities that the poor were much more likely to pay "speed money" for public services than households generally. Sam Paul, "Corruption: Who will Bell the Cat?," April 1997.

- A consensus exists that corruption is a major barrier to economic development for most economies (with some uncertainty regarding East Asia). Corruption renders efforts at policy formulation, public sector management, and the protection of the environment less effective. Corruption's impact falls more heavily on the poor, who are powerless to protect themselves.
- Staff believe the time is ripe for the Bank to assist countries with a vigorous anti-corruption effort. They believe the Bank can do more to confront corruption, both in its analytical work (which has suffered from excessive timidity on the subject in the past) and in its formal policy dialogue with governments (where the subject has often been avoided as too sensitive or too political). Government responses, in the minority of cases where the subject has been addressed directly – principally in LAC and AFR – indicate that there is scope for the Bank to expand its work in this area. The notion of pilot projects, in countries keen to tackle corruption, is strongly endorsed by staff.

2.25 **Conclusion.** Corruption is a complex phenomenon whose impact on development is likely to vary with country conditions. But, while costs may vary and systemic corruption may co-exist with strong economic performance, *experience suggests that corruption is bad for development*. It leads governments to intervene where they need not, and it undermines their ability to enact and implement good policies in those areas where government intervention is clearly needed – whether environmental regulation, health and safety regulation, social safety nets, macroeconomic stabilization, or contract enforcement. And as an institution which believes in the power of public policy to achieve developmental goals, the Bank needs to be more ready to acknowledge the impact of corruption on the programs of borrowers if outcomes are affected.

CHAPTER 3

TACKLING THE PROBLEM OF CORRUPTION: GUIDELINES FOR A BANK STRATEGY

3.1 The Working Group believes that the Bank should address the problem of corruption more directly than it has done in the past. Corruption is of growing concern to donors, NGOs, and governments and citizens in developing and industrialized countries alike. In many of the Bank's borrower countries, corruption undermines the country's development objectives. Moreover, corruption undermines the effectiveness of aid and in turn threatens its political support. The opportunities to address corruption have never been greater. New global standards of behavior appear to be emerging, driven partly by changing attitudes to transnational bribery in developing countries (see Chapter 6), and partly by the effects of information technology in both developing and industrialized countries. With its cross-country expertise and broad development mandate, the Bank can be a leader in helping countries design anti-corruption strategies and participate in international efforts to deal with the issue, rather than sitting on the sidelines as a passive player.

3.2 Given its responsibilities to shareholders and clients, the Bank cannot help being concerned with corruption to the extent it compromises the success of the Bank's own projects and policy advice. The Bank found in the 1980s that inappropriate macroeconomic policies could prevent well-designed projects from achieving intended results. It is now faced with widespread evidence that weak institutions undermine policy implementation and project outcomes. While a Bank project can be protected in the short run from an adverse public sector environment by separate staffing and financial arrangements during loan disbursement, sustained outcomes cannot be ensured this way. Moreover, such "enclaving" in high inflow countries may perpetuate institutional weaknesses (see Chapter 5). To ensure the desired outcomes for Bank-financed projects, the Bank must pay greater attention to the institutional environment as a whole.

3.3 Not only *should* the Bank be concerned about corruption as a development issue, but the Bank can as a legal matter address the issue within certain limits. The General Counsel, in a recent paper on the subject, has pointed out that:

...."the World Bank can hardly insulate itself from major issues of international development policy. Corruption has become such an issue. Its prevalence in a given country increasingly influences the flow of public and private funds for investment in that country. The Bank's lending programs and in particular its adjustment lending take into account factors which determine the size and pace of such flows. From a legal viewpoint, what matters is that the Bank's involvement must always be consistent with its Articles of Agreement. The Bank can in my view take

many actions to help the fight against corruption. It can conduct research on the causes and effects of this worldwide phenomenon. It can provide assistance, by mutual agreement, to enable its borrowing countries to curb corruption. It may take up the level of corruption as a subject of discussion in the dialogue with its borrowing members. And, if the level of corruption is high so as to have an adverse impact on the effectiveness of Bank assistance, according to factual and objective analysis, and the government is not taking serious measures to combat it, the Bank can take this as a factor in its lending strategy towards the country. The only legal barrier in this respect is that in doing so the Bank and its staff must be concerned only with the economic causes and effects and should refrain from intervening in the country's political affairs. While the task may be difficult in borderline cases, its limits have been prescribed in detail in legal opinions endorsed by the Bank's Board.¹⁷

According to one such legal opinion,¹⁸ the concept of governance in the sense of the overall management of a country's resources cannot be irrelevant to an international financial institution which at present not only finances projects but also is deeply involved in the process of economic reform carried out by its borrowing members. Clearly, the concern here is not with the exercise of state powers in the broad sense but specifically with the appropriate management of the public sector and the creation of an enabling environment for the private sector. It is a concern for rules which are actually applied and institutions which ensure the appropriate application of these rules, to the extent that such rules and institutions are required for the economic development of the country and in particular for the sound management of its resources.¹⁹

No doubt, the Bank has to address issues of corruption in this context with great caution, acting on the basis of established facts and only to the extent that the issues clearly affect the economic development of the country. It cannot, however, ignore such issues at a time when they have become a major concern, not only to the sources of international

¹⁷ See "Issues of Governance in Borrowing Members - The Extent of Their Relevance Under the Bank's Articles of Agreement, Legal Memorandum of the General Counsel," dated December 21, 1990 (SecM91-131, February 5, 1991) and "Prohibition of Political Activities in the Bank's Work, Legal Opinion of the General Counsel," dated July 11, 1995 (SecM95-707, July 12, 1995).

¹⁸ "Issues of Governance in Borrowing Members," issued in December 1990.

¹⁹ For details, see I. Shihata, "The World Bank in a Changing World," Vol. 1, 53-96 (1991).

financial flows but also to business organizations and indeed to the governments and peoples of most of its member countries."²⁰

Corruption, therefore, can be addressed by staff as an economic phenomenon within the framework already approved by the Board for governance issues. This framework provides scope for the Bank to assist countries, through advice on economic policy reform, strengthening of institutional capacity, and participation in the international effort to control corruption. However, in this area – as in others – the Bank should focus on its areas of comparative advantage. The Bank's mandate does not extend to the political aspects of the control of corruption. And though the engagement of civil society is crucial for the long-run control of corruption, there are obvious limits on the extent to which the Bank can directly support civil society's efforts to control corruption. So, while the Bank's mandate provides scope for the institution to assist countries in controlling corruption, it shapes the way the Bank may respond.

Understanding the Causes of Corruption

3.4 The ultimate goal of a Bank strategy to help countries address corruption is not to eliminate corruption completely, which is an unrealistic aim, but to help these countries move from systemic corruption to an environment of well-performing government where the negative development impact of corruption is minimized. Such a strategy should be guided by a view of what causes corruption and in what environments it tends to thrive.

3.5 The particular causes of corruption in a country will always be contextual, rooted in the country's policies, bureaucratic traditions and social history. Abstracting from country circumstances, we can generalize that corruption flourishes when institutions are weak and government policies generate economic rents. Some characteristics of developing and transition settings make corruption particularly difficult to control. First, the normal *motivation* of public sector employees to work productively may be undermined in these settings by many factors, including low and declining civil service salaries and promotion unconnected to performance. And poor personnel policies may not be the only demotivator. Dysfunctional government budgets, inadequate provision of supplies and equipment, delays in the release of budget funds (including pay), and a loss of organizational purpose may all contribute to staff demoralization. Furthermore, the motivation to remain honest may be weakened if senior officials and political leaders are using public office for private gain. Or the public service may have long been dominated by patron-client relationships, in which the sharing of bribes and favors has become entrenched. In some countries, pay levels may always have been low, with the informal understanding that staff will find their own ways to supplement inadequate pay. Sometimes these conditions are exacerbated by closed political systems dominated by

²⁰ See Ibrahim F.I. Shihata, "Corruption - A General Review with an Emphasis on the Role of the World Bank," a paper based on a keynote address delivered on the occasion of the International Symposium on International Crime at Jesus College, Cambridge, England, September 9, 1996.

narrow vested interests, and by international sources of corruption associated with major projects or equipment purchases.

3.6 The *opportunity* for corruption is a function of the size of the rents under a public official's control, the discretion that official has in allocating those rents, and the accountability that official faces for his or her decisions.²¹ *Monopoly rents* can be very large in highly regulated economies, and, as noted above, corruption breeds demand for more regulation. In transition economies, economic rents can be enormous because of the amount of formerly state-owned property essentially "up for grabs." The *discretion* of many public officials may also be large in developing and transition countries, exacerbated by badly-defined, ever-changing, and poorly disseminated rules and regulations. Finally, *accountability* is typically weak. The ethical values of a well-performing bureaucracy may have been eroded or never built. Rules on conduct and conflict of interest may be unenforced, financial management systems (which normally record and control the collection of revenues and the expenditure of budgeted resources) may have broken down, and there may be no formal mechanism to hold public officials accountable for results. The "watchdog" institutions that should scrutinize government performance, such as ombudsmen, external auditors, and the press, may be ineffectual. And special anti-corruption bodies may have been turned into politically partisan bodies, whose real purpose is not the detection of fraud and corruption but the harassment of political opponents.

The Three Pillars of a Bank Strategy

3.7 This points to a strategy that addresses all parts of the equation in a manner consistent with the Bank's mandate. And, because corruption has become a global problem, the strategy needs to have an international dimension. We recommend that the Bank's strategy to help countries combat fraud and corruption rest on three "pillars" that together help to reduce rents, channel discretion, and increase accountability:

- Economic and Sector Policy Reform
- Institutional Strengthening
- International Cooperation

These three pillars are described in detail in the following three chapters. In addition, Chapter 7 on Implementation briefly summarizes changes in Bank procurement and disbursement procedures, which should support country efforts to control corruption.

²¹ Robert Klitgaard uses the equation $C \text{ (corruption)} = M \text{ (monopoly)} + D \text{ (discretion)} - A \text{ (accountability)}$. See R. Klitgaard, "Cleaning Up and Invigorating the Civil Service," World Bank Operations Evaluation Department, November 1996.

Tailoring Strategy to Country Circumstances

3.8 The approach to assist a particular country will depend on that country's circumstances. In some countries, the priority will be economic policy reform. In others the immediate need may be targeted interventions in agencies like tax or customs, or procurement reform. Circumstances will also determine whether the strategy should be comprehensive or more incremental. Comprehensive strategies can be developed where national leadership is committed to change and the political will exists to undertake in-depth economic and institutional reforms. Governments are seldom undifferentiated in their reform commitment, and there may be opportunities for in-depth reform at the local level, or in particular agencies or departments, even if they are missing at the national level. In some cases there may be more political will for economic policy reform than for in-depth work at the institutional level. And when even the possibility for economic policy reform is limited, there may still be scope for activities, such as public education or dialogue with leaders in government and civil society, which can lay the foundation for more substantial action later.

3.9 Countries range across a spectrum, from those in which there are dynamic forces working for more transparent and accountable government to those caught in a vicious circle of systemic corruption and no growth. In some countries, historical forces are on the side of state modernization, and are working in much the same way as they did in the industrialized world a century ago. In Latin America, civil society is engaged and policy makers see the control of corruption as an integral part of public sector modernization. Privatization has been substantial, and economies are now much more open to market forces. In a number of East Asian countries, the private sector is especially dynamic, and policy makers are aware of the challenges and opportunities of the global economy and the need for a changed role for the state. The role of the Bank in such circumstances is to be ready to help governments improve performance by providing policy advice and assisting with institution strengthening, while at the same time ensuring that Bank-financed projects are corruption free.

3.10 Poorer countries, particularly some in Africa, cannot wait for historical processes, particularly if the preconditions for change are absent. In Africa, the modern private sector has remained small and operates by informal rules in its relations with government. In such countries high levels of corruption may be a stable equilibrium, with political elites, bureaucratic functionaries, entrepreneurs, and ordinary people all bound by its rules. Although the context is quite different, aspects of this can also be seen in some transition countries, where the institutions of a command economy are no longer relevant, resulting in a vacuum in government capacity. In such countries, combating systemic corruption and building strong institutions needs to be a more deliberate process, maintaining a focus not just on building the various component parts of the "integrity system" but also on economic policy reform, and how policy reform and institution building can reinforce each other. Success will depend on the roles played by national leaders, public officials, and civil society, on the design and implementation of economic policies, and on the condition

of public management systems. External agents like the Bank and bilateral donors also have an important role to play, both because significant external support is needed to help build capacity, and because aid plays a major role in shaping and maintaining the state.

Corruption and Bank Operations

3.11 The Working Group believes that, in reflecting corruption in Bank operational work, the following should be the main considerations:

- (i) whether Bank projects are affected by corruption, either during the disbursement phase or thereafter;
- (ii) the extent to which corruption is detrimental to development efforts; and
- (iii) the willingness of the government to act to control corruption if it threatens the effectiveness of Bank projects and/or economic and social development policy.

3.12 Addressing corruption in the country dialogue and in the CAS requires sensitive handling. It will be important to view corruption not in moral terms but as a constraint to development. The extent to which it can be presented in terms of its effect on the outcomes of government policies, programs and projects, the more constructive that dialogue is likely to be. The objective is not to rate countries on the extent of corruption, but to shed light on how it affects government objectives, particularly in the areas we deem important for sustainable development. Cross-country indices of the level of corruption (such as TI's Corruption Perception Index) open up avenues for empirical research, but are no guide to economic impact.

3.13 Assessing the effect of corruption on development will seldom be a precise exercise, and will require the exercise of judgment based on the available evidence. Corruption comes in many forms, and the impact varies greatly between countries, according to circumstances. One type of bribery may be relatively benign in one setting but economically crippling in another. And the harm caused may be mitigated or magnified by the macroeconomic or sector policies followed by the government.²² Thus the impact of corruption should always be assessed in the context of other factors constraining or supporting development. Furthermore, if corruption is addressed rather than side-stepped in ESW, insights will progressively be gained, evidence of the impact of corruption will accumulate, judgments will become more informed, and the costs can be

²² Ten percent on the cost of a good public investment project depresses the economic rate of return only slightly. A bribe that saddles the country with a white elephant investment may result in economic costs far exceeding the corrupt payment, particularly if the policy environment causes a value subtracting investment to appear nominally profitable.

better articulated to governments.²³ In turn, this should help governments prepare and implement strategies to combat corruption. We are not proposing special corruption assessments, just a fuller recognition of the issue in ESW when staff encounter its effects.

3.14 Performance-based procedures for determining IDA allocations already exist. The Working Group believes that a concern for the impact of corruption and the efforts of countries to control it can be incorporated into that framework more explicitly.²⁴ Where the impact is negative to country and Bank development objectives, corruption should be raised in the dialogue, with the expectation that action will be taken (with or without Bank support) to address it.

²³ As noted elsewhere in this Report, Private Sector Assessments (PSAs) are yielding information on the extent to which entrepreneurs see bribery as a constraint to business development. Service Delivery Surveys (SDS) are starting to provide insights into whether beneficiaries have to pay bribes to receive government services. International price benchmarking can point to whether procurement is affected by corruption. And in one country, Bank staff were able to bring to the authorities' attention major fraud by comparing customs revenue receipts with central bank balance of payments data.

²⁴ IDA resources, for example, are allocated to eligible countries mainly on the basis of their performance in meeting economic and social goals. Countries are rated according to three sets of criteria: (i) macroeconomic stability; (ii) structural policies; and (iii) portfolio performance. Pervasive corruption will have an impact on all three of these areas.

CHAPTER 4

ECONOMIC AND SECTOR POLICY REFORM

4.1 The Bank's record of giving good policy advice has been a highly positive contribution to the struggle to control corruption, and *economic policy reform should be recognized as a main pillar of the Bank's anti-corruption strategy*. Deregulation and the expansion of markets is a powerful tool for the control of corruption, and the Bank should continue to encourage governments to follow this approach where it is feasible. Where governments must continue to be involved in the economy, Bank staff should carefully consider the demands a new policy might make on institutional capacity. In the 1970s, the Bank recognized the importance of the economic policy environment for project success. Now the Bank needs to take more systematic account of the institutional environment for both policy and project success.

Deregulation and the Expansion of Markets

4.2 Markets discipline participants more effectively than public sector accountability mechanisms generally can. Enlarging the scope and improving the functioning of markets strengthens competitive forces in the economy and curtails rents, thereby eliminating the bribes public officials may be offered (or may extort) to secure them. And there is a strong correlation between policy distortion and the level of corruption found in countries.²⁵

4.3 Some results of policy reform can come quickly, particularly macroeconomic reform, which does not make heavy demands on institutional capacity. The incentives of economic actors can be changed overnight by the removal of controls and the introduction of market-determined allocation systems in areas like foreign exchange and bank credit. Resistance to structural-adjustment reforms is now more likely to be from vested interests than from ideological opposition.

4.4 Examples of both macroeconomic and sector policy reforms that contribute to the expansion of markets and the reduction of rents include:

- Lowering tariffs and other barriers to international trade;
- Moving from dual to single exchange rates, with market-determined rates;
- Introducing competitive credit markets;
- Eliminating price controls;
- Reducing subsidies to enterprises;

²⁵ As illustrated by the 1997 World Development Report, Figure 2-2.

- Reducing regulations, licensing requirements, and other barriers to entry for new firms, both domestic and foreign;
- Privatizing government assets in clearly competitive markets; and
- Abolishing monopoly export marketing boards.

4.5 The Working Group discussed these and other policy areas with operational staff across the Bank, who confirmed that policy reform has contributed to the reduction of the impact of corruption in many countries. Where countries have carried out economic reform programs and corruption persists, the answer may be found in an unfinished reform agenda. In many countries the benefits of macroeconomic reforms have been blunted by the absence of complementary microeconomic reforms at the sector level. Thus many countries – transition economies in particular – need to maintain the reform momentum. And supplying advice to governments on macroeconomic and sector policies that improve performance is an area of comparative strength for the Bank.

4.6 Policy reform may be especially relevant in circumstances where powerful elements in the public sector seek to retain control over areas of public activity for rent seeking purposes, and consensus on far-reaching institutional reforms has still to be achieved. Well targeted policy reforms, supported by the Bank, could have a decisive effect in reducing corruption and building public support for further reform. Deregulation, accompanied by publicity, can dramatically reduce the burden of corruption on firms and individuals.

Policy Advice When Government Has a Continuing Role

4.7 There are some areas where the Bank's policy advice may need to pay greater attention to anti-corruption goals. Typically, these involve areas where the government must continue to be involved because of market failure, but where public policy can work only if sufficient institutional capacity exists. Without institutional capacity, well-intended policies can lead to poor outcomes and even greater corruption. Several examples illustrate the links between design and institutional capacity: infrastructure privatization, environmental regulation, tax reform, and public expenditure reduction. The issue in each of these areas is not that the policies are necessarily misguided, but that institutional capacity is critical to a successful outcome, and policies must be designed in the light of a realistic assessment of institutional capacity.

4.8 ***Infrastructure Privatization.*** In the long run, privatization should decrease corruption, because it reduces the power and discretion of public managers and bureaucrats and increases competition and transparency. In the short run, the complex deals to negotiate – usually in a situation of shifting policies and regulations – create temptation and opportunity. Weak institutions are unlikely to resist temptation. As this becomes evident, a negative image of privatization builds in the public's eye – even though the transactions themselves still make good economic and financial sense.

4.9 The dangers are particularly acute in infrastructure privatization, where, typically, the stakes are larger, the negotiations prior to sale more elaborate, and continued government oversight is justified. When a firm is divested into a competitive market, the opportunities for corruption more or less end. In the case of a natural monopoly, corruption can continue indefinitely in the regulatory system.

4.10 In all cases, the solution is the reinforcement of institutional capacity so that clear rules may be impartially applied, both before and after sale. In the case of *infrastructure, privatization should not be undertaken without also establishing a minimum regulatory capacity*. It has proven costly to privatize first and try to install a regulatory regime later. Corruption is not an argument for not proceeding, but for better design and implementation of privatization programs.²⁶

4.11 **Environment.** Unlike most areas in which the Bank works, environment is one in which governments have tended not to be involved enough in the past and are now seeking greater involvement and regulation. But tighter regulation without strong institutions is likely to lead to more corruption because it creates rents and gives the government more coercive powers. A careful *balance between policy and institutional capability* is critical but easily overlooked.

4.12 New and innovative ways to use more transparent market mechanisms for environmental control are being tested in some countries. These include, for example, auctions of tradable permits to pollute, or negotiated contracts with industry consortia on acceptable pollution levels in a particular watershed basin. In each case the level of acceptable pollution is set by government, but how that level is reached is ultimately decided by the market or the private sector. Strengthening governments' capacity to design and implement such decentralized, market-based approaches to pollution control could be an important service the Bank might provide to reduce corruption in this sector.

4.13 **Tax reform.** In most cases, reforms to tax policy that eliminate multiple rates and exemptions and limit the discretionary powers of tax officials serve to reduce corruption and enhance economic efficiency. But sometimes a concern for closing a fiscal gap has caused the Bretton Woods institutions to press governments to impose rates of taxation that can be collected only from a few large corporations, if at all. *Tax rates that exceed what taxpayers view as legitimate or what tax offices can administer not only encourage the informalization of the economy but also induce tax evasion and the corruption of tax*

²⁶ Daniel Kaufmann and Paul Siegelbaum, "Privatization and Corruption in Transition Economies," *Journal of International Affairs*, Vol. 50 No. 2, Winter 1997, pp. 419-458.

*officials.*²⁷ High tax rates coupled with weak collection arrangements simply serve to inflate the gains from corruption without increasing the risk of detection.

4.14 **Public expenditure reduction.** Corruption may also increase when governments are under pressure to reduce the share of the public service wage bill in the budget, but find it hard politically to reduce numbers in the short run. *In such circumstances, a mandated reduction in the wage bill will translate into yet lower real pay for government employees.* This can have devastating effects on government performance, through the loss of skilled professionals, demotivation of those who remain, and lowered resistance to corruption. When the erosion of pay makes it impossible for staff to maintain basic living standards, the government can quickly lose capacity to control fraud, and even the honest can be driven to absenteeism and moonlighting activities which may be in conflict with their roles as public servants. On the surface, the formal processes of government may be maintained, while underneath an alternative set of informal rules operates to the detriment of public welfare.

4.15 Large public sector wage bills are fiscally unsustainable and must be addressed. But this should happen within an *integrated framework of public sector and governance reform* if measures aimed at strengthening the fiscal performance of the government are not to have adverse effects on its capacity to perform its tasks efficiently and effectively (see Chapter 5).

²⁷ For example, in a number of transition economies where the ratio of total government revenue to GDP is under ten percent, value-added tax rates exceed 20 percent.

CHAPTER 5

STRENGTHENING INSTITUTIONS

5.1 Building strong institutions is a central challenge of development and key to the control of corruption. Well-functioning public sector management systems, accountable organizations, a framework of laws, an independent judiciary and a vigilant civil society protect a country against corruption. Thus the Bank's strategy for helping countries control corruption in public institutions should match its strategy for achieving well-performing government. Seen this way, strengthening institutions to control corruption is part of the larger task of improving performance. This means (i) addressing the internal systems that determine how organizations and those who work in them perform and, (ii) helping to improve the governance environment in which public sector organizations operate and are held accountable. It also means coordinating with other agencies which are providing assistance in this area.

5.2 In strengthening institutions to control corruption, countries have moved forward in three areas:

- The traditional systems of well-performing government: a professional civil service, sound financial management, disciplined policy-making processes, and the balance of responsibilities between central, state and local government;
- The legal framework, including the judicial system;
- Greater transparency and other measures which can strengthen the role of civil society in demanding better performing government.

Although some aspects of the third category lie beyond the Bank's mandate, the Bank can do a great deal to help countries strengthen the capacity of institutions inside and outside government to control corruption. For many years the Bank has been active helping countries build well-performing public sector institutions, and has increasingly recognized the important role played by civil society. But institution building is hard work. Continued efforts are needed both within the Bank and outside to understand how to design and implement successful institutional reforms. This chapter lays out some initial thoughts.

When Formal and Informal Rules Diverge

5.3 First, it is worth noting a characteristic of the environment in which corruption occurs – the divergence between the formal and the informal rules governing behavior in the public sector. The Working Group is unaware of any country that does not have some rules against corruption, although not all countries have all the rules that may be

necessary. These range from laws making it a criminal offense to bribe a public official to public service regulations dealing with conflicts of interest, the acceptance of gifts and the duty to report fraud. Individual agencies of government – police and army, tax and customs departments, local governments, and public enterprises – may have their own laws, regulations, and codes of behavior. There are organic laws, often embedded in constitutions, about budgeting, accounting and auditing, supported by laws and regulations on public procurement and the safeguarding of public assets. In addition, there are laws on the conduct of elections and the appointment of judges, and codes governing the conduct of legislators. Some of these laws are a colonial inheritance, some have been copied from countries with a similar legal tradition, and some are additions to existing laws, for example, providing for special anti-corruption commissions and other watchdog bodies.

5.4 Where corruption is systemic, the formal rules remain in place, but they are superseded by informal rules. It may be a crime to bribe a public official, but in practice the law is not enforced or is applied in a partisan way, and informal rules prevail. Government tender boards may continue to operate even though the criteria by which contracts are awarded have been perverted. Seen in this light, strengthening institutions to control corruption is about shifting the emphasis back to the formal rules. This implies acknowledging that a strong legal framework to control corruption requires more than having the right legal rules in place. It means addressing the institutional sources of informality, first by understanding why the informal rules are at odds with the formal rules, and then addressing the causes of divergence. In some countries, the primary reason may be political, which limits what the Bank can do. In others, the reason may be weaknesses in the systems of public management, which the Bank can help countries improve.

5.5 The dichotomy between the formal and informal rules lies at the heart of understanding why corruption may be systemic in a country. This has major implications for how staff undertake project preparation and ESW. If corruption is "off the radar screen," staff will too readily assume that the formal rules determine behavior, and projects will be designed and policy advice tendered that is ill-suited to implementation realities. In such circumstances, there is no alternative to an open dialogue with counterparts to explore how best this dualism can be addressed.

Public Management Reform

5.6 *National Leadership.* Public management reforms are usually institutionally intensive, and require sustained commitment by both the borrower and the Bank over several years if they are to yield benefits. There is a need to ensure that the scope of institutional reform programs is matched by leadership commitment, recognizing, though, that successful reform programs build commitment as they proceed. Political commitment to reform is best seen as working capital that must be sufficient to start a reform endeavor, yet may be built progressively if reforms are designed strategically. There will be countries where corruption remains systemic in the public sector, but there is a reforming

core with whom a strategy can be developed, blending institutional reforms with economic reforms, according to country circumstances.

5.7 Civil Service Reform. One of the most important institutions of the state is a professional and well motivated civil service, with selection and promotion based on merit not patronage. A well-performing civil service resists petty corruption and provides the staff for many of the institutions that protect integrity in government: finance and personnel ministries, government tender boards, technical departments that evaluate bids, bodies that implement regulatory policy, accounting units, internal and external audit departments. However, drawing upon the lessons of the Bank's experience in assisting in civil service reform in over sixty countries, it is clear that progress in this field has been slow.²⁸ Mere downsizing in the absence of an integrated reform program has not worked well and has been subject to reversal. *Better approaches to civil service reform need to be developed if countries are to make headway in the control of corruption.* It lies beyond the Working Group's task to set forth how the Bank's efforts with civil service reform can be made more effective. However, some markers can be laid down. Personnel policy, including recruitment, promotion, and pay, is clearly a vital issue.²⁹ Defining what is meant by the civil service and differentiating more clearly between a core civil service and public employees generally is another. So are mechanisms to protect the civil service from unwarranted political interference. Ethics codes and institutional values, once established, help protect a civil service's integrity and professionalism, but require continual nurturing. And if civil services are overstaffed, or governments are trying to carry out too many tasks, or if some functions are best contracted out, reductions in manpower may be needed. This raises the issue whether the Bank should consider afresh the direct financing of severance pay as a component of civil service reform. Overall, the work that is taking place in several parts of the Bank needs to be pulled together, and approaches to civil service reform need to be reviewed.

5.8 Budget Reform. Government should undertake only what it can do well within its resource constraints.³⁰ The Bank should pay greater attention to helping governments build well-functioning budget processes, that achieve the government's macroeconomic targets, allocate resources strategically, and enable programs and projects to be implemented efficiently and effectively.³¹ In a larger sense, matching policy and

²⁸ The difficulties are detailed in numerous studies of the Bank's experiences in CSR, by the center, by the Regions and by OED. A study of Bank approaches to civil service reform is currently underway. See Barbara Nunberg, "Rethinking Civil Service Reform: An Agenda for Smart Government."

²⁹ As the 1997 WDR shows in Figures 5.5 and 5.6, pp. 92-93

³⁰ In many countries, decisions to introduce new policy are made without regard to the long term costs of implementation. This is because policy making is not disciplined by institutional processes that require the costs to be identified and considered before the policy decision is made. Where aid is additional, the discipline of a hard budget constraint is lost.

³¹ There is tentative empirical evidence that corruption affects the allocation of budget resources between sectors, specifically of a negative relationship between corruption and government

affordability for many countries means changing assumptions about the role of government in the post-independence "development state." In matching policy with affordability, governments may have to downsize. Shedding staff can be costly, and *in the context of a broader review of the Bank's experience with CSR, it may be necessary to revisit present policy on direct financing of severance pay.*

5.9 Financial Management. Good financial management systems are powerful instruments for preventing, discovering, or facilitating the punishment of fraud and corruption. They allocate clear responsibility for managing resources, reveal improper action and unauthorized expenditures, facilitate audit by creating audit "trails," and protect honest staff. By reducing opportunities for corruption and increasing the risks of detection, good financial management systems help change corrupt conduct from "high profit/low risk" to "high risk/low profit." Yet government financial management systems function poorly in many (possibly the majority) of our borrowers. Control systems are inoperative, permitting widescale fraud, and auditing in many cases is impossible.³²

5.10 The Bank has been active in a number of countries helping to strengthen government financial management systems and audit institutions, often using systems that better integrate the stages of budgeting, cash management, accounting and auditing.³³ But, the emphasis of the Bank in many countries has been on measures to improve financial management in Bank projects, which does not create a capacity for better financial management on a sustained basis outside the confines of the project. While the Bank will always have a fiduciary responsibility for its projects, the Working Group believes that *the Bank must pay greater attention to broader financial management systems, especially in poorer countries where standards are so low. The Bank should help governments install and operate modernized systems where appropriate, and should give more weight to government-wide financial management as a factor in lending program decisions.*³⁴

expenditure on education. And since educational attainment is an important determinant of economic performance, this could have adverse long-run consequence for growth. See Paulo Mauro, "The Effects of Corruption on Growth, Investment, and Government Expenditure: A Cross-country Analysis." IMF (Draft), 1996.

³² This is particularly a problem in Sub-Sahara Africa, where Auditors General frequently complain in their reports that audits could not be completed in departments and agencies because accounting records were incomplete, audit queries were unanswered and consolidated government accounts are presented to parliament years after the spending took place, if ever.

³³ The Bank is working with a growing number of countries to strengthen the capacity of the Supreme Audit Institution (SAI), by modernizing audit laws, training staff, and installing improved management systems. EDI has begun working with parliamentarians in selected countries to help watchdog bodies, such as public accounts committees, become more effective.

³⁴ If governments were enterprises operating in competitive markets, many could not afford such inattention to financial management. While the Bank (along with the IMF) has always emphasized the importance of aggregate financial control, we believe it has never given sufficient weight to

5.11 A key step in making this happen would be to integrate government-wide financial management into the CAS, the country dialogue, and decisions on the lending program. The Bank would also need to equip itself with an adequate number of professionally qualified financial management staff in each region and ensure that Financial Accountability Assessments³⁵ are done for all countries receiving Bank loans on a timely basis.

5.12 Here, mention should be made of the Loan Administration Change Initiative (LACI) now under development. LACI emphasizes the importance of borrower financial management and accounting systems to manage and monitor Bank projects. The Working Group believes that implementing LACI would help to strengthen borrower financial management through its potential to bridge the gap between Bank projects and government-wide systems. Instead of disbursing against individual expenditure transactions or SOEs, loans would be disbursed by more intensive use of special accounts recording individual expenditures, which would be replenished quarterly based on information derived from borrower financial management systems – provided these were determined to be of an acceptable standard.

5.13 **Tax and Revenue Departments.** Tax and customs departments are often the locus of major fraud and corruption and thus are candidates for inclusion in national strategies to control corruption. Such malfeasance can often be meaningfully addressed – assuming strong commitment from the top – by giving revenue agencies greater managerial freedom to hire, fire and set pay levels as compared with normal civil service rules, while subjecting their performance to scrutiny. By controlling theft, good financial management systems change the economics of bribery, and businesses no longer have an incentive to collude with a corrupt official to avoid taxes, rather their incentive is to report extortion.³⁶ Organizational restructuring (for example, to separate the tax assessment function from the collection function) and staff rotation may help reduce the opportunities

government-wide financial management from the perspective of spending efficiency and the control of corruption.

³⁵ FAAs take stock of financial management systems: the adequacy of design, how they are implemented, the stock of professional and technical skills in both the public and private sectors, accounting and auditing standards, and the legal framework for transparent and regular financial reporting. They have been carried out in Ghana, South Africa, Peru, Armenia, Moldova, Mongolia, Egypt, Yemen and Indonesia.

³⁶ When corrupt tax or customs officials systemically collude with taxpayers to substitute a lower rate and pocket the entire amount collected (bribery with theft), businesses operating in competitive markets have no alternative but to comply. To insist on paying the official tax or duty would put them at a competitive disadvantage compared with colluding firms. If a strong financial management system can be installed which controls theft (e.g., recording assessments made by individual officials and requiring superiors to sign off on the work performed by subordinates, daily reporting of valuations, assessments and collections, – by spot checks and independent valuations) firms have, instead, an incentive to report bribes, since paying bribes raises business costs. See Andrei Schleifer & Robert Vishny, "Corruption," *Quarterly Journal of Economics*, August 1993.

for corruption. Tax policy may also affect anti-corruption goals, as noted in Chapter 4. Simplifying tax and tariff schedules and keeping rates at moderate levels reduces the discretion of tax and customs staff and narrows the scope for corrupt payments. How governments spend the revenues they collect matters also. If taxpayers do not see their taxes put to good use, evasion and corruption may become socially acceptable.

5.14 The Bank has provided both policy advice and technical assistance and is also supporting tax modernization projects in a number of countries. The IMF is also active in this area, and coordination between the two institutions is important. Intrinsic to Bank efforts to help countries improve their tax and customs agencies are reforms which help government control corruption.

5.15 **Government Procurement.** Government procurement and contract management systems in both rich and poor countries are highly vulnerable to fraud and corruption. In terms of size, government-wide procurement far outweighs procurement under Bank lending in our borrowers. (Governments may procure goods and services equivalent to as much as 5 percent of GDP). Although documentary proof is usually lacking, there is plenty of hearsay information about officials taking bribes from contractors and suppliers, as a charge either for having the bid considered or to influence contract award. Later, there may be bribes to speed contract payments. In some cases, the goods may not be delivered at all, or substandard work may be performed.

5.16 Reducing fraud and corruption requires a willingness to install or reestablish sound systems and the capacity to operate them as intended. The basic principles of procurement are well known and are reflected in the Bank's approach to its own projects. The Bank has also helped a number of countries (mostly transition) enact procurement legislation that specifies open, competitive bidding for public contracts, and has conducted training.³⁷ Although this has been valuable, it has been low key, and there has been very little systematic effort to assess government-wide systems and to incorporate the findings in the CAS. Our primary concern to date has been corruption-free procurement in Bank projects. An increased effort is needed to help interested borrowers build capacity to procure goods and services and manage contracts. The working group supports proposals being considered in the Bank for a progressive shift of smaller value contracts from prior review to post-audit. It also supports the Loan Administration Change Institution (LACI), now being piloted, which has the potential to improve project financing management and streamline disbursement. Both initiatives should strengthen borrower accountability. Local capacity is the best insurance against fraud and corruption. There may be scope for approaches which involve specialist international firms, either to take over part of the procurement process, or to provide independent price information with which to benchmark the results of official processes.

³⁷ Using a model law (UNCITRAL) adapted to individual country legal systems, the Bank has helped many countries, especially transition ones African, establish legal frameworks for public procurement. This work has been funded from loans and IDG grants.

5.17 The Working Group recommends that *current Country Procurement Assessment Reviews (CPARs) be developed into a more effective vehicle for public management improvement*. PSM and procurement specialists in the Bank should work more closely to integrate the development of procurement capacity into country strategies for public sector reform. And there is always more for the Bank to learn about evolving approaches to procurement around the world. We should continue to search for new techniques and approaches that help minimize opportunities for corruption and improve value for money.

5.18 **Decentralization.** Decentralization involves the shifting of power to lower tiers of government or the granting of greater authority to line managers. Its effect on performance and corruption depends on the individual situation. On the one hand, decentralization can help reduce corruption if it improves government's ability to handle tasks effectively while increasing transparency and accountability to local beneficiaries. On the other hand, decentralization may increase the overall level of corruption if local and regional governments have greater incentives (due, for example, to lower formal pay levels) and/or more opportunities or to carry out fraudulent activities, and are less constrained by financial management and auditing systems (which are often in even shorter supply in the regions than in the center). In many federal countries, more corruption is thought to exist in state and, in particular, local governments than in the federal government. This is not an argument in principle against any and all decentralization, which for many other reasons may still have positive economic impact. Rather what is needed is to *take into account the relative accountability and capacity of national and subnational levels of government when considering the structure of power sharing, and to work with governments to develop the capacity of decentralized entities alongside the devolution of functions*.

5.19 **Service Delivery Surveys.** In a growing number of countries the Bank, through EDI, has helped governments carry out Service Delivery Surveys (SDS). Such surveys of program beneficiaries ask questions about the quality and reliability of government services, and in so doing may bring to light patterns of petty bribery. They shed light on how programs are delivered, and can contribute to building demand for more accountable and better performing government. If beneficiaries complain of bribes, surveys can be a vehicle for a dialogue with the government on corruption. They are best carried out as part of a broader reform program, aimed at improving performance rather than specifically exposing corruption.

Legal and Judicial Reform

5.20 The legal system of a country, the laws and regulations as well as the processes and institutions through which they are applied, is vital for addressing corruption, just as it is for resolving civil conflicts, establishing property rights, and defining the limits of state power. On the substantive side, laws and regulations that delineate market-friendly policies are powerful anti-corruption tools (see Chapter 4). The Bank has long been

involved in helping design macroeconomic and sector policies, and the laws through which they are implemented, in many countries in all Regions.

5.21 *Judicial Reform.* Enforcement of anti-corruption legislation requires an efficient, predictable, and accountable judiciary. In recent years, the Bank has been building experience in judicial reform, especially in Latin America and Africa, and there is scope for similar efforts in other regions. Bank-supported judicial reform has focused on judicial independence (including proper criteria for the selection and removal of judges, pay scales, training and judicial ethics); improved court administration and case flow management; procedural reform, including reducing *ex parte* communication between judge and litigants; better access to justice (through small claims courts, alternative dispute resolution mechanisms and legal aid); and legal education and bar entrance requirements. Steps also need to be taken in many countries not only to bolster the independence and impartiality of judges, but also to counter corruption by court staff who, as gatekeepers to the adjudication system, may extract bribes.

5.22 Assessing the effectiveness of the judicial system should be part of the diagnostic framework that Bank staff apply when asked to assist a country strengthen its capacity to combat corruption. But because this is a relatively new area for the Bank, like many of the institutional topics discussed in this chapter, we still have much to learn about how to judge effectiveness and which approaches to judicial reform work best. We need to build evaluation into our activities and use the Networks to debate new approaches, draw in outside expertise, and gather lessons from experiences elsewhere.

5.23 *Prosecutorial Capacity.* Effective judicial action against fraud and corruption requires not only efficient courts and procedures, both criminal and civil, and competent judges, but also the capacity of authorities to gather evidence to secure conviction. In addition to clear, comprehensive laws against fraud and corruption, prosecutorial capacity is needed to bring cases to successful conclusion in criminal courts. Heretofore, the Bank has restricted interventions in judicial reform to issues and institutions related to civil or commercial law reform – based on the interpretation of the "productive purposes" test of the Articles of Agreement – except in situations where courts were used simultaneously for both civil and criminal cases.

5.24 While the Working Group acknowledges that criminal justice is a highly specialized field and that there are bilateral and other agencies providing assistance, the rising costs of corruption and other forms of white collar crime suggest this may be an area where support should be given by the Bank. Effective detection, investigation and prosecution is, perhaps, the most telling way in which the "high profit/low risk" perception of corruption can be reversed. It is also what the public expect to see when they are told that reform is taking place. For these reasons, the Working Group recommends that the Bank should consider whether its legal reform activities should be expanded *to include the financing of technical assistance in the area of prosecutorial capacity-building for white collar crime and associated criminal court reform.*

5.25 Such support would focus on the training of judges and prosecutors in methods of investigation and bringing successful cases. It would be limited to those with formal legal or financial training, and exclude the police. This kind of intervention would also benefit the Bank's work on improving tax administrative capacity through effective criminal sanctions. We are mindful of concerns lest the Bank become involved in supporting the criminal justice system in a general way. If the Bank were to support prosecutorial capacity building it should limit it to areas with an economic nexus, such as white collar crime, taking care to avoid such work spreading into support for the criminal justice system more generally. Here it may be noted that proceeds of fraud and corruption may be "laundered" through national and international banking systems. *The Bank's assistance to countries with improved banking regulations should strengthen the capacity to control money laundering.*

5.26 **Special Anti-Corruption Bodies.** The Working Group reviewed the experience of independent bodies, typically set up on by statute, to improve integrity in public life. In particular we looked at ombudsman offices, inspectors-general, and independent corruption commissions. Experience in developing countries with ombudsman offices, which pursue allegations of abuse of official power, is mixed. In Sub-Saharan Africa and other regions the prevailing model has been an "executive" ombudsman, reporting to the head of the government rather than to the legislature, and thus lacking the independent status a true ombudsman should have. Inspectors-general can be powerful agents for controlling fraud and corruption within departments and agencies, depending on how they are established and operate, but they can also work at cross-purposes to accountability and performance.

5.27 Corruption commissions and special fraud units have been highly successful in Hong Kong, Chile, and in the State Government of New South Wales. However, they have been used as instruments of partisan politics in a number of developing countries, and this has undermined their effectiveness and public support.³⁸ Powerful anti-corruption legislation in the wrong hands can be abused.³⁹ Independent attorneys-general charged with the prosecution function have proven very effective in bringing charges against those at the highest level of government in some countries in Latin America.⁴⁰ Had they been

³⁸ Interestingly, in a recent survey of public and private-sector participants from developing countries attending some high level training programs in the US, the creation of anti-corruption agencies was ranked low in the steps a country should take to counter corruption. (See Daniel Kaufmann, "Listening to Stakeholders' Views about Corruption in Their Countries," draft, Harvard Institute for International Development, January 1997.)

³⁹ Such legislation may provide that where a public official is in a position to amass corrupt wealth, and when he/she has been shown to be in possession of assets which are out of line with known income, the judge may, *in the absence of any satisfactory explanation*, draw the inference that these assets have been acquired corruptly. Without a strong and independent court system, a shifting of the "evidential burden" to the defence, under circumstances carefully defined by anti-corruption legislation, may instead become a reversal of the onus of proof.

⁴⁰ For instance, Brazil, Colombia and Venezuela.

part of the executive branch, they would not have had the independence necessary to act decisively against high level corruption.

5.28 Special anti-corruption bodies appear a promising option, if they can be made truly independent of the executive and if there is a strong and independent judiciary. However, we need to understand better the experience of these bodies, where they have been effective and where they have failed, before recommending them to governments.

Civil Society and the Media

5.29 Civil society and the media are critically important to creating and maintaining an atmosphere in public life that discourages fraud and corruption. *Indeed, they are arguably the two most important factors in achieving and maintaining the elimination of systemic corruption in public institutions.* Governments are not the only stakeholders in the anti-corruption landscape. Private sector organizations, professional organizations, religious leaders, and civil society groups all have a stake in the outcome and an interest in the process. For the most part, the Bank, as lender to governments, can play only a limited role in supporting civil society in the fight against corruption. However, within its mandate and with the full support of governments, the Bank has undertaken, mostly through EDI, activities such as "integrity workshops" and the training of journalists. More participatory approaches to project design and implementation also make a contribution, as do Bank efforts to help countries improve the legal framework for NGOs. And, as our understanding of what can be done grows, there may be scope for further activities involving partnerships with civil society, such as public education programs.⁴¹

5.30 **National Coalitions.** In countries where the government has sought Bank assistance in developing an anti-corruption strategy, policy makers may be interested in developing a non-partisan approach to corruption. *The "integrity workshops" that EDI has facilitated can be an effective way of assisting this process by providing a forum for the discussion of international experience and local alternatives.* This is a new and promising activity for the Bank, but it requires careful preparation and sensitive handling.⁴² It is worth emphasizing that this type of activity should be carried out only in response to a request from the national authorities.

5.31 **Open and Transparent Government.** Corruption thrives in the dark. The Working Group reviewed activities that the Bank might support to encourage open and transparent government. Publication of government budgets and their availability in easy-to-read summary form, frequent reports to the legislature on budget implementation that enable comparisons to be made between budgeted and actual revenues and expenditures, and timely preparation of public accounts and audit reports and their scrutiny by the

⁴¹ Public education is, for example, strongly emphasized in the anti-corruption strategy of Hongkong's Independent Commission Against Corruption (ICAC).

⁴² EDI normally seeks both a government and a civil society partner.

legislature and the media are the foundation of open and accountable government. Government departments and agencies should be encouraged to produce annual reports on their activities, achievements, and financial results, and, eventually, national governments should report. To the extent that performance information can be included, agency accountability should improve. In some countries "sunshine laws" (which require agencies to hold public hearings prior to making policy or program decisions) and "freedom of information" laws (which require governments to make available information surrounding decisions unless there are supervening public policy measures for secrecy) may be appropriate. Court decisions should be published. And the regular publication of consultative documents when new policy is contemplated is good practice everywhere.

External Agency Practices and Public Sector Management

5.32 Finally, the Working Group considered the effect of Bank lending on country efforts to control corruption. We concluded that Bank (and bilateral aid donor) modes of operation might work against national efforts in a number of respects, and *certain Bank practices associated with "enclaving" needed to change*. In a broader sense, it is also possible that high levels of aid to poor countries may, in ways not fully understood, slow the emergence of institutions of state accountability that otherwise might develop (as they did historically in industrialized countries) if states were more dependent on local revenue sources. This is not an argument against aid, but rather a caution about the risks of externalizing accountability where aid flows are a significant part of government revenues.

5.33 **Enclaving.** One concern we have is with the Bank's instinct to "enclave" – the safeguarding of Bank operations from the weaknesses of the borrower's public sector by insisting on an implementation environment different from the prevailing government management systems. A long acknowledged (and now less common) example is the project implementation unit (PIU), appropriate only in specified circumstances. Another example is salary supplements (or "leave of absence" contracts). Social funds, if they are used for what properly are central government functions, may weaken public management.⁴³ The reasons for enclaving are understandable, given the Bank's fiduciary responsibilities and staff desire for smoothly running projects in situations where government systems of budgeting, accounting, procurement and personnel management are weak. To some extent, they are inherent in any project-centered approach to lending.

5.34 *Bank staff need to pay more attention to the government's budgeting, accounting, auditing, procurement, and personnel management systems, and on how they affect the*

⁴³ It is appropriate to create a social fund if the activities to be performed are, in public management terms, best handled by relatively autonomous agencies with separate governance structures at arms length from the government department with portfolio responsibility. Credit to small entrepreneurs or grants to community schemes without recourse to further government funding can be administered effectively by stand-alone agencies. But where the financing of an activity (for example, building a public primary school) results in recurring departmental staffing and maintenance responsibilities, or involves policy-making, a social fund may not be an appropriate mechanism.

sustainability of Bank projects. This would focus management and staff attention more explicitly on the condition of those systems and how the Bank might give assistance to governments for their improvement. In turn, this would help governments control fraud and corruption.

5.35 ***Soft Budget Effects of Aid.*** Concerns were voiced within the Working Group that the way aid has traditionally been provided by the Bank and bilateral donors may have undermined governance in high aid inflow countries, by expanding government's reach, by discouraging a rationalization of functions and redeployment of resources, and by softening budget constraints. Donor preferences for funding projects in public investment programs (PIP), channeled through a dual budget structure, may have had a powerful expansionary effect on government spending, when coupled with increasing aid flows. Although donor projects now support the rehabilitation of existing services more than their expansion, the *de facto* fragmentation of budgets in aid dependent countries resulting from dual budgeting still discourages a full consideration of trade-offs in the allocation of resources. Furthermore, the addition of aid softens budget constraints, which should discipline policy choice.⁴⁴ When accountability is externalized, national accountability mechanisms are weakened and this may allow corruption to flourish.

5.36 One way to promote more discipline in policy making and better financial management in countries that are highly aid dependent would be *to shift a proportion of aid flows from project to program-based financing, and to conditional general budgetary support, within a Medium Term Expenditure Framework. This has long been politically difficult to achieve, given bilateral aid objectives, but the Bank should renew its efforts to build support among donors, and provide lending instruments to underpin such an approach.*

5.37 On the Bank's part, such budget support lending could be conditioned on the installation and operation of sound public management systems (with the control of corruption as one objective), just as earlier policy-based lending supported economic policy reform. The new form of lending would disburse more slowly, based on quarterly releases of budgetary spending reports, annual accounts, and audit reports.⁴⁵

⁴⁴ Faced with an offer of concessional project aid, a government in a poor country has every incentive to accept it even where it doubts the domestic budget can sustain project operating costs. Governments have been right so far in their assumption that donors will meet the shortfall, perhaps disguised in a "rehabilitation" project.

⁴⁵ The proposal differs from a PSAL (public sector adjustment loan) in that (i) it would be linked to a MTEF; (ii) disbursed over several years; and (iii) explicitly support budget process reform.

CHAPTER 6

INTERNATIONAL EFFORTS

6.1 Corruption is a global problem which requires complementary action by both industrialized and developing countries. Current efforts among OECD countries to criminalize foreign bribery and end tax deductibility in a coordinated way are strongly supported. In the international area, we believe the Bank's objectives, working in partnership with other organizations, should be:

- to support initiatives among countries to control bribery in international-business transactions; and
- to demonstrate to our borrowers that we are complementing our advice on national efforts with action on the international front.
- to ensure that the Bank's initiatives in fighting corruption are understood in international fora; and,
- to take advantage of the Bank's unique position, as the only organization with near-universal membership whose *raison d'être* is economic development of poor countries to stress the importance of international action against corruption.

Current International Initiatives

6.2 Although corruption of national officials is a criminal offense in most countries, transnational bribery generally is not. To make international corruption a crime will require changes in laws or the adoption of new laws and mechanisms to enforce them. This in turn will require the necessary parliamentary support and enforcement machinery. Except for the United States, which adopted the Foreign Corrupt Practices Act in 1977, countries have been reluctant to act unilaterally for fear of jeopardizing the business interests of their nationals by subjecting them to more stringent standards of behavior than their foreign competitors. International organizations provide a forum to agree upon common definitions and standards and to coordinate actions. Regional organizations have sponsored international conventions making bribery (including international bribery) a crime.

6.3 *The OAS Convention.* The most advanced effort so far is the OAS Inter-American Convention Against Corruption, adopted at Caracas, Venezuela on March 29, 1996. At present, 23 of 35 members of the OAS have signed the Convention. It is now in force between the first two countries that have ratified it, Bolivia and Paraguay. The

Convention is open to ratification by all OAS Member States, and any other State may accede to it.

6.4 Building on the Convention, the OAS General Assembly will be considering a comprehensive Plan Against Corruption at its meeting in Lima, Peru, June 1-5, 1997. Under the Plan of Action, the OAS would provide support to its member countries and cooperate with other international organizations, including the Bank, the Inter-American Development Bank (itself preparing a plan of action) and OECD, and with local populations in the prevention and control of corruption.

6.5 *OECD Working Group on Bribery.* The OECD initiative, begun in 1994, encourages member states to end the tax deductibility of bribes and criminalize the bribing of foreign officials. In 1996 the OECD Council adopted a Recommendation on ending tax deductibility for foreign bribery, and member states, within the framework of their laws, are now amending existing legislation in this regard. At its Ministerial-level meeting on May 26-27, 1997, the OECD Council endorsed the Revised Recommendation on Combating Bribery in International Business Transactions prepared by the OECD Working Group on Corruption. In particular, the Ministers reaffirmed their commitment to criminalize bribery of foreign public officials in an effective and coordinated manner. They recommended that member countries should submit criminalization proposals to their legislative bodies by April 1, 1998 and seek their enactment by the end of 1998. They also decided, to this end, promptly to open negotiations of a convention to be completed by the end of this year with a view to its entry into force as soon as possible within 1998. Ministers also urged the prompt implementation of the 1996 recommendation on eliminating the tax deductibility of bribes to foreign public officials.

6.7 In related work, at the May 1996 High Level Meeting, the Development Assistance Committee of the OECD recommended to members that they "introduce or require anti-corruption provisions governing bilateral aid-funded procurement."

6.8 *The European Union.* On May 21, 1997, the European Commission adopted a Communication to the Council and the European Parliament on a Union Policy Against Corruption. This Communication sets out the Commission's comprehensive policy on corruption inside the Community as well as in its relations with non-member countries. Inside the Community, the communication deals with a wide range of actions, including the ratification of conventions criminalizing the corruption of EC officials and officials of member countries, tax deductibility of bribes, public procurement, accounting and auditing, etc. In the case of non-member countries, the Commission proposes to "establish a coherent anti-corruption strategy in the area of its cooperation with third countries which benefit from EC assistance or have concluded cooperation or assistance agreements with the EC", and to establish special anti-corruption programs, particularly in the applicant countries of Eastern and Central Europe.

6.9 *The Council of Europe.* The Council of Europe Programme of Action Against Corruption, prepared by the Multidisciplinary Group on Corruption (GMC) and adopted

by the Committee of Ministers in November 1996, serves as the basis for the preparation of two conventions. The first is a Framework Convention on Corruption, which would contain broad principles, and the second is a Convention on Corruption, under which parties would agree to legislate (if necessary) to criminalize certain types of corrupt behavior. The GMC has also undertaken work on the administrative and civil law aspects of corruption.

6.10 *The United Nations.* In December 1996, the UN General Assembly adopted a Declaration against Corruption and Bribery in International Commercial Transactions, as recommended by the UN Economic and Social Council. Although not legally binding, the Declaration's wording on criminalization of foreign bribery and ending of tax deductibility signifies broad political agreement in the international community on this matter. In February 1996, the United Nations General Assembly recommended that the Economic and Social Council take steps to prevent illicit payments.

6.11 *Financial Action Task Force.* International organizations have been active in addressing money laundering and expanding the list of offenses, including corruption, that constitute money laundering. The forty Recommendations of the Financial Action Task Force on Money Laundering (FATF) include non-drug predicate offenses. They now require the criminalization of money laundering based on "serious offenses." This recognizes that it is practically impossible to distinguish between drug trafficking proceeds and their laundering and any other type of dirty money. Each jurisdiction is responsible for determining which serious crimes should be designated as money laundering predicate offenses. This opens the way for countries to include corruption as a predicate offense. Originally targeted for OECD countries, the 40 FATF recommendations are now being addressed also to middle income countries in the hope that governments adopt them and cooperate with other authorities in international efforts to control money laundering.

6.12 *International Business Initiatives.* In March 1996, the International Chamber of Commerce (ICC) issued revised Rules of Conduct to Combat Extortion and Bribery in International Business Transactions. The Rules prohibit extortion and bribery for any purpose. They also recommend implementation of the 1994 OECD recommendation on curbing bribery in international business. The Rules are not binding on ICC members, but corporations may endorse them voluntarily. To promote the new rules, the ICC will set up a standing committee of business executives, lawyers and academics. ICC national committees mobilize support for the Rules in their own countries.

6.13 *Non-Governmental Organizations.* NGOs around the world are participating in the efforts of local governments and other entities to curb corruption. Among the international NGOs, Transparency International, based in Berlin, Germany, aims to: (i) curb corruption through international and national coalitions encouraging governments to establish and implement effective laws, policies and anti-corruption programs, (ii) strengthen public support for anti-corruption programs and enhance public transparency and accountability in international business transactions and in the administration of public procurement, and (iii) encourage all parties to international

business transactions to operate at the highest levels of integrity, guided by TI's Standards of Conduct. TI has established more than 70 national chapters that fight corruption at the national level. TI has contributed significantly to making corruption a public issue in the press and elsewhere and is cooperating with international organizations (including the Bank) in actions against corruption. In June 1996, the Bank invited TI to participate in a senior management seminar on corruption.

Bank Actions at the International Level

6.14 **The Bank should increase its participation in and support for international efforts to fight corruption.** As the Bank gains a better feel for the issues being confronted and the politics involved, the Bank may identify initiatives to lend its weight to or may make proposals of its own. The Bank's support of international efforts at curbing corruption could include:

- *Using conferences, meetings and interviews with the media to explain the need to control fraud and corruption and to maintain public awareness of the Bank's contribution to this effort.* The Bank is well placed to articulate the economic costs of corruption to developing countries.⁴⁶ We also need to demonstrate to opinion-makers in the North that the Bank places high priority on international actions to control corruption.
- *Increasing collaboration with the IMF,* recognizing the complementary role of the Bank and the Fund with each institution focusing on areas of its expertise.⁴⁷
- *Cooperation with other MDBs in this area.* These institutions have been briefed on the Bank's approach to corruption, and we have begun exchanging information in number of areas. We should also work closely with bilateral aid donors, as appropriate.
- *Contributing to the work of the OECD Working Group on Bribery* by ensuring that the Bank's technical expertise is at its disposal.⁴⁸

⁴⁶ As an example, the Bank will be participating at a high level in the Eighth International Anti-Corruption Conference in Peru on September 8-12, 1997. Teleconferencing should be used to broaden the reach of major anti-corruption conferences, and existing teleconferences by other organizations should be supported upon request (as the Bank is doing with USAID's Western Hemisphere teleconferences on anti-corruption).

⁴⁷ The Fund's Board has recently approved a paper on guidance to staff in governance issues, with particular reference to corruption. Traditional areas of Fund assistance, such as macroeconomic policy, Treasury and expenditure management systems, tax, and statistics, complement Bank efforts to improve the management of public resources, and reduce corruption.

⁴⁸ The Bank has already attended four meetings of the Working Group on Corruption, in July and November 1996 and February and April 1997, contributing its experience to technical discussions on

- *Contributing to the work of the Council of Europe's Multidisciplinary Group on Corruption (GMC) in which the Bank has observer status.*⁴⁹
- *Developing and maintaining contacts with other agencies active in this area, such as the UN Drug Control Program, the UN Center for Crime Prevention and Control, the Commonwealth Secretariat, and professional bodies such as the International Commission of Jurists, the International Organization of Supreme Audit Institutions (INTOSAI), the International Bar Association (IBA) and the International Federation of Accountants (IFAC), and the Financial Action Task Force (FATF), which coordinates international efforts against money laundering.*
- *Consulting with the business community to understand better their perspectives on corruption and the feasibility of measures to control bribery in international business transactions.*

procurement, accounting and auditing standards, and on public service issues in developing countries. Following the adoption of Recommendations by OECD Ministers in May 1997 to proceed with an international convention on criminalization of foreign bribery, the Working Group on Bribery will be engaged in monitoring implementation of the Recommendations and drafting a treaty.

⁴⁹ The Council of Europe has invited the Bank to attend its meetings as an observer and to brief members on anti-corruption activities. Bank staff attended the most recent meetings of the GMC in Strasbourg, January and March 1997.

CHAPTER 7

IMPLEMENTATION

7.1 This final chapter suggests how the Bank should move forward to bring a greater concern for corruption into the mainstream of Bank work. Five key thoughts should guide these efforts.

7.2 First, a Corruption Action Plan is best thought of not as a set of new initiatives, but rather the more explicit integration of the problem (of which staff and management have long been aware) in country strategy formulation, Bank lending, ESW, research, and country dialogue. Therefore, the Report's recommendations are primarily about modifying and/or expanding existing approaches rather than launching radically new approaches.

7.3 Second, if the Bank is to help its member countries, it has some catching up to do of its own. It will have to learn what works and what does not in the fight against corruption. Notwithstanding mostly successful efforts over many years to control corruption within the projects it finances and a distinguished record of policy advice, the Bank is at an early stage in building up the knowledge it requires to help countries develop and implement anti-corruption strategies. This Report provides a framework, not a blueprint. This framework must now be filled in, with research, policy work, project design, country studies, open dialogue with governments, learning from country experience, participation in international efforts, and interaction with other bodies active in this field. In gathering this information and disseminating it, the new "knowledge management" systems of the Bank will be crucial. NB

7.4 Third, while corruption has clear economic costs, corruption is also a dimension of the way power is exercised, and thus a sensitive issue of governance in many countries. Although many governments are more receptive to discussing the control of corruption than they were several years ago, the subject remains one that requires careful handling. Consequently, we are not making a blanket recommendation for "regional action plans." While this solution may be appropriate for some regions, it is by no means the choice for all. Such a decision should be left to regional managers. Corruption is no longer an embargoed subject, and the responsibility rests with country and regional managers to use that freedom in ways that support the borrower's development objectives.⁵⁰

7.5 Fourth, institutions are central in the fight against corruption. Getting economic policy right, maintaining financial management systems, and practicing sound procurement

⁵⁰ There will, however, be reporting objectives for the Strategic Compact, and regional management will be expected to move ahead strengthening skills in areas such as financial management and procurement.

across the public sector depends on well-functioning institutions. Seen in this way, corruption is a symptom as much as a cause of malaise. The Bank needs to deepen its existing understanding of how institutions evolve, and what external agencies can do to help countries develop strong institutions. It needs to put more emphasis on high-quality public sector management and governance work. This has implications for staff skills and the resources the Bank devotes to this area.

7.6 Fifth, the Bank should not think of itself working alone in this area. If progress is to be made by countries combating the costs of corruption, it will come about only through national efforts which external agents like the Bank can support with policy advice and financial resources. And in providing this support, the Bank needs to develop partnerships with other agencies and non-governmental organizations that are active in this area.

Economic Work

7.7 *Increasing Transparency.* The first requirement in mainstreaming a concern for corruption is for the Bank to bring the issue "out of the closet." To a significant extent, this is already happening. Discussion of corruption has been intensifying within the Bank in recent years, and the President's Annual Meetings Speech in 1996 has accelerated it. But corruption needs to be addressed more systematically in Bank analytical work. Until this happens the phenomenon will not be sufficiently understood nor integrated into management decisions. And the Bank is to some extent playing "catch-up," acknowledging that corruption poses a threat to development but doing so in the wake of media attention and international recognition of a major problem.⁵¹

7.8 *Economic and Sector Work (ESW).* Nor will we be able to provide governments with sound policy advice if we do not make the required intellectual investment. Economic and Sector Work (ESW) has not dealt much with the topic of corruption, referring to it elliptically with phrases like "rent seeking," "leakage," and "misappropriation." Staff reluctance to address the topic directly is easily comprehended in the light of perceived political sensitivity, the lack of hard evidence, the complexity of the subject, and, hitherto, lukewarm encouragement from management. Few, if any, Poverty Assessments (PAs) discuss the impact of petty corruption, even though the poor in many countries experience extortion by public officials daily. Public Expenditure Reviews (PERs), with their focus on the allocation of government spending, rarely confront the issue – even though corruption may mean that inputs are used to produce "outputs" and result in "outcomes" quite different to those represented in budgets approved by the legislature. Most country economic memoranda (CEMs), sector studies, and environmental assessments also choose to ignore the issue. The only category of

⁵¹ The most outstanding example of how open governments have become in acknowledging the problem and their preparedness to discuss it is the communiqué of the Summit of the Americas in Miami in 1995.

ESW that has a solid track record of surveying corruption issues regularly are Private Sector Assessments (PSAs). In select countries EDI's Service Delivery Surveys, which ask beneficiaries about the quality of government services, also yield information on corruption.

7.9 As discussion and analysis of corruption becomes more explicit in ESW, in staff dialogue with country counterparts, and in project design, a body of best-practice knowledge will gradually be built. It will be important to capture this and disseminate it through the Knowledge Networks and in staff training. *A "Knowledge Centre" on anti-corruption should be created in the Poverty Reduction and Economic Management Network (PREM), which in turn should draw on the knowledge and insights of other networks, given the multifaceted character of corruption. Guidance should be provided to staff by PREM (with the assistance of the Legal Department) on the treatment of corruption issues in ESW, in the design of projects, and how to help countries design anti-corruption strategies.*

7.10 **Research.** Research outside the World Bank on corruption has grown considerably. There is now a substantial body of academic literature. Much of this is theoretical, but it has begun to shed light on the complexities of corruption and how it affects economic performance. There is also a growing body of work on how corruption might be controlled. Little of this work is empirical, but this is beginning to change as survey data accumulates (and will be given a boost by the 1997 WDR survey of over 3,600 firms in 69 countries). Inside the World Bank there is little explicit research under way on corruption. However, research in several areas, such as property rights and aid effectiveness, touches on the issue.

7.11 *The Working Group believes there is a need for the Bank to put more resources into research on corruption.* Our principal concern has been whether there will be adequate funding. In recent years, funding for research has declined. This trend needs to be reversed if the Bank is to build the intellectual capital it needs to become a "Knowledge Bank. DEC/PREM should develop a research program on corruption, and the Research Committee, on its part, should be open to well-thought-out research proposals on corruption. As this research yields insights, we will reflect the results in policy advice to countries, and in what we say in international fora on the costs of corruption.

Country Assistance Strategies

7.12 We also carried out a review of current Country Assistance Strategy (CAS) papers. This showed that corruption is seldom fully addressed either as a factor affecting Bank projects or as a development effectiveness issue. The reasons are similar to ESW – the complexity of the subject, the lack of direct evidence, borrower sensitivity and uncertainty by managers on how to tackle the issue. In addition staff are unclear how to deal with systemic corruption if its presence is determined. For all these reasons, Bank

staff feel professionally more at ease assessing a government's economic policy record than whether its programs are affected by corruption.

7.13 But failure to address corruption in countries where it undermines the country's development prospects and the effectiveness of Bank activities diminishes the value of the CAS as a mechanism both for programming Bank lending and ESW and for raising important matters with the government. This needs to be rectified, and future CASs should be the appropriate place to discuss any sectors impact of corruption on a country's development prospects and how the Bank could help mitigate the problem.

Lending and Portfolio Management

7.14 The Bank needs to take corruption into account more explicitly in decisions on country operations. In the past the Bank has been criticized for continuing to lend to countries where corruption was pervasive and a clear obstacle to development. However, it would be unrealistic and at cross-purposes with the thrust of this Report to move from a position where little notice of corruption was taken to one in which the level of corruption determined the size of the lending program. While this might satisfy some critics of the Bank, it would be at odds with the Bank's interest in addressing corruption not in moral terms but as a constraint to development. From this perspective, corruption, like inadequate skills, is something standing in the way of a well-performing public sector and the achievement of a country's development of goals.

7.15 Within the broad framework described in Chapter 3, country operations may need to be adjusted according to the extent to which corruption affects both Bank projects and development objectives generally, and the efforts of government to control it. This can be done without changing existing IDA and IBRD allocation criteria, which are based on country and portfolio performance. In some cases, corruption may be a country risk factor that will require special attention.

7.16 This Report has argued that projects need to be prepared in a way that integrates institutional considerations and assesses corruption risks more explicitly at the design stage. The professionalism of Bank staff means that many have been doing this already, but experience has not been widely shared, and institutional learning has thus been low.

7.17 The control of corruption can be supported through portfolio management. The increased emphasis by staff on looking at the Bank's portfolio on a country-wide basis and regularly discussing portfolio implementation issues with borrower governments provides an opportunity for raising corruption issues – if significant – and agreeing on actions to address the problem.

7.18 In his 1996 Annual Meetings Speech, Mr. Wolfensohn pledged the Bank's support for countries that seek assistance in the control of corruption. In at least three regions (ECA, Africa, and LAC), countries have made approaches to the Bank. Whatever these

initial country cooperation programs are called (the term "pilot" may have the wrong connotation), it is important that the experience is shared within the Bank and lessons are learned and disseminated. It will also be desirable to share lessons learned with other MDBs, consistent with the current policy of exchanging information on this issue.

Lending Instruments

7.19 The Bank should be prepared to use a wide range of lending instruments to support countries that are seeking to control corruption. The Institutional Development Fund (IDF) has been extensively used to finance innovative public management activities and we expect this to extend into anti-corruption work. TA loans, often accompanying SALs and SECALs, have been a mainstay of Bank efforts to help countries implement public management reforms.

7.20 SALs and SECALs can continue to be used to support economic policy reform. However, new lending approaches – for example, slow-disbursing fiscal support lending – might also be considered to help the Bank more effectively support the broad institutional changes needed to improve public sector performance. Within a clearly articulated medium term framework, such loans could support the restructuring of government policies and programs consistent with a changed role of the state, and foster transparency and accountability in financial management and in the conduct of public business generally.⁵²

Procurement and Disbursement Under Bank-Financed Projects

7.21 Two important initiatives are moving forward within the framework of Bank-financed projects. These are aimed at improving borrower accountability and thus complement the broader country measures described in this report. First, there are proposals being developed for a progressive shift of emphasis from pre- to post audits for most small-value contracts, to be carried out by local consultants. Second, the Loan Administration Change Initiatives (LACI) will make the Bank's own disbursement process more transparent and cost effective. By moving from a transaction-based disbursement system to lump-sum disbursements, based on a sound financial plan for the project and quarterly financial reports submitted by borrowers, borrower accountability should be strengthened. This will build the capacity to control corruption if it is reinforced, where required, with institutional reforms.

⁵² This idea has much in common with the proposal, now being discussed in the Bank, to develop a Public Expenditure Adjustment Loan, but ties it expressly to a MTEF, to support a hard budget constraint. The emphasis of policy conditionality would be shifted to the processes of a transparent and well-functioning budgeting and financial management system. Such a loan would provide resources fungible across all sectors in support of sound budgeting, and would counter the fragmentation of budgets that, *de facto*, has occurred in heavily aided countries and undermined government financial management systems, which are a vital against corruption.

7.22 As to specific measures that borrowers might adopt, the Working Group looked at two current proposals for controlling bribery in government procurement: first, "white-listing" or certification; second, "no bribery pledges" either in their basic form or in the context of a broader "integrity pact."

7.23 Through its national committees, the International Chamber of Commerce (ICC) (see para 6.12), is promoting corporate codes of conduct, which include anti-bribery clauses. Voluntarily adopted by firms, codes have the potential to reduce bribery, particularly if they become commonplace for major firms in a country. Presently, codes found are mainly in industrialized countries, most notably the US. The Bank has already expressed support for their adoption.⁵³ The Working Group looked further at whether they might be mandated in Bank procurement, but concluded this would be premature, resulting in either restricted competition or the spread of token codes.

7.24 We also looked at the proposal for "no bribery pledges" ⁵⁴ as a condition of bidding and execution in government procurement, either as a stand-alone requirement or as part of a broader "integrity pact." The emphasis the latter places on accompanying institutional reforms is strongly endorsed (and mirrors many of the areas stressed in Chapter 5). The Working Group is conscious of the argument that conditioning bidding on the submission of a pledge to obey the country's laws against bribery risks token compliance or reduced competition. On balance, however, we believe that if a country is strongly committed to reducing corruption in government procurement, has evolved a broad program of anti-corruption reforms, including amending government procurement regulations, where necessary, the Bank should be prepared to incorporate such an undertaking in the bid form for Bank financed projects.

International Efforts

⁵³ Mr. Wolfensohn, in his 1996 Annual Meetings speech, endorsed the adoption of voluntary codes by firms.

⁵⁴ In its simplest form a NBP would be a statement by the CEO of a bidding company (typically but not exclusively for international bidding) that the company would not pay bribes in obtaining or executing the contract, matched by a similar declaration by the head of government on the conduct of public officials. More elaborate versions (such as that proposed by TI) provide for the submission of codes of conduct and compliance procedures, lists of agents' payments, and a certification at the end of the contract that no bribes have been paid. The "Integrity Pact," of which the NBP would form a part, in effect would be an anti-corruption alliance between government, firms and civil society, involving institutional reforms (e.g., addressing civil service pay, improving financial management, and strengthening procurement processes) as well as a watchdog role for NGOs in monitoring public procurement.

7.25 The Bank should continue participation as an observer in fora like the OECD Working Group on Bribery, the Council of Europe, and the FATF, making its specialist knowledge available as necessary. This will primarily be the responsibility of central departments such as PREM, Legal, OPR and PSD.

7.26 Once this Report has been discussed by senior management and the Board, and agreement reached on Bank policy, it will be necessary to explain the Bank's approach to a wider audience, beginning with the MDBs and bilateral donor agencies. PREM should be responsible for organizing this follow-up.

Monitoring and Dissemination

7.27 Anti-corruption work undertaken by the Bank should be carefully monitored. A progress report on governance is due to the Board in FY99. This could contain a substantive section on the control of corruption. In addition, specific implementation indicators should be developed as part of the monitoring of the Strategic Compact. And where it has an impact on project outcomes, it should be explicitly addressed in the Bank's evaluation reports.

7.28 The CAPWG Report is an internal report to senior management by a group of Bank staff. Based on the feedback and guidance from Executive Directors, the recommendations in this report could be incorporated into various aspects of the Bank's work. To reach the Bank's external audience an abridged version of the report should be prepared for publication. It should explain why the Bank believes corruption undermines development, what countries can do, and how the Bank will support efforts to control corruption. It will also re-iterate the Bank's determination to keep the projects it finances free from corruption, and its support for international efforts to control corruption.

Training

7.29 A theme of this report is that addressing corruption is not an additional set of activities but an underlying factor in the Bank's assessment of development prospects, and it should be integrated into Bank work. Thus, the training proposals for mainstreaming the control of corruption are about adapting existing training courses as well as launching new ones. We propose the following:

- (i) Current training programs oriented to a particular sector should progressively include material showing how projects may be designed in ways to minimize scope for corruption. Case studies will need to be developed over time, building on regional experience and using the network anchors to assemble the material.
- (ii) Public sector management training programs should be modified to include a module on anti-corruption, to sensitize staff and to show how corruption can be addressed within a PSM and governance framework.

- (iii) Workshops on the analysis of corruption and the development of anti-corruption strategies should be organized, aimed initially at Bank staff working on countries that have approached the Bank for assistance in combating corruption.⁵⁵ Diagnostic frameworks need to be developed and provided to staff. How to deal with this sensitive subject should be included in staff media training.

Staffing Implications

7.30 If the mainstreaming recommended in this report is accepted, the bulk of the responsibility for implementation will fall upon existing staff. Thus the additional manpower required to implement the recommendations are limited, and many needs can be accommodated through staff training.

7.31 However, in three areas staffing levels are inadequate and need to be improved.

- (i) The number of skilled financial management specialists in central VPs and the regions has declined in recent years, a trend the Financial Reporting and Auditing Task Force Report in 1994 drew attention to. Existing specialists are already overloaded, and new staff are needed to enable the Bank to assess borrower financial management systems and to provide assistance to countries seeking to improve them.
- (ii) The Bank also needs more procurement specialists. In theory, some relief may be obtained by shifting the emphasis from prior review to post-audits (as recommended in the Working Group's companion report on internal controls). But these, too, require budget funds to hire local external auditors. Furthermore, if the Bank is to help more governments improve their own procurement systems, there will be additional staff costs.
- (iii) Public sector reform expertise needs strengthening. Building better institutions helps control corruption. This means calls on the existing cadre of public management specialists and institutional and public finance economists are likely to grow, and an increase in their numbers will be necessary. This is particularly true for the central VPs, if lessons of experience and best practices are to be duly collected and disseminated through the Knowledge Networks.

Costs of Mainstreaming a Concern for Corruption

7.32 Implementing this Report will require additional resources which the Working Group has not costed in detail. However, the Group has identified the principal areas where costs will fall:

⁵⁵ A pilot workshop took place in the beginning of February 1997, coordinated jointly by the PSM Unit and the LLC. This has been evaluated for lessons that can be included in future training events.

- (i) **Control of Corruption in Bank Financed Projects.** The bulk of added costs will be for strengthening procurement and financial management in Bank projects. There is a need to increase the number of procurement staff and fund external auditors to systematically carry out post-audit work on both procurement and disbursement. While the increase in resources should be used primarily for procurement and financial management in Bank projects, the additional staff and consultants will be used partly to strengthen government capacity more generally.
- (ii) **Economic and Sector Policy Reform.** There should be some limited additional costs to the regions in providing advice on economic and sector policy reform to the government. These added costs will come partly from incorporating a greater focus on the impact of corruption in ESW. There will, also be additional costs for Regions engaged in specific assistance to anti-corruption strategies. Another area where more resources will be required is research on corruption, and its impact on development.
- (iii) **Institutional Strengthening.** A concern for corruption means a greater emphasis on the performance of public sector institutions. Over time this will require a strengthening of public sector management and institutional economics expertise in the regions and in PREM. We also anticipate an increased demand for short-term consulting support, above that provided for by regular PSM work, when the Bank has been requested by governments to assist in the preparation of anti-corruption strategies. This will have to be absorbed by existing department budgets or financed through trust funds. EDI is also expected to expand its "integrity workshops" and related work.
- (iv) **International Efforts.** Costs are likely to be moderate – the travel and subsistence expenses of Bank staff attending international meetings and perhaps the sponsorship of selected conferences.

Personal Security and Risks

7.33 Finally, the Report ends with a warning on personal risks to Bank staff, consultants, and counterparts working with them. Previous initiatives of the Bank - on poverty, participation, the environment, or private sector development - have not resulted in Bank staff and consultants being directly threatened by those engaged in criminal activities. Anti-corruption work is different. Not only is the bribing of public officials illegal in all borrower countries, but in many countries there are close links between systemic corruption and organized crime. The risk to the personal security of Bank staff and consultants and those working with them cannot be lightly dismissed. Close inspection of substandard construction, the persistent checking of project accounts that have been subject to large scale fraud, pressure on governments to abandon white elephant projects in which politically powerful figures have a financial stake, or work on the banking system in countries experiencing large scale money laundering can be hazardous

activities for Bank staff and local counterparts. Managers need to be sensitive to these risks. They must avoid placing staff in potentially dangerous situations and be prepared to support them, if necessary by withdrawal, in the face of threats. Staff need to be aware of possible danger and to know that managers will support them.

Annex A

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ANNEX B

IFC's Approach to Combating Fraud and Corruption in Project Finance

As the world's largest source of financing for private sector projects in developing countries, IFC is deeply concerned about the potential for corruption in projects that it finances. In congruence with the World Bank's perspective, IFC must act to fight corruption in order to retain the confidence of its shareholders and the financial markets on which it relies. Moreover, the avoidance of corruption is necessary to ensure that IFC's investments are successful, that its resources are being used effectively, and that its developmental objectives are met.

IFC's strategy to combat corruption in its operations is concentrated in the following two areas identified in the Bank's strategy:

- Control of Corruption in Projects
- Institution Strengthening

IFC's specific efforts to combat corruption will complement those of the Bank to the extent that IFC's activities are distinctly focused on the private sector.

Control of Fraud and Corruption in Projects. IFC acts to control fraud and corruption in projects in which it invests by employing appropriate methods and procedures at every stage of the investment process.

IFC's investment staff will conduct a due diligence review of the individuals involved and their primary businesses. On-site visits will be made to both project and non-project installations to obtain a first-hand impression of the sponsor/operator and its affiliated companies. IFC will generally not invest in a project without knowing the identity of its partners, or if IFC believes that a sponsor/operator may be controlled by an undisclosed third party or believes that the project may be sponsored, directly or indirectly, by individuals holding public office.

Before making an investment, IFC staff perform an investment appraisal, in which IFC must be persuaded that the interests of the sponsor/operator in undertaking the project are compatible with those of the other investors. The appraisal must establish to IFC's satisfaction that the contractual undertakings made to structure the project (e.g., supply, distribution and off-take agreements) do not unfairly benefit some of the parties to the transaction at the expense of others. Each party's share of the investment's rewards must be known by IFC and judged to be commensurate with the risks taken and the contributions made by the party. This analysis is a necessary step to

IFC's first line of defense against corrupt costing is its extensive experience and familiarity with industry best practices, technologies and capital costs in a broad range of industrial sectors. IFC's project team of investment officers, engineers and lawyers – which sometimes includes outside specialist consultants – will be familiar with best practices, time to completion and current world prices of capital goods in the major industries. They can therefore identify significant price anomalies and distortions that may mask corrupt practices. IFC will not finance a project where material deviations from fair pricing cannot be explained by specific, acceptable circumstances.

IFC will not invest in a project where a lack of transparency in the awarding of a concession or a contract makes it impossible to determine that business is being conducted on an arm's length basis between a government and a project company. Also, at an early stage in the process of evaluating a proposed project – the Initial Project Summary – IFC's management will review the structure of the project and examine the relationships between the parties. If a project is found wanting in any of these areas, management will direct staff to agree on improvements with the various parties to the transaction.

After making its investments, IFC supervises them closely and on a regular basis. IFC consults periodically with the management of investee companies, sends field missions to visit the enterprises, and requires quarterly progress reports during project implementation. In some projects, a full-time, on-site lender's representative may be required during the project's construction phase. IFC requires, in its capacity as lender, that investee companies provide it with quarterly and annual financial statements (the latter audited) and insurance reports, and give it direct access to the company's external auditors for the purpose of reviewing the company's accounts, operations and the management letter.

IFC's direct presence and relationships in developing countries also aid in supervision by alerting IFC to problems that may indicate the occurrence of a corrupt practice in an IFC-financed project. Staff of IFC's resident and regional missions assist in this process by maintaining direct contacts with various governmental agencies, NGOs, and other parties in local financial business communities. Outside counsel employed by IFC to assist in preparing legal documentation and negotiating terms and conditions for an IFC investment may also transmit information to IFC that they are uniquely positioned to obtain because of their contacts in the local legal and business communities.

Institution Strengthening. The strengthening of institutions in developing countries sometimes occurs as a secondary effect of IFC's efforts to control fraud and corruption in projects. However, IFC also engages in activities whose primary purpose is to build and strengthen institutions – and these activities have the effect of operating to combat corruption. In this regard, IFC advises its member governments on how to

create new institutions and to strengthen existing institutions, so that disclosure and transparency in the conduct of financial transactions will be improved and administrative discretion conducive to corruption will be eliminated. IFC's Capital Markets Department plays an important role in this area, e.g., providing advisory services for the establishment of stock exchanges and securities commissions in IFC's member countries.

IFC also acts to combat corruption in its operation (with the World Bank) of the Foreign Investment Advisory Service (FIAS). FIAS works at the request of IFC's member governments, helping them to build effective institutional frameworks for investment promotion strategies, and to interact with potential foreign investors. FIAS helps governments to accomplish their own objectives with respect to foreign direct investment. Its advisory services seek to stimulate inflows of foreign direct investment by creating a more favorable investment climate in the member country. FIAS' advice typically focuses on the reform of laws, policies and procedures needed to increase those inflows.

MIGA's Approach to Combating Fraud and Corruption in Guarantees

With a mandate to encourage the flows of foreign direct investment (FDI) to developing member countries and transition economies, MIGA has a natural interest in the issue of corruption as an inhibitor of FDI flows. While there may not be hard and fast evidence on the role corruption plays in deterring FDI, anecdotal evidence suggests that it is an important factor. Companies are often concerned not only about the initial payments to be made to make a deal but also about their inability to predict the scope and extent of future possible payments. Moreover, as noted elsewhere in the report, companies from some countries, e.g., the United States, are prohibited from engaging in payment of bribes or offering other extraordinary incentives in order to make a deal. Thus, they are at a disadvantage in doing business in countries in which corruption is endemic.

MIGA's focus on the issue of corruption comes both through its guarantees activity and through its technical assistance programs. In terms of guarantees, MIGA would be entitled to cancel a contract with an investor should MIGA learn that the investor is not complying with the legislation of the host country. Moreover, MIGA would not be legally obliged to pay compensation on a claim against its insurance if it could be shown that the investor had not complied with the laws of the country receiving the FDI.

As part of its technical assistance to member countries on attracting FDI, MIGA's technical assistance arm, Investment Marketing Services (IMS), includes the issue of corruption in its training sessions on how to attract and retain foreign investment. The topic is treated under the heading of investor decision making, stressing the need for transparency and clearly identifying the payment of bribes as an important issue that needs to be addressed.

OFFICE MEMORANDUM

Received 5/27
cc: JA

①

DATE: May 23, 1997

TO: Executive Management Group

FROM: Caio K. Koch-Weser, MDOMD *CKW*

EXTENSION: 35250

SUBJECT: **Report of the Corruption Action Plan Working Group: The View from Operations**

The above report was reviewed by the Operational Policy Committee (OPC) on May 9, 1997. (The minutes are attached.) The OPC generally endorsed the proposed approach, especially the upgrading of attention to corruption issues in Bank operational work and research, and the proposed reliance on international partnerships.

The OPC discussion emphasized the following points:

- The Bank would address corruption in its country programs where
 - i) the government requested Bank assistance; and/or
 - ii) corruption had a substantial negative impact on country development prospects and/or Bank-financed activities in the country.
- Where appropriate, the Bank should address corruption issues in the CAS, lending and non-lending services, and portfolio management.
- The risks of addressing corruption issues in Bank programs need to be carefully managed--including clear and hands-on guidance and legal advice to staff.
- The role of establishing indicators of corruption and monitoring them should be left to other groups, such as Transparency International, with a clearer mandate for dealing with corruption *per se*, rather than its broader developmental implications.

Subject to the outcome of the Executive Management Group and Board discussions, Operations plans to implement the proposed approach in its country programs along the above lines, relying on the PREM Network for monitoring and knowledge management of new developments.

Attachment

Distribution:

Messrs./Mmes. Wolfensohn, Baird, Berry, Conrad, Einhorn, Frank, Iida, Kaji,
Lindbaek, Malloch Brown, McArthur, Sandström, Shihata, Stiglitz,
Strong, Wood, Zhang

cc: Mmes./Messrs. Anstey, Assaad, Boehmer, Montoliu, Salop, Shilling

Operational Policy Committee

Minutes of the Meeting of May 9, 1997

Report of the Corruption Action Plan Working Group

1. The Chairman opened the meeting by noting that the Report had been much improved since its last version and commended the authors. He thanked the Members for the useful comments circulated prior to the meeting and suggested that the discussion concentrate on the priorities for the Bank: What are the areas where corruption does the most harm to development objectives? And what actions will have the most impact on mitigating that harm, particularly those over which the Bank has some influence? What are the 'big ticket' items to focus on? In addition, the Committee should concentrate on the recommendations contained in Chapter 7, in particular identifying the new actions to be taken and the cost implications.
2. The authors noted that the Report is focused on defining the scope of corruption, its implications for development, and how it might be mitigated. It is not yet an action plan, so it is not able to answer all the questions posed by the Chairman. The intention is to have a discussion with the Board at this stage and get more feedback before drafting an action plan. Volume I concerning corruption-related issues in Member-countries has been circulated. There is a second volume concerning issues relevant to the Bank Group's processes which will be presented separately to Management. However, in general, the Report, beyond the diagnostics, addresses IBRD/IDA responses and not the Bank Group. IFC was represented on the Working Group.
3. Members emphasized that the best way to position the Bank would be as a partner working with governments wanting to reduce corruption rather than as an external arbiter of the degree of corruption on some absolute scale. The Bank's basis for addressing the issue is its impact on development. The evidence of corruption's harmful effects was viewed as mixed and not sufficient to justify universal conclusions. Much depended on the country and circumstances. In many countries, there were unambiguously detrimental effects, but not everywhere. Private sector aspects of corruption deserved attention as well as public sector aspects. The Bank clearly had a responsibility to raise the issue -- the moral high ground -- and to be sure that its own operations were rigorously monitored to avoid corruption. Beyond that, it is less clear how far

the recommendations should go.

4. Some Members suggested that Bank efforts to reduce regulations that created incentives for corruption were reasonable, and the Bank has clear comparative advantage in these areas. More research is both feasible and justified. Most were uncomfortable with Bank actions that would be interpreted as political, which is also beyond the Bank's mandate, and there was little support for any direct association of lending levels with indicators of corruption. To the extent that corruption had negative effects, they would show up in the usual indicators that helped determine lending volumes. The Bank's responses in this area should also be very sensitive to the political and legal issues that would attend any direct relationship to lending.

5. The authors suggested that the various speakers supported the propositions that the Bank should make sure its own operations were free of corruption and that the Bank should raise the general issue of corruption and its costs publicly. There was more cautious support for the Bank to do more general analysis and research on corruption and to assist countries try to reduce corruption where it is their priority and where the Bank can provide appropriate assistance. But there was little support for setting out explicit or implicit corruption measures or linking the extent of Bank activity in a country directly to measures of corruption.

6. The Chairman noted that the CAS would be the appropriate place to make an assessment of the impact of corruption on a country's development prospects, if they were substantial (e.g. it retards private investment or leads to serious misallocation) and to suggest how the Bank could help mitigate the problem. He noted that in some countries, the Bank had already taken a strong stand when the impacts of corruption were severe. However, the phrasing in several places, and particularly para. 3.10, needs to be revised to reflect the sensitivities expressed by the Committee to be less judgmental and sweeping and to be more specific on the relation of the Bank's objectives regarding development and the success of its program in assisting the government promote development. Several Members suggested that the tone of the quotation from the General Counsel in para. 3.3 is more appropriate.

7. The Chairman then directed the discussion to the recommendations in Chapter 7. While the recommendations on more attention to corruption in ESW and Research are welcome, there needs to be more guidance to staff on how to carry out the work as well as on the priorities

among the aspects of corruption to be addressed. Staff will need guidance on how much can be stated in various documents that may go public, what are appropriate vehicles for carrying the messages, and how the issue should be framed, as this is a very charged topic. The CASs should be selective in which countries and sectors this becomes an issue, bearing in mind that it is a document on the Bank's assistance strategy to the country.

8. Members agreed it is important that staff handle the subject sensitively and not over-react, especially in the links to operations. Even selectively raising the issue may be interpreted as a judgment on corruption itself rather than on impacts. The basis of the evaluation needed to be clear. Some felt that it would be better for senior management to handle severe cases discreetly rather than bringing the issue into mainstream documents, but most felt some treatment, carefully handled, in CASs and ESW, is justified. It was emphasized that any public statements would have to be judiciously phrased because of potential legal liability as well as political sensitivity.

9. The authors responded that it is important for the Bank to get beyond the current self censorship and point analysis in the right direction. Much of the guidance of what to address, how far to go, and how best to present the concerns would have to depend on guidance from Regional management. The PREM Network can also define some parameters for this work.

10. The Chairman noted that the recommendations on links to the lending program should be revised to reflect the earlier discussion in terms of impacts of corruption on achieving development objectives. He asked what are the implications of the proposed pilot program, whether the focus on lending is broad enough, and if the proposed new instrument is needed.

11. Members commented that the objectives could readily be achieved with existing lending instruments if the projects were well designed. In fact, it would be valuable to have some guidelines on what sort of things the Bank could finance in projects addressing corruption. Suggestions to finance improvements in criminal justice systems would get the Bank on a slippery slope of supporting police activities. And the question of financing civil service severance pay directly had not been supported when last addressed at the OPC. In addition to suggestions about lending, there should be greater emphasis to portfolio management and supervision, both to reduce the possibility of corrupt acts in Bank projects and, as important, to build the capacity of borrowing governments to control corruption in all their projects. The proposal to shift to more

post audits in procurement was questioned as potentially leading to more opportunities for corruption and to disputes with the Bank over procurement issues. There are a number of issues that involve Bank policies and which need further discussion.

12. The authors responded that these ideas were being presented as options to be explored. At this stage, the paper is to provoke discussion and not make definitive proposals. It is important for the Bank to do more than just assure its projects are clean. It should also build borrower capacity and accountability to discourage corruption more broadly. This would also reduce the burden on the Bank to monitor procurement so closely.

13. The Chairman turned to the recommendations on monitoring, dissemination and training. Members suggested caution in trying to monitor and report on corruption, beyond the concerns expressed about ESW. It isn't clear what instruments the Bank should or could use. There were questions about the kinds of partnerships that were envisaged, as there was little reflected in the recommendations. It was also suggested that training include support on how to deal with the media, or not deal with the media. Both monitoring and reporting on corruption are best left to groups, such as Transparency International. Some suggested more attention be paid to the role of agents from OECD countries in contributing to, or mitigating corruption. The Committee urged that additional formal assessments not be proposed. There are enough burdens on staff. CASs should be encouraged to selectively identify where there is a problem. The costs should be estimated realistically. Members asked what is the formal status of the Report. Is it a Working Group report or a Management proposal? There is considerable outside interest in the paper, and something will have to be made public before the Annual Meetings. Prior to that, the Report should be discussed by the EMG and Board.

14. The authors stated they would be sure that the cost estimates would be consistent with the Strategic Compact and business plans.

15. The Chairman concluded that the Committee endorsed the thrust of the Report, but further revisions are necessary. i) The tone should be moderated and the Report carefully edited to reflect the discussion of the Committee, particularly with regard to the justification of Bank involvement in trying to mitigate corruption, in determining the Bank's reaction to situations where corruption is an issue, and in the linkages to the operations program. ii) The Report should

be clearer on the forms of corruption that have the most serious impacts on development and the priorities for Bank interventions where it has a comparative advantage. iii) The role of partnerships should be developed more fully, including the implications for the Bank. iv) The Report should provide more guidance on what analysis of corruption should be included in ESW, how staff should handle the issue, and how the analysis should be used. v) The proposal to do more research is accepted and DEC/PREM should develop a work program in this area. vi) The Report should clarify the role of CASs in selectively identifying situations where corruption is an issue to be addressed by the Bank. Additional assessments on a general basis should not be proposed. vii) The cost estimates should be updated. The Report will be sent soon to EMG for discussion and decision as to how to present the issue to the Board. The revisions should be completed in a week's time.

Attendance: Mr. Koch-Weser (Chairman); Members/Acting: Messrs./Mme. Ahmed, Kanaan, Nishimizu, Serageldin, Shihata, Stiglitz, van der Garg, Wood; Shilling (Secretary). Others: Messrs./Mmes. Adamolekun, Armitage, Forget, Guerrero, Nellis, Porter, Salop, Stevens, Williams; Calderon and Glantz (IFC).

To: Caio K. Koch-Weser
Gautam S. Kaji
Masood Ahmed
David De Ferranti
Kemal Dervis
Callisto E. Madavo
Mieko Nishimizu
Jean-Francois Rischard
M. Ismail Serageldin
Ibrahim F. I. Shihata
Joseph Stiglitz
Brian V. Wilson
D. Joseph Wood

Mark Malloch Brown

05/19/97 06:35 PM

To: Jane Armitage/Person/World Bank, Geoffrey B. Lamb/Person/World Bank, Judith A. Maguire/Person/World Bank
cc:
Subject: MINUTES OF OPC MEETING 5/9/97

Please see the attached for your information.....

----- Forwarded by Mark Malloch Brown/Person/World Bank on 05/19/97 06:36 PM -----

Wesilat Olaitan Alli

05/19/97 05:32 PM

To: Caio K. Koch-Weser/Person/World Bank, Gautam S. Kaji/Person/World Bank, Masood Ahmed/Person/World Bank, David De Ferranti/Person/World Bank, Kemal Dervis/Person/World Bank, Callisto E. Madavo/Person/World Bank, Mieko Nishimizu/Person/World Bank, Jean-Francois Rischard/Person/World Bank, M. Ismail Serageldin/Person/World Bank, Ibrahim F. I. Shihata/Person/World Bank, Joseph Stiglitz/Person/World Bank, Brian V. Wilson/Person/World Bank, D. Joseph Wood/Person/World Bank
cc: John D. Shilling/Person/World Bank, Myrna L. Alexander/Person/World Bank, Akira Iida/Person/World Bank, Jannik Lindbaek, Shengman Zhang/Person/World Bank, Shahid Javed Burki/Person/World Bank, Johannes F. Linn/Person/World Bank, Jean-Louis Sarbib/Person/World Bank, Jean-Michel Severino/Person/World Bank, Jessica P. Einhorn/Person/World Bank, Richard H. Frank/Person/World Bank, Sven Sandstrom/Person/World Bank, Mark Malloch Brown/Person/World Bank, Hiroo Fukui/Person/World Bank, Andres Rigo Sureda/Person/World Bank, Mark Baird/Person/World Bank, Anandarup Ray/Person/World Bank, Lyn Squire/Person/World Bank, John Wilton/Person/World Bank, Ishrat Husain/Person/World Bank, Paula Donovan/Person/World Bank, Robert Picciotto/Person/World Bank, Hans-Martin Boehmer/Person/World Bank, Michael A. Cohen/Person/World Bank, Catherine C. Kleynhoff/Person/World Bank, Suellen L. Lazarus/Person/World Bank, Bernard C. Pasquier/Person/World Bank, Ian C. Porter/Person/World Bank, Enrique Rueda-Sabater/Person/World Bank, Alexander Shakow/Person/World Bank, Joanne Salop/Person/World Bank, Gerald Thomas West/Person/World Bank, Michael L. O. Stevens/Person/World Bank, Cheryl W. Gray/Person/World Bank, Adil J. Kanaan/Person/World Bank, Jacques Van Der Gaag/Person/World Bank, Oladipupo O. Adamolekun/Person/World Bank, Jane Armitage/Person/World Bank, Louis Forget/Person/World Bank, John R. Nellis/Person/World Bank, Myla Taylor Williams/Person/World Bank, Peter Calderon, Robin L. Glantz/Person/World Bank
Subject: MINUTES OF OPC MEETING 5/9/97

Attached are the minutes of the Operational Policy Committee meeting held on Friday, May 9, 1997. The Report of the Corruption Action Plan Working Group was discussed. The minutes have been cleared by Mr. Koch-Weser.

Operational Policy Committee

Minutes of the Meeting of May 9, 1997

Report of the Corruption Action Plan Working Group

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Attendance: Mr. Koch-Weser (Chairman); Members/Acting: Messrs./Mme. Ahmed, Kanaan, Nishimizu, Serageldin, Shihata, Stiglitz, van der Garg, Wood; Shilling (Secretary). Others: Messrs./Mmes. Adamolekun, Armitage, Forget, Guerrero, Nellis, Porter, Salop, Stevens, Williams; Calderon and Glantz (IFC).

The World Bank

SVEN SANDSTRÖM
Managing Director

May 8, 1997

5/12 Received

H.E. Mr. Philippe Maystadt
Vice-Premier Ministre
Ministre des Finances et du Commerce Extérieur
Rue de la Loi, 12
1000 Bruxelles
Belgique

cc. JK
KM
PS

Re: Galand report

Dear Minister Maystadt:

Thank you for your letter of April 7. In your letter, you suggested that the Bank examine a recent report in which allegations are made that the Bank and other multilateral institutions failed to monitor the proper implementation of their loans in Rwanda during the 1990-94 period, and that materials financed by those loans were used in the April 1994 genocide in Rwanda. The report recommends that on this basis, Rwanda should receive exceptional relief, including debt cancellation. The report was authored by Mr. Pierre Galand and Mr. Michel Chossudovsky. Mr. Galand provided Messrs. Madavo and Sarbib a copy of the preliminary version in early March, following a meeting he had with them in February.

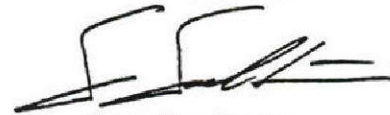
We have reviewed the preliminary report. Our conclusion, on the basis of the documentation available to us, is that disbursements and supervision of the structural adjustment credit were consistent with our policies and procedures. We have spoken with Mr. Galand about our conclusions, and sent him a letter that provides him with our analysis. For your information, I am attaching a copy of the letter sent to Mr. Galand by Mr. Madavo.

Mr. Galand has noted that the preliminary report does not contain all of the information that forms the basis for the recommendations. We have asked him to provide us with the full information so that our assessment can take into account all of the facts of the situation.

The Bank has been deeply concerned about events in Rwanda, and the tragic escalation of violence and genocide in 1993-94. We are now working actively to assist the country in developing policies and programs, including urgently needed support, that can help in rebuilding the nation and in bridging the deep divisions among its people. We believe that it is vital that these efforts continue in order to develop a new and better future for Rwanda's people.

Please let me know if you would like additional information on this matter.

Sincerely yours,

A handwritten signature in black ink, consisting of several stylized, overlapping loops and horizontal strokes.

Sven Sandström

Attachment: Letter from Mr. Madavo to Mr. Galand

cc: Messrs/Mmes. Bourhane (EDS13); Kaji (EXC); Madavo, Sarbib (RVP); Malloch-Brown, Stevens, Martin (EXT); Rigo, Ofosu-Amaah (LEG); Muis, Sengamalay (LOA); Tcheyan (AFR)

NTcheyan/MPiette
rwanda/maystadt.doc

CALLISTO E. MADAVO
Vice President
Africa Region

April 23, 1997

Mr. Pierre Galand
European Forum for North-South Solidarity
115 Stevin Street
1000 Brussels
Belgium

Dear Mr. Galand:

*L'usage de la dette extérieure du Rwanda (1990-1994):
La responsabilité des bailleurs de fonds, analyse et recommandations*

I am writing to follow up on our discussion of February and the draft report which you provided to us in early March regarding your analysis of IDA financing of the Structural Adjustment Program in Rwanda during the 1990-94 period. Like you, we are deeply concerned about events in Rwanda, and the tragic escalation of violence and genocide in 1993-94. Hopefully, enough can be learned from this tragedy so that it will never be repeated in Rwanda or elsewhere. The Bank remains engaged in efforts to support the country in improving the quality of life of its people, and believes it is vital that these efforts continue.

I have reviewed the main issues raised in your report regarding IDA financing under the Structural Adjustment Program. Our documentation confirms that Bank disbursements and supervision of the structural adjustment credit was consistent with our policies and procedures. IDA's decision to proceed with the financing of the Structural Adjustment Credit (SAC) was undertaken on the basis of our judgment, supported by the international community, that the political process underway in Rwanda would establish the minimum conditions to enable economic reforms to enhance economic growth and poverty reduction.

Under the SAC, financial resources are made available to a country in the framework of an agreed policy program. The aim is to support the country to achieve sustainable economic growth and social development. As you have pointed out, the Bank was, along with other international partners, concerned about the increase in military expenditures in 1990 and 1991. Between November 1991 and February 1992, we carried out a Public Expenditure Review with a focus of ensuring that development activities be adequately financed by the budget. The review agreed on minimum thresholds for expenditures in key social sectors, as well as the expansion of "safety net" expenditures in

the budget for 1992. Moreover, IDA, other donors and Government also agreed that local resources generated from counterpart funds (derived from commodity aid and food aid programs) would be used for the safety net and the public investment program expenditures. Bank financing under the SAC was therefore provided in a context of substantial agreements on the use of resources for the 1992 budget.

In the course of the program, and with the deterioration that became apparent in the course of 1993, IDA continued its efforts to help enable effective economic reforms to continue. However, we continued to withhold release of the second tranche in light of the deterioration in performance in policy issues. In late 1993, following preliminary contacts with the Rwanda Patriotic Front (RPF), the Bank hosted the visit of a joint delegation to Washington for discussions. During these discussions--which we understood to be the first time the two parties discussed economic matters--the Bank sought to facilitate economic policies that could continue to promote social and economic development as the Arusha Accord was implemented.

I would also like to review our findings regarding the specific use of IDA funds. Our records indicate that imports of machetes totaled only US\$149 thousand of the total US\$55 million disbursed. These were imported as agricultural tools, which are, as you know, used by peasants throughout Africa. The negative list excludes, as you have noted, military goods or goods used for military purposes. Agricultural tools do not fit that category. In addition, the audit of 1991-92 expenditures under the SAC identified ineligible expenditures in the amount of US\$21.7 thousand and US\$370.3 thousand for expenditures claimed twice. These amounts were reimbursed to the Bank in February 1993. The ineligible items were for wine, and the amounts claimed twice were for powdered milk.

With respect to overall levels of imports of specific goods, IDA monitors only overall imports of any category of goods which are financed under our credit or cofinancing agreements. We would, therefore, have had no basis upon which to determine whether imports of machetes or any other item was excessive.

On the basis of our review, I believe that IDA did meet its obligation to supervise the use of resources it provided under the SAC. In your report, you refer to documentation that substantiates the allegations made about the specific uses of IDA financing in Rwanda for ineligible items or for military use. This would suggest that the documentation presented to us, which is the basis for our disbursement and audit, does not correctly reflect the transactions made. This is of serious concern to us. If this is the case, I would greatly appreciate that this information be made available to us for a determination as to whether the amounts disbursed have been used consistent with the provision of our agreements with Rwanda.

We are now working actively to assist Rwanda in developing economic and social policies which we all hope will enable the people of the country to prosper, and to permit peace and security to return to the region. To this end, we have worked closely with the

April 23, 1997

Government in providing urgently needed support to resume economic activity. We have restructured our operations in the country to focus on community level activities, restoration of basic transport and water infrastructure and education and health services. Again, we believe it is vital that these efforts continue in order to develop a new and better future for Rwanda's people.

In closing, I would like to thank you for sharing your findings with us. I hope that the information I have provided here clarifies the issues you have raised. In view of their direct interest in this matter, I am taking the opportunity to advise the Government of our findings through separate correspondence.

Sincerely,

A handwritten signature in dark ink, appearing to read 'Callisto Madavo', with a stylized, cursive script.

Callisto Madavo
Vice President
Africa Region



Le Vice-Premier Ministre
Ministre des Finances
et du Commerce Extérieur

1000 Bruxelles, le 7.4.97
Rue de la Loi, 12
Tél.: (02) 233 81 11
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Mr SANDSTRÖM
Managing Director
Corporate planning & Resource Management
The World Bank
WASHINGTON, D.C. 20433

Ref.: BD/m/0401-bd.02/97401

Dear Mr. Sandström,

It was a pleasure to meet you during my stay in Washington two weeks ago and to discuss with you the prospects for an expeditious implementation of the HIPC-debt initiative. I was encouraged by the Bank's view on this issue.

You will remember that I also informed you on a report on Rwanda's external debt which was recently brought to my attention and of which I am attaching a preliminary version.

The authors of this report argue that the official lending which Rwanda received in 1990-94, especially from the World Bank, enabled the government to increase drastically military expenditures and thereby created the conditions for the genocide of 1994. The authors claim that the staff of the World Bank and other multilateral institutions have seriously failed to monitor the proper implementation of their loans. They conclude that the Rwandese people cannot be held responsible for the debts corresponding to these past failures, but should instead benefit from exceptional relief, including debt cancellation.

The case is, in my view, serious enough to warrant a comprehensive examination and response by the Bank.

I look forward to your reaction and to see you again at the end of this month at the Development Committee meeting.

Yours sincerely,

Philippe MAYSTADT

To: Caio K. Koch-Weser/Person/World Bank, Gautam S. Kaji/Person/World Bank, Masood Ahmed/Person/World Bank, David De Ferranti/Person/World Bank, Kemal Dervis/Person/World Bank, Callisto E. Madavo/Person/World Bank, Mieko Nishimizu/Person/World Bank, Jean-Francois Rischard/Person/World Bank, M. Ismail Serageldin/Person/World Bank, Ibrahim F. I. Shihata/Person/World Bank, Joseph Stiglitz/Person/World Bank, Brian V. Wilson/Person/World Bank, D. Joseph Wood/Person/World Bank

cc: John D. Shilling/Person/World Bank, Myrna L. Alexander/Person/World Bank, Akira Iida/Person/World Bank, Jannik Lindbaek, Shengman Zhang/Person/World Bank, Shahid Javed Burki/Person/World Bank, Johannes F. Linn/Person/World Bank, Jean-Louis Sarbib/Person/World Bank, Jean-Michel Severino/Person/World Bank, Jessica P. Einhorn/Person/World Bank, Richard H. Frank/Person/World Bank, Sven Sandstrom/Person/World Bank, Mark Malloch Brown/Person/World Bank, Hiroo Fukui/Person/World Bank, Andres Rigo Sureda/Person/World Bank, Mark Baird/Person/World Bank, Anandarup Ray/Person/World Bank, Lyn Squire/Person/World Bank, John Wilton/Person/World Bank, Ishrat Husain/Person/World Bank, Paula Donovan/Person/World Bank, Robert Picciotto/Person/World Bank, Hans-Martin Boehmer/Person/World Bank, Michael A. Cohen/Person/World Bank, Catherine C. Kleynhoff/Person/World Bank, Suellen L. Lazarus/Person/World Bank, Bernard C. Pasquier/Person/World Bank, Ian C. Porter/Person/World Bank, Enrique Rueda-Sabater/Person/World Bank, Alexander Shakow/Person/World Bank, Joanne Salop/Person/World Bank, Gerald Thomas West/Person/World Bank, Michael L. O. Stevens/Person/World Bank, Cheryl W. Gray/Person/World Bank

Subject: AGENDA AND ISSUES NOTE FOR THE OPC MEETING ON 5/9/97

Please find attached the agenda and issues note for the OPC meeting on Friday, May 9, 1997 at 2:30 p.m. in Room D10-100. The meeting will be chaired by Mr. Koch-Weser.

Agenda

I. Paper for Discussion/Decision:

Report of the Corruption Action Plan Working Group

II. Other Business

WIA - FYI
96

Operational Policy Committee

Issues Note for the Meeting on May 9, 1997

Corruption Action Plan

1. The only item on the agenda is a discussion of the *Report of the Corruption Action Plan Working Group* which was circulated on May 2. Additional copies can be obtained from the office of Michael Stevens (ext. 37493).

Report of the Corruption Action Plan Working Group

2. *Background:* The issue of corruption has received increased attention lately and was raised at the 1996 Annual Meetings by the President in his speech. A Working Group has been formed to prepare an action plan for the Bank. This Report of that Working Group lays out the major issues concerning corruption, its negative impacts on development, and the range of actions the Bank could take to reduce corruption. This will be a long-term effort and little can be done without the cooperation of the Bank's member countries. The Report has been extensively reviewed within the Bank and this draft incorporates a wide range of comments. It has been shortened from earlier versions. The parts dealing with Bank projects and internal controls have been put into a separate report which will be discussed with Management. This paper is intended for the Board. Some resources were earmarked in the Strategic Compact for the anti-corruption initiative.

3. *Key Issues:* The Report proposes a broad definition of corruption as *abuse of public office for private gain* and describes the various forms it can take, including various kinds of bribery and theft. Corruption can occur at both political and bureaucratic levels and can be isolated or systemic. The theoretical arguments and empirical studies available argue that corruption is generally detrimental to sustainable development, harmful to the poor, and corrosive to effective government. Even in cases where it is argued that corruption may have beneficial effects, they tend to be short-term and related to offsetting other distortions in the system. Informal interviews of Bank staff indicate widespread and increasing perception of corruption. (This is not a 'scientific' survey and the Committee should consider whether that section should be deleted before sending the Report to the Board.)

4. The Bank has a number of instruments to address corruption and doing so is within the Bank's mandate for supporting development. The key elements of an anti-corruption program would include Economic and Sector Strategy Reform and Institutional Strengthening directly focused on reducing the incentives and conditions that are conducive to corruption. The Report also proposes greater Bank involvement in international efforts to reduce corruption. These thrusts could be supplemented by reductions in the Bank's lending in countries where corruption is rampant and the government unwilling to curb it.

5. Implementation is critical. Redirecting ESW and enhancing attention to corruption in

operations would not require much in the way of additional resources, but would require a substantial shift in emphasis in country dialogue, ESW programming, and project design. This would have to be reflected in greater attention to the issue in CASSs. Some adaptation of lending instruments would be required. A selective approach of country emphasis initially is recommended. Increasing research and developing a "knowledge center" on corruption would require more resources, as would additional training and increased participation in international activities. Staffing in financial management, procurement, and public sector reform would have to be strengthened.

6. The basic message of the Report is that the Bank should to move away from its traditional "enclave" approach of protecting its own projects from corruption through special project implementation units, special procurement rules, etc. and take on the issue of corruption in member countries in a more systemic way. It would have to address the more fundamental causes of corruption through its ESW and lending and would have, in some cases, to condition the level and type of lending to a country's own stance on corruption.

7. *Issues for Discussion and Decision:* The Report reviews the state of evidence and Bank experience. Does it make a strong enough case that corruption is harmful to development and merits strong action by the Bank? Does the three-pillar approach of using Economic and Sector Strategy Reform, Institutional Strengthening, and International Cooperation provide a strong enough response? Are the instruments available adequate? Will the proposed program for implementation and monitoring be effective enough to have an impact? What can be monitored through the CASSs or other means to determine whether there is progress? If the Committee is satisfied that the case is made, does the Report offer a feasible and strong enough action plan? Members should consider what will be required in Operations to make the proposed plan work, how it fits with other initiatives, and the added demand it will make on resources. Some indication should be given of how this should be placed in relation to all the other priorities in the Strategic Compact and the kind of support it will receive from management.

OFFICE MEMORANDUM

DATE: May 2, 1997

TO: Distribution

FROM: Mike Stevens, PGP

EXTENSION: 37493

SUBJECT: **Report of the Corruption Action Plan Working Group**

*Memorandum Draft report
is with me
June to review
GL.*

Enclosed is a copy of the Report of the Corruption Action Plan Working Group: "Country and International Strategies," for consideration by the OPC on Friday, May 9.

Distribution: Messrs./Mme. C. K. Koch-Weser, G.S. Kaji, M. Ahmed, D. De Ferranti, K. Dervis, C. Madavo, M. Nishimizu, J.-F. Rischard, M.I. Serageldin, I. Shihata, J. Stiglitz, B.V. Wilson, D.J. Wood, S. Zhang, S.J. Burki, J.F. Linn, J.-M. Severino, S. Sandström.

cc: Messrs./Mmes.: M.L. Alexander, M. Baird, H.-M. Boehmer, M.A. Cohen, P. Donovan, J.P. Einhorn, R.H. Frank, H. Fukui, I. Husain, A. Iida, S.L. Lazarus, C.C. Kleynhoff, J. Lindbaek, **M. Malloch-Brown**, B.C. Pasquier, R. Picciotto, I.C. Porter, A. Ray, E. Rueda-Sabater, J.-L. Sarbib, A. Shakow, J. Salop, J.D. Shilling, L. Squire, A.R. Sureda, G.T. West, J. Wilton.

Attachment

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Report of the
Corruption Action Plan Working Group
Country and International Strategies

OPC Review Draft

May 1997

05/2/97

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CHAPTER 1

INTRODUCTION AND KEY MESSAGES

1.1 Worldwide attention to the issue of corruption has intensified in recent years. In his Annual Meetings speech in October 1996, the President of the World Bank, Mr. James D. Wolfensohn, offered the Bank Group's assistance to member governments to implement national programs to discourage corrupt practices and pledged support for international efforts. His remarks received worldwide attention.

1.2 The establishment of the Corruption Action Plan Working Group (CAPWG) in 1996 is the latest in a series of recent moves by the Bank to address governance and corruption.¹ The CAPWG's mandate includes the following: (1) to develop a strategic framework for the Bank's work on corruption; (2) to identify actions that the Bank might take to assist countries to implement national measures; (3) to determine how the Bank should contribute to international efforts to control corruption; (4) to identify actions that the Bank should take to strengthen the control of fraud and corruption within Bank-financed projects and to ensure their compatibility with country efforts; and (5) to look at internal controls and the use of the Bank's own administrative budget resources. The first three tasks are covered in this Report. (The Bank's project-related and internal controls are covered in a separate document.) While the Report is quite specific in some areas, the overriding objective has been to develop a framework within which Bank staff and management can address the issue.

1.3 The key messages of this Report can be summarized as follows:

(i) *Corruption is a global problem (Chapter 2).* It exists in all countries to varying degrees. It is systemic in most of the countries that borrow from the Bank and in some industrialized countries. And corruption has significant transnational dimensions.

¹ The Bank has long been concerned with controlling fraud and corruption in its own projects. In 1995, a report by the Controller highlighted the need to review controls against fraud and corruption in Bank loans and to strengthen borrower accountability. The Bank's procurement and disbursement procedures have been progressively refined to minimize the risks for both lender and borrower. Corruption as an issue of development was highlighted in the Bank's two governance reports, "Governance and Development" in 1992 and "Governance: The World Bank's Experience" in 1994, and in several Bank reports on Africa. In some countries, the Bank has registered its concern about corruption in high level meetings with government leaders -- for example, when governments have persisted with unviable and costly public investment projects. The Bank has curtailed lending, sometimes drastically, where systemic corruption and other manifestations of poor governance has affected Bank projects.

(ii) *Corruption retards economic growth and perpetuates poverty (Chapter 2).* A growing body of empirical evidence supports what Bank staff have long sensed -- that the social and economic costs of corruption are high and fall disproportionately on the poor. Corruption also burdens the private sector, harms the environment, and undermines the credibility of government and the effectiveness of public policy.

(iii) *The Bank can and should address the problem of corruption (Chapter 3).* The Bank's charter permits it to address corruption as a development issue. The Bank has been reluctant to confront the issue openly in the past, however, because of its political sensitivity and the lack of demand for assistance from borrowers. Today, a window of opportunity has opened to address corruption in a more comprehensive way. Bank staff, other donors, and many individuals in borrowing countries strongly support such efforts. Indeed, it is imperative that the Bank and other donors confront the issue more directly, because perceptions of widespread corruption are increasingly undermining political support for aid around the world.

(iv) *Tackling corruption is neither easy nor quick (Chapter 3).* The causes of corruption are complex and deep-seated, and the means to control it are not fully understood. Corruption is as much a symptom as a cause of underdevelopment. Corruption thrives when economic policies are poorly designed, education levels are low, civil society is underdeveloped, and the accountability of public institutions is weak -- conditions that exist in many settings but are particularly prevalent in developing countries. It has an important political dimension and to a large extent reflects the way power is exercised in a society. Like others working in this area, Bank staff must address the issue with humility, realizing that we all have as much to learn as to offer. Many "easy" solutions turn out to have serious limitations and unintended consequences. Nevertheless, the Bank's central role in the development community makes it well-placed to help its borrowers tackle the problem, as well as to join in international efforts to reduce the offering of bribes by multinational firms.

(v) *Despite the complexity and difficulty of the issue, there are some things the Bank can do to make inroads into the problem:*

(a) *The Bank can raise the profile of this issue in its dialog with borrowers and in consideration of the lending program (Chapter 3).* The existence of systemic corruption is not a reason to withdraw Bank support. Even where corruption is widespread, the Bank should instead seek ways to help governments and civil society address the problem. But if Bank projects and the country's development objectives are affected, and the government is unwilling to act, the Bank should reconsider the level of support to that country.

(b) *The Bank can pay more attention to corruption in designing and assessing programs of economic reform (Chapter 4).* Although most of the Bank's economic policy recommendations clearly reduce opportunities for

corruption, there are some areas -- including tax policy, expenditure controls, privatization of natural monopolies, and environmental regulation -- where closer attention is needed to the capacity of governments to implement policy reform. If such capacity is lacking, policy change may inadvertently increase rather than decrease the extent of corruption. The answer is not to forego reform, but to consider institutional capacity in tandem with policy design and help create it.

(c) *The Bank can put additional emphasis on strengthening public sector management (Chapter 5).* Although many of the Bank's existing activities help to build public institutions, a greater focus on this goal is warranted. Well-performing public sectors are characterized by a professional civil service, strong financial management, accountable organizations, and a capacity for effective policy making. Fighting corruption also means strengthening the rule of law through clear legislation, effective enforcement capacity, alert statutory watchdog bodies, an independent judiciary, and an engaged civil society.

(d) *The Bank can participate more actively in international efforts to deal with corruption (Chapter 6).* The Bank should take an active role in multilateral efforts to control corruption and reduce transnational bribery. One example is the current initiative, led by the OECD, to explore ways in which member governments can criminalize transnational bribery in a coordinated way.

(vi) *To take a more active role in this area, the Bank needs (Chapter 7):*

(a) *to address corruption and its economic impacts more explicitly in the CAS, in ESW, in the design of projects, and in research.* But at the same time the Bank must tailor its efforts to the circumstances of individual countries. The needs and receptivity to outside assistance differ among countries, and we must be sensitive to these differences. Furthermore, given the difficulties of uncovering corrupt behavior and measuring its intensity, we cannot expect to be able to establish numerical thresholds and monitor anticorruption initiatives as we monitor other development objectives. The difficulty of monitoring is not a reason, however, to disregard the objective altogether.

(b) *to continue to build working relationships with partners, both in borrowing countries (including local NGOs and the private sector) and outside them (including other donors, NGOs, and international organizations);*

(c) *to fill critical skill gaps -- particularly in financial management, procurement, and public sector management.*

(d) *to address critical knowledge gaps*, by dedicating more resources to learning how successful countries have reduced corruption, to disseminating such knowledge, and to applying such learning actively in its own work.

(e) *to ensure that its own projects and internal operations set an example of best practice, while taking into account their impact on borrowing countries*. Bank projects must not be seen in isolation, because its lending activities affect public management and governance in borrowing countries, particularly those with high aid inflows. In procurement and disbursement, for example, the Bank should move away from a strict enclave approach and place more emphasis on borrower accountability.

(f) *to consider the introduction of a new lending instrument to support sustained improvements in public sector management*. This could be a medium-term slow-disbursing loan for general budget support, conditioned on regularly monitored improvements in public sector management. To assist the reform of key agencies, *direct financing of severance pay for civil service reform* should also be considered.

(g) *to be alert to the inherent security risks that Bank staff and their counterparts may face*. The Bank must respond quickly if staff are threatened.

CHAPTER 2

CORRUPTION AND ECONOMIC DEVELOPMENT

How Do We Define Corruption?

2.1 Corruption covers a broad range of human actions. To understand its impact on an economy or a political system, it helps to unbundle the term by identifying specific types of activities or transactions that might fall within it. The Working Group sought a usable definition of corruption and a taxonomy of the different forms corruption could take consistent with that definition. We settled on a straightforward definition – the *abuse of public office for private gain*. This is both simple and sufficiently embracing to cover most aspects of corruption that the Bank encounters, and it is a definition widely found in the literature. Bribery can occur entirely in the private sector, but bribery in the public sector, offered or extracted, is the central concern of the Bank.² Public office is abused for private gain either when a private actor offers a bribe to somebody in an official position or when an official accepts, solicits or extorts a payment. Public office may be abused for personal benefit even if no bribery occurs, by patronage and nepotism, the theft of state assets, or the diversion of state revenues.

2.2 **Bribery.** Bribes can be used by private parties to “buy” many things provided by the public sector:

- *Government Contracts.* Bribes can influence the government’s choice of firms to supply goods and services, and the exact terms of those supply contracts. Firms may offer bribes to win a contract or have sub-standard work accepted. Officials may demand bribes as a condition of contract award, or of work certification and the processing of payment requests.
- *Government Benefits.* Bribes can influence the allocation of government benefits, whether monetary benefits (such as subsidies to enterprises or individuals or access to pensions or unemployment insurance) or in-kind benefits (such as access to certain schools, medical care, or stakes in enterprises being privatized). Firms may bribe to keep subsidies flowing, and officials may demand bribes for services they are obligated to provide.
- *Lower Taxes.* Bribes can be used to reduce the amount of taxes or other fees collected by government from private parties. Such bribes may be proposed by the tax collector or the taxpayer.

² Bank activities can also promote the control of bribery within the private sector by helping countries strengthen the legal framework to support a market economy and by encouraging the growth of professional bodies, setting standards in areas like accounting and auditing.

- *Time.* Bribes may be offered to speed up the government's granting of permission to carry out legal activities, such as company registration or the granting of construction permits. Bribes may be extorted by the threat of inaction.
- *Legal Outcomes.* Bribes can change the outcome of the legal process as it applies to private parties, by inducing the government either to ignore illegal activities (such as drug dealing or pollution) or to favor one party over another in court cases or other legal proceedings.

2.3 Not only are the government benefits purchased by bribes quite varied in type, but they can also be different in size. Contracts and other benefits can be enormous ("grand corruption") or very small ("petty corruption"), and reinterpretation of laws can be dramatic or only minor in their impact. Grand corruption is often associated with international business transactions. Petty corruption may be pervasive throughout the public sector.

2.4 *Theft.* *Theft of state assets* by those in official positions charged with stewardship is also corruption. An extreme form is the large scale "spontaneous privatization" of state assets by enterprise managers and other officials in some transition countries. At the other end of the scale is petty theft of items such as office equipment and stationery, vehicles and fuel. The perpetrators are usually middle and lower level officials, compensating, in some cases, for inadequate public service salaries. Typically, asset control systems are weak or non-existent, as are the institutions to detect and punish the wrongdoers.

2.5 *Theft of government financial resources* is another form of corruption. Officials may pocket tax revenues or fees (often with the collusion of the payer, in effect, combining theft with bribery), steal cash from treasuries, extend advances to themselves that are never repaid, or draw pay for fictitious "ghost workers." In such cases financial control systems have typically broken down or are neglected by managers. Theft of state assets and revenues may take place with or without the payment of bribes, with differing consequences (Chapter 3).

2.6 *Political versus Bureaucratic Corruption.* Corruption within government can take place at both the political and the bureaucratic levels. The first may be independent of the second, or there may be collusion. At one level, controlling political corruption involves election laws, campaign finance regulation, and conflict of interest rules for parliamentarians. These types of laws and regulations lie beyond the mandate and expertise of the Bank, though the Bank can be a conduit for dissemination and discussion of best practice and its discussion in these areas.⁴ At another level, corruption may be

⁴ Participants in EDI's "integrity workshops" may discuss such matters, as part of the "integrity infrastructure" required to control corruption. "Integrity infrastructure" is a term coined by Transparency International to describe the full range of values, processes and organizations within and outside the public sector that contribute to accountable, transparent and honest government. See TI's "National Integrity Source Book," published in 1996 and used by EDI in anti-corruption workshops.

intrinsic to the way power is exercised and cannot be changed through law making alone. In the extreme case, state organs may be infiltrated by criminal elements.

2.7 *Isolated versus Systemic Corruption.* Not only is there great diversity in the types and sizes of corruption, but the extent of corruption in a society can be rare or widespread. If it is rare, consisting of a few individual acts, it is straightforward (though seldom easy) to detect and punish. In such cases non-corrupt behavior is the norm, and institutions in both the public and private sectors support integrity in public life. In contrast, corruption is "systemic" (pervasive or entrenched) where bribery, large or small scale, is routine in dealings between the public sector and firms or individuals. Where systemic corruption exists, formal and informal rules are at odds with one another; bribery may be illegal but is understood by everyone to be routine in transactions with government. And there may be different degrees of coordination between those taking bribes, ranging from uncontrolled extortion by multiple officials to highly organized bribe collection and distribution systems. While the Working Group found no countries lacking anti-bribery laws, there are many where bribery characterizes the "rules of the game" in private/public interactions. Systemic corruption may occur uniformly across the public sector, or it may be confined to particular agencies -- such as customs or tax authorities or public works or other ministries, or particular levels of government.⁵

What are the Effects of Corruption on Development?

2.8 While it would be simple to take a moral view that all corruption is bad, the Bank must base its policies on evidence and analysis. The political sensitivity surrounding issues of governance underscores the need for such a foundation. We therefore examined the views and evidence concerning the effects of corruption on development, compiled both within the Bank and by outside researchers.

2.9 When surveying existing evidence or planning new projects, research, or economic and sector work, it is important to keep in mind that corruption is an exceedingly difficult phenomenon to uncover and measure, because the perpetrators have a strong incentive to hide it from the public eye. Even if it were clearly visible, corruption is correlated with many other attributes of weak governance, and isolating its impact on development can be tricky. This is not a reason to avoid the subject altogether, but we need to appreciate the limits to exact measurement and monitoring as future research and anticorruption initiatives are planned.

2.10 *Economic research.* The body of research that addresses the economic impact of corruption has grown significantly in recent years. The research is both macroeconomic

⁵ Once it is widespread, or "systemic", the likelihood of detection and punishment falls in any individual case. As the expected "cost" of corruption falls for the public official, the incidence rises still further. This pattern of initially rising but then falling "cost" can lead to multiple equilibria. One equilibrium is a society relatively free from corruption; the other is one where corruption is widespread and systemic. Moving from the latter to the former may be much harder than merely reducing corruption at the margin within either one.

and microeconomic, theoretical and empirical. The outcomes depend in part on what the researcher views as the "bottom line." (i) short-term economic efficiency in private markets, (ii) longer-run dynamic efficiency and economic growth, (iii) equity and fairness, or (iv) political legitimacy.

2.11 One strand of literature⁶ looks at the links between investment and/or economic growth and the quality of government institutions. It finds that weak public institutions, as evidenced by unreliable contract enforcement, corruption, and other indicators, significantly reduce private sector investment and lead to slower growth. While very useful in highlighting the broad economic impacts of institutional deficiency, the literature is unable to separate the impact of corruption *per se* from other dimensions of government quality.

2.12 A second strand of literature explores, primarily from a theoretical perspective, the likely economic impact of particular forms of corruption.⁷ While it is possible to define conditions in which corruption may not harm, and theoretically could improve, efficiency, the impact of corruption tends to be far more negative when longer-term effects are taken into account. First, the argument is made that corruption may not distort the short-run efficiency of an economy if it entails merely a transfer of economic "rents" from a private party to a government official. Examples include the awarding of a government concession to the highest bidder (where the "bid" includes both the contract price and the bribe price) or the use of "grease" payments to speed up legal approvals. In both cases, bribes can be viewed as a substitute for civil service salaries, a kind of performance pay that motivates civil servants to do their jobs more efficiently. A major problem with this line of reasoning is that it fails to take into account any objectives other than short-term efficiency. In the longer run, expectations of bribery may distort the number and types of contracts put up for bid, the method used to award contracts, or the speed or efficiency with which public officials do their work in the absence of bribes. In addition, the gains from such bribery may be inequitably distributed (accessible only to certain firms and public officials), widespread bribery will undermine the public's trust in government, and prevent the emergence of a well-performing bureaucracy, capable of implementing policy in the public interest.

2.13 Second, bribes can theoretically increase economic efficiency if they allow firms to avoid overly-restrictive regulations or confiscatory tax rates. For example, some countries make it illegal to import second-hand equipment, believing this restriction will spur

⁶ S. Borner, A. Brunetti, and B. Weder, Political Credibility and Economic Development, New York: St. Martin's Press, 1994; P. Mauro, "Corruption and Growth," Quarterly Journal of Economics, August 1995; P. Keefer and S. Knack, "Why Don't Poor Countries Catch Up? A Cross-national Test of an Institutional Explanation," IRIS Working Paper, University of Maryland; survey for World Development Report 1997.

⁷ S. Rose-Ackerman provides an excellent overview of this literature in "When is Corruption Harmful", a background paper for the 1997 World Development Report, August 1996. Also see P. Bardhan, "The Economics of Corruption in Less Developed Countries: A Review of Issues," Center for International and Development Economics Research Working Paper C76-064, February 1996.

technological change. But if second-hand equipment is perfectly adequate for the job and is less expensive than new equipment, it may make economic sense to pay a bribe to evade the law. This is a "second-best" solution. The country would be better off getting rid of the restrictive law altogether. But what if this is not politically possible? There may be some validity to this argument, particularly in the short run. The counterargument is that such bribery defuses pressure for broader reform, and it invites firms to evade good regulations as well as bad. Furthermore, the costs of such bribery may fall disproportionately on smaller firms.⁷ A system based on many legal restrictions and widespread bribery to avoid them is like a highly regressive tax system on the private sector, and few would argue for the latter in developing countries. And in some transition countries such restrictions have proliferated in an uncontrolled way with the express purpose of extracting rents.

2.14 The juxtaposition of high growth and systemic corruption in some Asian countries challenges those who believe strongly that corruption is economically harmful. Several possible explanations have been suggested. First, perhaps predictability is what matters, and some corrupt governments reliably deliver what is "bought" with bribes while other corrupt governments do not.⁸ Second, some view highly-concentrated corruption at the top of the political system (perhaps more the model in some Asian settings) as less distortionary than uncontrolled corruption at lower levels (as, for example, in parts of the FSU).⁹ Third, if political systems are stable and the rules of the game are well-known, the transaction costs of rent-seeking may be less costly than in a more unstable, uncertain environment. In any case, few observers would argue that corruption is *beneficial*, even in high-growth countries, just that it may do less harm than in other settings. And even this is debatable.

2.15 To summarize, the models purporting to show that corruption can have positive economic impacts are usually looking only at static effects in the short-run. In the longer-run, opportunities for bribery are likely to lead public officials to change the underlying rules of the game or their own behavior in the absence of bribes, and the results are likely to be costly in terms of economic efficiency, political legitimacy, and basic fairness.

2.16 A survey of 3700 firms in 69 countries carried out for the 1997 World Development Report provides further evidence of the widespread existence and negative impact of corruption. As noted in the Report:

"The survey confirmed that corruption was an important -- and widespread -- problem for investors. Overall, more than 40 percent of entrepreneurs reported having to pay bribes to get things done as a matter

⁷ For examples of such regressive impact, see S. Rose-Ackerman and A. Stone, "The Costs of Corruption for Private Business: Evidence from World Bank Surveys," mimeo, May, 1996.

⁸ The importance of predictability is stressed in the 1997 World Development Report, "The State in a Changing World."

⁹ Schleifer and Vishny, *op cit*.

of course Further, more than half the respondents worldwide thought that paying a bribe was not a guarantee that the service would actually be delivered as agreed, and many lived in fear that they would simply be asked for more by another official The consequences of corruption often do not end with paying off officials and getting on with business. Government arbitrariness entangles firms in a web of time-consuming and economically unproductive relations..."¹⁰

The survey also confirmed the negative correlation between the level of corruption (as perceived by businesspeople) and the level of investment in an economy.

2.17 Political theory. Political scientists look beyond the visible signs of corruption to the broader setting in which it occurs. Seen this way, corruption is a manifestation of deeper attributes of a society – the way political power is contested and exercised, the legitimacy of the state, and the strength of civil society. Over time, most industrialized countries have evolved professional bureaucratic values, competitive politics, transparent government processes, an active media, and an informed civil society. These constrain political and bureaucratic corruption, making it the exception rather than the norm. In developing countries, by contrast, government institutions are weaker, civil society less engaged, and political and bureaucratic processes less accountable and transparent. An effective state apparatus and capacity for law enforcement may be virtually non-existent. In such settings, sustained progress in building an honest and effective state apparatus requires addressing the mix of factors in state and society which give rise to both corruption and weak social and economic performance. This is an exceedingly complex and long-term effort.¹¹

2.18 Public management. The public management view of corruption is very clear cut. Corruption undermines the bureaucratic values of equity, efficiency, transparency, and honesty. It thus weakens the ethical fabric of the public service and prevents the emergence of well-performing government, capable of developing and implementing public policies that promote social welfare. While economies may still grow in countries where corruption is entrenched in the public sector, successive stages of economic and social development will be harder if not impossible to achieve without well-performing government. Ultimately, countries need to create durable institutions to foster and protect integrity in public life if public policy is to achieve the social objectives (such as the reduction of poverty and the protection of the environment) that the Bank promotes.

2.19 Bank economic and sector work. Rarely has Bank economic and sector work (ESW) directly addressed the topic of corruption. However, a small but growing number of Public Expenditure Reviews (PERs) have looked at the problem, and survey data gathered in the course of Private Sector Assessments (PSAs) are beginning to illuminate

¹⁰ "The State in a Changing World," World Development Report 1997, forthcoming.

¹¹ See "What Can Be Done About Entrenched Corruption?" Michael Johnston, Colgate University. Paper presented at Annual Bank Conference on Development Economics, April 1997.

the costs of bribery to entrepreneurs. By drawing on the ESW that does address the topic, tapping informal country knowledge within the institution, and by trawling the Bank's vast store of country reports for examples where the influence of corruption can be inferred (even if the term corruption is seldom used), the following picture emerges of the many ways in which corruption imposes costs on our borrowers.

- (i) *Macroeconomic stability* may be undermined by loss of government revenue and excessive expenditure. This can happen through corruption in tax and customs departments; through debt incurred when the scrutiny of finance ministries and central banks is by-passed; through awarding contracts to higher cost bidders or without competitive bidding and colluding with the supplier to charge a higher than market price; and through the general erosion of expenditure control. Macroeconomic stability may also be threatened by debt guarantees and other off-budget contingent liabilities agreed to in corrupt transactions without public scrutiny. In transition countries, and in many developing countries,¹² corruption may reduce revenue collection by driving firms (or their most profitable activities) out of the formal sector and by providing a moral justification for widespread tax evasion. The costs of macroeconomic instability are borne by all elements in society, but especially the poor.
- (ii) *Foreign direct investment* may still flow to countries where corruption is systemic, but only if bribery is affordable and the results are predictable. Even so, corruption may well have a negative effect on foreign investment. Where corruption is systemic and large, investment may be concentrated in extractive industries where operations can be enclaved, or in light manufacturing or trading operations, which can be relocated if corruption costs become unbearable. Or foreign investors may shun the country altogether. For most foreign firms, corruption is a cost of doing business to be recouped from revenues. If the costs become too high or unpredictable, they will disengage unless global marketing or sourcing considerations require a presence to be maintained in that country. Countries with very high levels of corruption are marginalized in the international economy.
- (iii) *Small entrepreneurs* may be affected in many developing and transition countries. Evidence from Private Sector Assessments (PSAs) suggests that corruption increases the costs of doing business, that small firms bear a disproportionately large cost, and that bribes can prevent firms from growing.¹³
- (iv) *The environment* may be endangered. Many countries have enacted laws to protect the environment and have created special agencies to enforce the laws, but there is too often a "disconnect" between policy and its implementation.

¹² See for example Hernando de Soto's description of the informal sector in Peru, in "The Other Path," 1989.

¹³ See Susan Rose-Ackerman and Andrew Stone, "The Costs of Corruption for Private Business: Evidence from World Bank Surveys."

Complying with environmental regulations imposes costs on firms that can be avoided by bribery. There are huge rents to be earned from activities, such as logging in tropical rain forests, where permits are obtained through bribery or where inspectors can be bribed to ignore illegal logging. The environmental costs of corruption may take the form of ground water and air pollution, soil erosion, or climate change, and can be global and intergenerational in their reach.

- (v) The *poor* suffer. While Poverty Assessments have been more focused on measuring poverty than explaining it,¹⁴ anecdotal and survey evidence reveal the cost of petty corruption on the poor. When access to public goods and services requires a bribe, the poor are excluded. Furthermore, when corruption results in shoddy services, the poor lack the resources to pursue "exit" options such as private schooling, health care or private power generation.
- (vi) *State assets or revenues may be stolen* either through uncontrolled privatization, theft from treasuries, or diverting government revenues to private accounts. Aggregate leakage can be substantial. When the leadership steals state assets, petty officials have little incentive to remain honest.
- (vii) "*White elephant*" projects may be undertaken which may not only be excessively costly to construct, but also subtract wealth when they are operated.

2.20 *The views of Bank staff.* To augment the evidence from research and ESW, the Working Group carried out informal interviews of Bank staff to assess their views and gather their insights. Common patterns emerged, but there were important regional differences -- most notably regarding the economic impact of corruption in East Asia. Raising the topic tapped into deep and strongly held beliefs among the Bank's task managers. From the responses we drew the following conclusions:

- Bank staff believe corruption is widespread – even pervasive – in all regions of the world and at all levels of government. They also believe it is growing in most countries, either in amount or in visibility, in response to the weakness of institutions, as well as in response to the special conditions of the post-socialist transition economies.
- A consensus exists that corruption is a major barrier to economic development for most economies (with some uncertainty regarding East Asia), and one which frustrates the Bank in achieving its objectives and makes Bank projects more costly and less effective. Corruption's impact falls more heavily on the poor, who are powerless to protect themselves. Corruption renders efforts at policy formulation, public sector management, and the protection of the environment less effective.

¹⁴ This is now changing with Participatory Poverty Assessments which seek to tap the experiences of the poor directly.

- Staff believe the time is ripe for the Bank to mount a vigorous anti-corruption effort. They believe the Bank did not do enough in the past to confront corruption, either in its analytical work (which has suffered from excessive timidity on the subject) or in its formal policy dialog with governments (where the subject has often been avoided as too sensitive or too political). Government responses, in the minority of cases where the subject has been addressed directly -- principally in LAC and AFR -- indicate that there is scope for the Bank to expand its work in this area. The notion of pilot projects, in countries keen to tackle corruption, is strongly endorsed by staff.

2.21 In sum, corruption is a complex phenomenon whose impact on development is likely to vary with country conditions. But, while costs may vary, *neither theory nor evidence suggests that corruption is a spur to economic growth*. It leads governments to intervene where they need not, and it undermines their ability to enact and implement good policies in those areas where government intervention is clearly needed -- whether environmental regulation, health and safety regulation, social safety nets, macroeconomic stabilization, or contract enforcement.

CHAPTER 3

TACKLING THE PROBLEM OF CORRUPTION: GUIDELINES FOR A BANK STRATEGY

3.1 The Bank can and should address the problem of corruption. It should be concerned because, as noted in Chapter 2, corruption undermines economic, social, and political development. Corruption is of growing concern to donors, NGOs, and governments and citizens in developing and industrialized countries alike, and the problem is increasingly undermining international support for development assistance. The opportunities to address corruption have never been greater. New global standards of behavior appear to be emerging, driven partly by changing attitudes to transnational bribery in developing countries (see Chapter 6), and partly by the effects of information technology in both developing and industrialized countries. With its cross-country expertise and broad development mandate, the Bank should be a leader in helping design country and international efforts to deal with the issue, rather than sitting on the sidelines as a passive player.

3.2 Given its responsibilities to shareholders and clients, the Bank cannot help being concerned with corruption to the extent it compromises the success of the Bank's own projects and policy advice. The Bank found in the 1980s that inappropriate macroeconomic policies could prevent well-designed projects from achieving intended results. It is now faced with widespread evidence that weak institutions undermine policy implementation and project outcomes. While a Bank project can be protected in the short run from an adverse public sector environment by separate staffing and financial arrangements during loan disbursement, sustained outcomes cannot be ensured this way. Moreover, such "enclaving" may perpetuate institutional weaknesses (see Chapter 5). To ensure the desired outcomes for Bank-financed projects, the Bank must be concerned about the institutional environment as a whole.

3.3 Not only *should* the Bank be concerned about corruption as a development issue, but the Bank's Articles clearly permit it to do so. It is true that the Articles forbid the Bank from interfering in the political affairs of members and require that only economic considerations should bear on its investment decisions. But if corruption has identifiable social and economic costs, it is within the Bank's mandate to consider and reflect these costs in investment decisions. The General Counsel, in a recent paper on the subject, has pointed out that:

"the World Bank can hardly insulate itself from major issues of international development policy. Corruption has become such an issue. Its prevalence in a given country increasingly influences the flow of public and private funds for investment in that country. The Bank's lending programs and in particular its adjustment lending take into account factors which determine the size and pace of such flows. From a legal viewpoint, what matters is that the Bank's involvement must always be consistent with its Articles of Agreement. The Bank

can in my view take many actions to help the fight against corruption. It can conduct research on the causes and effects of this worldwide phenomenon. It can provide assistance, by mutual agreement, to enable its borrowing countries to curb corruption. It may take up the level of corruption as a subject of discussion in the dialogue with its borrowing members. And, if the level of corruption is high so as to have an adverse impact on the effectiveness of Bank assistance, according to factual and objective analysis, and the government is not taking serious measures to combat it, the Bank can take this as a factor in its lending strategy towards the country. The only legal barrier in this respect is that in doing so the Bank and its staff must be concerned only with the economic causes and effects and should refrain from intervening in the country's political affairs. While the task may be difficult in borderline cases, its limits have been prescribed in detail in legal opinions endorsed by the Bank's Board."¹⁵

Corruption, therefore, can be addressed by staff as an economic phenomenon within the framework already approved by the Board for governance issues.

Understanding the Causes of Corruption

3.4 The ultimate goal of a Bank strategy to address corruption is not the complete elimination of corruption, which is an unrealistic aim, but the move from systemic corruption to an environment where corrupt activities are the exception rather than the rule. Such a strategy should be guided by a view of what causes corruption and in what environments it tends to thrive. Some characteristics of developing and transition settings

¹⁵ See Ibrahim F.I. Shihata, "Corruption - A General Review with an Emphasis on the Role of the World Bank," a paper based on a keynote address delivered on the occasion of the International Symposium on International Crime at the Jesus College, Cambridge, England, on September 9, 1996. See also "Issues of Governance in Borrowing Members - The Extent of Their Relevance Under the Bank's Articles of Agreement, Legal Memorandum of the General Counsel," dated December 21, 1990 (SecM91-131, February 5, 1991) and "Prohibition of Political Activities in the Bank's Work, Legal Opinion of the General Counsel," dated July 11, 1995 (SecM95-707, July 12, 1995). The General Counsel added: "According to one such legal opinion ("Governance Issues and their Relevance to the Bank's Work," issued in December 1990), the concept of governance in the sense of the overall management of a country's resources cannot be irrelevant to an international financial institution which at present not only finances projects but also is deeply involved in the process of economic reform carried out by its borrowing members. Clearly, the concern here is not with the exercise of state powers in the broad sense but specifically with the appropriate management of the public sector and the creation of an enabling environment for the private sector. It is a concern for rules which are actually applied and institutions which ensure the appropriate application of these rules, to the extent that such rules and institutions are required for the economic development of the country and in particular for the sound management of its resources. (For details, see I. Shihata, "The World Bank in a Changing World," Vol. 1, 53-96 (1991).)

No doubt, the Bank has to address issues of corruption in this context with great caution, acting on the basis of established facts and only to the extent that the issues clearly affect the economic development of the country. It cannot, however, ignore such issues at a time when they have become a major concern, not only to the sources of international financial flows but also to business organizations and indeed to the governments and peoples of most of its member countries."

make corruption particularly difficult to control. First, the normal *motivation* of public sector employees to work productively may be undermined in these settings by many factors, including low and declining civil service salaries and promotion unconnected to performance. And poor personnel policies may not be the only demotivator. Dysfunctional government budgets, inadequate provision of supplies and equipment, delays in the release of budget funds (including pay), and a loss of organizational purpose may all contribute to staff demoralization. Furthermore, the motivation to remain honest may be weakened if senior officials and political leaders are using public office for private gain. Or the public service may have long been dominated by patron-client relationships, in which the sharing of bribes and favors has become entrenched. In some countries, pay levels may always have been low, with the informal understanding that staff will find their own ways to supplement inadequate pay. Sometimes these conditions are exacerbated by closed political systems dominated by narrow vested interests, and by international sources of corruption associated with major projects or equipment purchases.

3.5 The *opportunity* for corruption is a function of the size of the rents under a public official's control, the discretion that official has in allocating those rents, and the accountability that official faces for his or her decisions.¹⁶ *Monopoly rents* can be very large in highly regulated economies, and, as noted above, corruption breeds demand for more regulation. In transition economies, economic rents can be enormous because of the amount of formerly state-owned property essentially 'up for grabs'. The *discretion* of many public officials may also be large in developing and transition countries, exacerbated by badly-defined, ever-changing, and poorly disseminated rules and regulations. Finally, *accountability* is typically weak. The ethical values of a well-performing bureaucracy may have been eroded or never built. Rules on conduct and conflict of interest may be unenforced, financial management systems (which normally record and control the collection of revenues and the expenditure of budgeted resources) may have broken down, and there may be no formal mechanism to hold public officials accountable for results. The 'watchdog' institutions that should scrutinize government performance, such as ombudsmen, external auditors, and the press, may be ineffectual. And special anti-corruption bodies may have been turned into politically partisan bodies, whose real purpose is not the detection of fraud and corruption but the harassment of political opponents.

The Three Pillars of a Bank Strategy

3.6 What this points to is a strategy that addresses all parts of the equation. And, because corruption has become a global problem, the strategy needs to have an international dimension. We recommend that the Bank's strategy to assist countries combat fraud and corruption rest on three 'pillars' that together help to reduce rents, channel discretion, and increase accountability:

¹⁶ Robert Klitgaard uses the equation $C \text{ (corruption)} = M \text{ (monopoly)} + D \text{ (discretion)} - A \text{ (accountability)}$. See R. Klitgaard, "Cleaning Up and Invigorating the Civil Service," World Bank Operations Evaluation Department, November 1996.

- Economic and Sector Policy Reform
- Institutional Strengthening
- International Cooperation

These three pillars are described in detail in the following three chapters.

Tailoring Strategy to Country Circumstances

3.7 The specific approach in any particular country will depend on country circumstances. The latter will also determine whether the strategy should be comprehensive or more incremental. Comprehensive strategies can be developed where national leadership is committed to change and the political will exists to undertake in-depth economic and institutional reforms. Governments are seldom undifferentiated in their reform commitment, and there may be opportunities for in-depth reform at the local level, or in particular agencies or departments, even if they are missing at the national level. In some cases there may be more political will for economic policy reform than for in-depth work at the institutional level. And when even the possibility for economic policy reform is limited, there may still be scope for activities, such as public education or dialogue with leaders in government and civil society, which can lay the foundation for more substantial action later.

3.8 In general, countries range across a spectrum, from those in which there are dynamic forces working for more transparent and accountable government to those countries caught in a vicious circle of systemic corruption and no growth. In some countries, historical forces are on the side of state modernization, and are working in much the way as they did in the industrialized world a century ago. In Latin America, civil society is engaged and policy makers see the control of corruption an integral part of public sector modernization. Privatization has been substantial, and economies are now much more open to market forces. In a number of East Asian countries, the private sector is especially dynamic, and policy makers are aware of the challenges and opportunities of the global economy and the need for a changed role for the state. The role of the Bank, in such circumstances, is to help governments improve performance by providing policy advice and assisting with institution strengthening, while at the same time ensuring that Bank-financed projects, as far as possible, are corruption free.

3.9 Poorer countries, particularly those in Africa, cannot wait for historical processes, particularly if the preconditions for change are absent. In Africa, the modern private sector has remained small and operates by informal rules in its relations with government. In such countries high levels of corruption may be a stable equilibrium, with political elites, bureaucratic functionaries, entrepreneurs, and ordinary people all bound by its rules. Although the context is quite different, some aspects of this can also be seen in some transition countries, where the institutions of a command economy are no longer relevant and a vacuum has been created which many countries are struggling to fill. In such countries, combating systemic corruption and building strong institutions needs to be a more deliberate process, maintaining a focus not just on building the various component parts of the "integrity system" but also on economic policy reform, and how policy reform

and institution building can reinforce each other. Success will depend on the roles played by national leaders, public officials, and civil society, on the design and implementation of economic policies, and on the conditions of public management systems. A larger role is appropriate for external agents like the Bank and bilateral aid agencies, partly because external support is needed to help build capacity, but also because of the role aid has played in shaping and maintaining the state.

Corruption and Bank Lending Programs

3.10 Bank staff and management need to decide how far the extent of corruption should be taken into account in establishing country lending programs. The critical factor for the lending program is not so much the level of corruption as its impact on economic development, and whether the government is prepared to take steps, with or without the Bank's assistance, to control it. Country circumstances are likely to vary greatly. Established procedures for determining IDA and IBRD allocations already exist, so a concern for corruption would affect lending levels through its influence on already established criteria.¹⁷ The Working Group envisages the following broad lending outcomes:

- (i) If corruption is known to be systemic in government and affects Bank project implementation and project sustainability, and the government is unwilling to act, Bank lending would be sharply reduced or stopped altogether. The Bank may, however, still want to stay engaged in education and training programs and in partnerships with NGOs or other parts of civil society.
- (ii) If corruption is systemic and Bank projects are affected, but the government is prepared to act to control it, the lending program would not necessarily be curtailed. The Bank, however, would expect the government to discuss its anti-corruption program, and would have an interest in implementation, whether or not the Bank played a role in financing the program.
- (iii) If corruption is systemic and is considered to undermine development, but Bank projects do not appear to be affected, either during implementation or later, the Bank would still raise corruption in the country dialogue and may adjust lending levels according to the government's response. The justification for doing so would be the fungibility of Bank lending. The scale of that lending relative to total government spending, however, would be a factor in the Bank's response.
- (iv) If, under the circumstances described above, the Bank's program included a SAL or SECAL, the Bank would be justified in reducing lending if the government were unwilling to act against corruption. Balance of payments or other sector-wide

¹⁷ IDA resources, for example, are allocated to eligible countries mainly on the basis of their performance in meeting economic and social goals. Countries are rated according to three sets of criteria: (i) macroeconomic stability; (ii) structural policies; and (iii) portfolio performance. Pervasive corruption will have an impact on all three of these areas.

lending should bring under scrutiny the performance of the public sector as a whole.

3.11 Obviously, guidelines on lending programs must always be tempered by country circumstances. Nevertheless, there could be circumstances when a concern for anti-corruption could be in conflict with other lending program goals, and managers will have to resolve the resulting tensions.

CHAPTER 4

ECONOMIC AND SECTOR POLICY REFORM

4.1 The Bank's record of giving good policy advice has been a highly positive contribution to the struggle to control corruption, and *economic policy reform should continue to be a main pillar of the Bank's anti-corruption strategy*. Deregulation and the expansion of markets is a powerful tool for the control of corruption, and the Bank should continue to push this approach where it is feasible. Where governments must continue to be involved in the economy, Bank staff should carefully consider the demands a new policy might make on institutional capacity. In the 1970s, the Bank recognized the importance of the economic policy environment for project success. Now the Bank needs to take more systematic account of the institutional environment for both policy and project success.

Deregulation and the Expansion of Markets

4.2 Markets discipline participants more effectively than public sector accountability mechanisms generally can. Enlarging the scope and improving the functioning of markets strengthens competitive forces in the economy and curtails rents, thereby eliminating the bribes public officials may be offered (or may extort) to secure them.

4.3 Some results of policy reform can come quickly, particularly macroeconomic reform, which does not make heavy demands on institutional capacity. The incentives of economic actors can be changed overnight by the removal of controls and the introduction of market-determined allocation systems in areas like foreign exchange and bank credit. Resistance to structural-adjustment reforms is now more likely to be from vested interests than from ideological opposition.

4.4 Examples of both macroeconomic and sector policy reforms that contribute to the expansion of markets and the reduction of rents include:

- Lowering tariffs and other barriers to international trade;
- Moving from dual to single exchange rates, with market-determined rates;
- Introducing competitive credit markets;
- Eliminating price controls;
- Reducing subsidies to enterprises;
- Reducing regulations, licensing requirements, and other barriers to entry for new firms, both domestic and foreign;
- Privatizing government assets in clearly competitive markets; and
- Abolishing monopoly export marketing boards.

4.5 The Working Group discussed these and other policy areas with operational staff across the Bank, who confirmed that policy reform has contributed to the fight against corruption in many countries. Where countries have carried out economic reform

programs and corruption persists, part of the answer is likely to be found in an unfinished reform agenda. In many countries the benefits of macroeconomic reforms have been blunted by the absence of complementary microeconomic reforms at the sector level. Thus many countries – transition economies in particular – need to maintain the reform momentum.

4.6 Policy reform may be particularly relevant in circumstances where powerful elements in the public sector seek to retain control over areas of public activity for rent seeking purposes, and consensus on far-reaching institutional reforms has still to be developed. Well targeted policy reforms, supported by the Bank, could have a decisive effect in reducing corruption and building public support for further reform. Deregulation, accompanied by publicity, can dramatically reduce the burden of corruption on firms and individuals.

Policy Advice When Government Has a Continuing Role

4.7 There are some areas where the Bank's policy advice may need to pay greater attention to anti-corruption goals. Typically, these involve areas where the government must be involved because of market failure, but where public policy can work only if sufficient institutional capacity exists. Without institutional capacity, well-intended policies can lead to poor outcomes and even greater corruption. This can happen across the spectrum of Bank interventions. Several examples illustrate the links between design and institutional capacity: infrastructure privatization, environmental regulation, decentralization of governance activity, tax reform, and public expenditure reduction. The issue in each of these areas is not that the policies are necessarily misguided, but that institutional capacity is critical to a successful outcome, and policies must be designed in the light of a realistic assessment of institutional capacity.

4.8 ***Infrastructure Privatization.*** In the long run, privatization should and does decrease corruption, because it reduces the power and discretion of public managers and bureaucrats and increases competition and transparency. In the short run, the complex deals to negotiate – usually in a situation of shifting policies, regulations and practices – create temptation and opportunity. Weak institutions are unlikely to resist temptation. As this becomes evident, a negative image of privatization builds in the public's eye – even though the transactions themselves still make good economic and financial sense.

4.9 The dangers are particularly acute in infrastructure privatization, where, typically, the stakes are larger, the negotiations prior to sale more elaborate, and continued government oversight is justified. When a firm is divested into a competitive market, the opportunities for corruption more or less end. In the case of a natural monopoly, corruption can continue indefinitely in the regulatory system.

4.10 In all cases, the solution is the reinforcement of institutional capacity so that clear rules may be impartially applied, both before and after sale. In the case of *infrastructure, privatization should not be undertaken without also establishing a minimum regulatory capacity*. It has proven costly to privatize first and try to install a regulatory regime later.

Box 4.2 Reducing Corruption by Policy Reform: Pensions

In pension reform the Bank advises countries to move from government monopoly provident funds and pay-as-you-go schemes to competitive but well-regulated private funds, leaving the employee the flexibility to decide where his/her contribution should be paid, and requiring transparency in the funds' operation. Where national state provident funds are maintained, fund management can be contracted out, and governments can allow contributors the flexibility to use private schemes once a minimum contribution to the provident fund has been made. Policy reform in this direction guards against two forms of misuse: first, when governments use the proceeds of provident schemes for cheap financing of government spending, or when a fund is bankrupted by a combination of restrictive investment rules and high inflation; second, petty fraud when employers conspire with about-to-retire employees to raise their salaries to enhance a state pension (which is not possible with private schemes based on life-time contributions). However, pension funds require regulation to protect the public from private sector fraud. Policy reform should therefore confront early the need to create regulatory capacity.

4.11 **Environment.** Unlike most areas in which the Bank works, environment is an area in which governments have tended not to be involved enough, and in which governments and donors are often pushing for greater involvement and regulation. But tighter regulation without strong institutions is likely to lead to more corruption because it creates rents and gives the government more coercive powers. A careful *balance between policy and institutional capability* is critical but easily overlooked.

4.12 New and innovative ways to use more transparent market mechanisms for environmental control are being tested in some countries. These include, for example, auctions of tradable permits to pollute, or negotiated contracts with industry consortia on acceptable pollution levels in a particular watershed basin. In each case the level of acceptable pollution is set by government, but how that level is reached is ultimately decided by the market or the private sector. Strengthening governments' capacity to design and implement such decentralized, market-based approaches to pollution control could be an important service the Bank might provide to reduce corruption in this sector.

4.13 **Tax reform.** In most cases, reforms to tax policy that eliminate multiple rates and exemptions and limit the discretionary powers of tax officials serve to reduce corruption, as well as to enhance economic efficiency. But sometimes a concern for closing a fiscal gap has caused the Bretton Woods institutions to press governments to impose rates of taxation that can be collected only from a few large corporations, if at all. *Tax rates that exceed what taxpayers view as legitimate or what tax offices can administer not only encourage the informalization of the economy but are also an inducement to tax evasion*

*and the corruption of tax officials.*¹⁸ High tax rates coupled with weak collection arrangements simply serve to inflate the profit of corruption without increasing the risk of detection.

4.14 **Public expenditure reduction.** Corruption may also increase when governments are under pressure to reduce the share of the public service wage bill in the budget, but find it hard politically to reduce numbers in the short run. *In such circumstances, a mandated reduction in the wage bill will translate into yet lower real pay for government employees.* This can have devastating effects on government performance, through the loss of skilled professionals, demotivation of those who remain, and lowered resistance to corruption. When the erosion of pay makes it impossible for staff to maintain basic living standards, the government can quickly lose capacity to control fraud, and even the honest can be driven to absenteeism and moonlighting activities which may be in conflict with their roles as public servants. On the surface, the formal processes of government may be maintained, underneath an alternative set of informal rules operates, to the detriment of public welfare.

4.15 Large public sector wage bills are fiscally unsustainable and must be addressed. But this should happen within an *integrated framework of public sector and governance reform* if measures aimed at strengthening the fiscal performance of the government are not to have adverse effects on its capacity to perform its tasks efficiently and effectively (see Chapter 5).

¹⁸ For example, in a number of transition economies where the ratio of total government revenue to GDP is under ten percent, value-added tax rates exceed 20 percent.

CHAPTER 5

STRENGTHENING INSTITUTIONS

5.1 Building strong institutions is a central challenge of development and key to the control of corruption. Well-functioning public sector management systems, accountable organizations, a framework of laws, an independent judiciary and a vigilant civil society protect a country against corruption. In general the Bank's strategy for helping countries control corruption in public institutions should match its strategy for achieving well-performing government. Seen this way, strengthening institutions to control corruption is part of the larger task of improving performance. This means, (i) addressing the internal systems that determine how organizations and those who work in them perform; and, (ii) improving the governance environment in which public sector organizations operate and are held accountable.

5.2 Strengthening institutions to control corruption means moving forward in three areas:

- The traditional systems of well-performing government: a professional civil service, sound financial management, disciplined policy-making processes, and the balance of responsibilities between central, state and local government;
- The legal framework, including the judicial system;
- Greater transparency, and other measures which can strengthen the role of civil society in demanding better performing government.

Although some aspects of the third category lie beyond the Bank's mandate, there is a great deal that the Bank can do to help countries strengthen the capacity of institutions inside and outside government to control corruption. For many years the Bank has been active helping countries build well-performing public sector institutions, and has increasingly recognized the important role played by civil society. Continued work is needed both within the Bank and outside to understand how to design and implement successful institutional reforms. This chapter lays out some initial thoughts.

When Formal and Informal Rules Diverge

5.3 First, it is worth noting a characteristic of the environment in which corruption occurs -- the divergence between the formal and the informal rules governing behavior in the public sector. The Working Group is unaware of any country that does not have some rules against corruption, although not all countries have all the rules that may be necessary. These range from laws making it a criminal offense to bribe a public official to public service regulations dealing with conflicts of interest, the acceptance of gifts and the duty to report fraud. Individual agencies of government -- police and army, tax and customs departments, local governments, and public enterprises -- may have their own

laws, regulations, and codes of behavior. There are organic laws, often embedded in constitutions, about budgeting, accounting and auditing, supported by laws and regulations on public procurement and the safeguarding of public assets. In addition, there are laws on the conduct of elections and the appointment of judges, and codes governing the conduct of legislators. Some of these laws are a colonial inheritance, some have been copied from countries with a similar legal tradition, and some are additions to existing laws, for example, providing for special anti-corruption commissions and other watchdog bodies.

5.4 Where corruption is systemic, the formal rules remain in place, but they are superseded by informal rules. It may be a crime to bribe a public official, but in practice the law is not enforced or is enforced in a partisan way, and informal rules prevail. Government tender boards may continue to operate even though the criteria by which contracts are awarded have been perverted. Seen in this light, strengthening institutions to control corruption is about shifting the emphasis back to the formal rules. This means acknowledging that a strong legal framework to control corruption requires more than having the right legal rules in place, and addressing the institutional causes of informality, first by understanding why the informal rules are at odds with the formal rules, and then addressing the causes of divergence.

Public Management Reforms

5.5 **National Leadership.** Public management reforms are usually institutionally intensive, and require sustained commitment by both the borrower and the Bank over several years if they are to yield benefits. Bank staff must ensure that the scope of institutional reform programs is matched by leadership commitment, recognizing, though, that successful reform programs build commitment as they proceed. Political commitment to reform is best seen as working capital that must be sufficient to start a reform endeavor, yet may be built progressively if reforms are designed strategically. Typically, there will be countries where corruption has been systemic in the public sector, but there is a reforming core with whom a strategy can be developed, blending institutional reforms with economic reforms, according to country circumstances.

5.6 **Civil Service Reform.** One of the most important institutions of the state is a professional and motivated civil service. A well-performing civil service resists petty corruption by its members and provides the staff for many of the institutions that protect integrity in government: finance and personnel ministries, government tender boards, technical departments that evaluate bids, bodies that implement regulatory policy, accounting units, internal and external audit departments. However, despite the Bank's engagement in civil service reform in over sixty countries and some successes on the ground, this field has always been difficult.¹⁹ *Better approaches to civil service reform need to be developed if the Bank is to see countries make headway in the control of*

¹⁹ The difficulties are detailed in numerous studies of the Bank's experiences in CSR, by the center, by the Regions and by OED. A study of Bank approaches to civil service reform is currently underway.

corruption. It lies beyond the Working Group's task to set forth how the Bank's efforts with civil service reform can be made more effective. However, some pointers can be noted. Personnel policy is clearly a vital issue. Defining what is meant by the civil service is another. A third issue is more effective mechanisms to match policy with affordability.

5.7 Remuneration policy in the public sector is a key issue. Public employment expanded faster than revenues in many developing countries the 1970s and 1980s, and public sector pay levels were unable to keep pace with inflation. Pressure to reduce wage bills in structural adjustment programs may have exacerbated this problem (see Chapter 4). Declining real pay invites low productivity, bribery, and extortion. Adequate pay will not by itself ensure a professional civil service, but it is an indispensable foundation that is now absent in many countries. Most Bank-supported civil service reform programs have included measures to decompress pay scales, but in few countries has pay been restored to levels at which the formal rules of the public sector can hope to be re-established.

5.8 Pay scales cannot be looked at in isolation, but must be considered together with the issue of employment levels. In turn this means understanding the reasons behind the excessive hiring in the past. Policies can be implemented in many ways – by central government departments, by local governments, by separate agencies, by contracting out the delivery of intermediate or final services to the private sector, by funding users rather than suppliers, or by regulating wholly private providers. Governments rapidly expanded their functions in the 1960s and 1970s, partly because of the then prevailing view that governments needed to intervene in many areas of economic and social life and, for some countries, for patronage reasons. In high aid inflow countries, donors (including the Bank) largely financed the expansion of government. Too often the decision was taken to implement a new policy through direct civil service provision. This resulted in a rapid expansion of government payrolls and, in many cases, an inappropriate organizational form.²⁰ Creating (or re-creating) a professional civil service may therefore mean re-defining the term to encompass only those public employees working on the core functions of government. At the same time, pay a market-related levels needs to be given well-performing staff in other parts of the public sector. On the Bank's side, the situation argues for a *re-examination of the present policy on direct financing of civil service severance pay*.²¹

²⁰ It also resulted in a rapid expansion of government spending relative to GDP. While government spending in developing countries is less, in relative terms, than in industrialized countries, it is significantly greater than the share of government spending in many industrialized countries when they made the transition from systemic to individual corruption in the nineteenth century.

²¹ Under current policy the direct funding of severance pay in investment loans is restricted to public enterprise reform to facilitate the shedding of surplus staff prior to privatization. While civil service reform is a more complex and riskier area than public enterprise reform, the Bank at present cannot apply existing investment lending instruments to help governments move from an overexpanded and underpaid public service to one in which policy commitments, staffing levels and budgetary resources are in sufficient balance for a professional well-motivated civil service to emerge. Our inability to lend directly for severance pay may be reducing our usefulness to governments seeking to reform their public services. This issue needs to be investigated and is linked to whether a medium term

5.9 Attention should also be paid to the adequacy of mechanisms to protect the civil service from unwarranted political interference, by encouraging governments to limit the number of political appointments made to senior civil service positions, by ensuring that promotion is on merit, and by creating independent review and appeal mechanisms. Ethics codes and institutional values, once established, help protect a civil service's integrity and professionalism, but require continual nurturing.

5.10 Overall, the need is to match policy and affordability, with government undertaking only what it can do well within its own resource constraint. This suggests that solutions to civil service reform may well involve much more than reforming pay scales and strengthening public service ministries. They may also require looking at the dynamics of policy making so that a hard budget constraint is imposed on policy choices.²² Again, for poorer countries, this means *critically examining aid modalities*. In a larger sense, matching policy and affordability means changing assumptions about the role of government in the post-independence "development state," and forging a more sustainable social contract between government and governed.

5.11 **Financial Management.** Good financial management systems are powerful instruments for preventing, discovering, or facilitating the punishing of fraud and corruption. They allocate clear responsibility for managing resources, reveal improper action and unauthorized expenditures, facilitate audit by creating audit "trails," and protect honest staff. By reducing opportunities for corruption and increasing the risks of detection, good financial management systems help change corrupt conduct from "high profit/low risk" to "high risk/low profit." Yet government financial management systems function very poorly in many (possibly the majority) of our borrowers. Control systems are inoperative, permitting widescale fraud, and auditing in many cases is impossible.²³

5.12 The Bank has been active in a number of countries in strengthening government financial management systems and audit institutions, increasingly using systems that better integrate the stages of budgeting, cash management, accounting and auditing.²⁴ *But the Bank has not done enough to help borrowers build well-functioning systems government-*

budgetary support instrument could be developed. If it can, direct financing of severance pay for civil servants may not be so necessary.

²² In many countries, decisions to introduce new policy are made without regard to the long term costs of implementation. This is because policy making is not disciplined by institutional processes that require the costs to be identified and considered before the policy decision is made. Where aid is additional, the discipline of a hard budget constraint is lost.

²³ This is particularly a problem in Sub-Sahara Africa, where Auditors General frequently complain in their reports that audits could not be completed in departments and agencies because accounting records were incomplete, audit queries were unanswered and consolidated government accounts are presented to parliament years after the spending took place, if ever.

²⁴ The Bank is working with a growing number of countries to strengthen the capacity of the Supreme Audit Institution (SAI), by modernizing audit laws, training staff, and installing improved management systems. EDI has begun working with parliamentarians in selected countries to help watchdog bodies, such as public accounts committees, become more effective.

wide. Rather, the emphasis of the Bank in many countries has been on measures to improve financial management in Bank projects, which does not create a capacity for better financial management on a sustained basis outside the confines of the project. While the Bank will always have a fiduciary responsibility for its projects, the Working Group believes that *the Bank must pay greater attention to broader financial management systems, especially in poorer countries where standards are so low. The Bank should help governments install and operate modernized systems where appropriate, and should emphasize government-wide financial management as a factor in lending program decisions.*²⁵

5.13 *This requires a willingness on the part of Regional management to make government-wide financial management an integral part of the CAS, the country dialogue, and decisions on the lending program, something which can happen only if the Bank equips itself with an adequate number of professionally qualified financial management staff in each region and ensures that Financial Accountability Assessments²⁶ are done for all countries receiving Bank loans on a regular basis. A targeted external recruitment program is therefore recommended to fill skill gaps in financial management at the regional level and in the center.*

5.14 **Tax and Revenue Departments.** Tax and customs departments are often the locus of major fraud and corruption and thus are candidates for inclusion in national strategies to control corruption. Such malfeasance can often be meaningfully addressed -- assuming strong commitment from the top -- by giving revenue agencies greater managerial freedom to hire, fire and set pay levels as compared with normal civil service rules, while subjecting their performance to scrutiny. By controlling theft, good financial management systems change the economics of bribery, and businesses no longer have an incentive to collude with a corrupt official to avoid taxes, rather their incentive is to report extortion.²⁷ Organizational restructuring (for example, to separate the tax assessment

²⁵ If governments were enterprises operating in competitive markets, they could not afford such inattention to financial management. While the Bank has always emphasized (along with the IMF) the importance of aggregate financial control, it has never given sufficient weight to government-wide financial management from the perspective of spending efficiency and the control of corruption.

²⁶ FAAs take stock of financial management systems: the adequacy of design, how they are implemented, the stock of professional and technical skills in both the public and private sectors, accounting and auditing of standards, and the legal framework for transparent and regular financial reporting. They have been carried out in Ghana, South Africa, Peru, Armenia, Moldova, Mongolia, Egypt, Yemen and Indonesia.

²⁷ When corrupt tax or customs officials systemically collude with taxpayers to substitute a lower rate and pocket the entire amount collected (bribery with theft), businesses operating in competitive markets have no alternative but to comply. To insist on paying the official tax or duty would put them at a competitive disadvantage compared with colluding firms. If a strong financial management system can be installed which controls theft (e.g., recording assessments made by individual officials and requiring superiors to sign off on the work performed by subordinates, daily reporting of valuations, assessments and collections, -- by spot checks and independent valuations) firms have, instead, an incentive to report bribes, since paying bribes -- raises business costs. See Andrei Schleifer & Robert Vishny, "Corruption," *Quarterly Journal of Economics*, August 1993.

function from the collection function) and staff rotation may help reduce the opportunities for corruption. Tax policy may also affect anti-corruption goals, as noted in Chapter 4. Simplifying tax and tariff schedules and keeping rates at moderate levels reduces the discretion of tax and customs staff and narrows the scope for corrupt payments. How governments spend the revenues they collect matters also. If taxpayers do not see their taxes put to good use, evasion and corruption may become socially acceptable.

5.15 The Bank has provided both policy advice and technical assistance and is also supporting tax modernization projects in a number of countries. The IMF is also active in this area, and coordination between the two institutions is important. Intrinsic to Bank efforts to help countries improve their tax and customs agencies are reforms which help government control corruption.

5.16 **Government Procurement.** Government procurement and contract management systems in both rich and poor countries are highly vulnerable to fraud and corruption. In terms of size, government-wide procurement far outweighs procurement under Bank lending in our borrowers. In many countries, officials regularly take bribes from contractors and suppliers, as a charge either for having the bid considered or for contract award. Later, there may be bribes to speed contract payments. In some cases, the goods may not be delivered at all, or substandard work may be performed.

5.17 Reducing fraud and corruption requires a willingness to install or reestablish sound systems and the capacity to operate them as intended. The basic principles of procurement are well known and are reflected in the Bank's approach to its own projects. The Bank also helped a number of countries (mostly transition) enact procurement legislation that specifies open, competitive bidding for public contracts, and has conducted training.²⁸ Although this has been valuable, it has been low key, and there has been very little systematic effort to assess government-wide systems and to incorporate the findings in the CAS. Our primary concern to date has been corruption free-procurement in Bank projects. An increased effort is needed to building borrower capacity to procure goods and services and manage contracts. Local capacity is the best insurance against fraud and corruption. There may be scope for approaches which involve specialist international firms, either to take over part or all of the procurement process, or to provide independent price information with which to benchmark the results of official processes.

5.18 The Working Group recommends that *current Country Procurement Assessment Reviews (CPARs) be developed into a more effective vehicle for public management improvement*. PSM and procurement specialists in the Bank should work more closely to integrate the development of procurement capacity into country strategies for public sector reform. And there is always more for the Bank to learn about evolving approaches to procurement around the world. We should continue to search for new techniques and approaches that help minimize opportunities for corruption.

²⁸ Using a model law (UNCITRAL) adapted to individual country legal systems, the Bank has helped many countries, especially transition ones, establish a legal framework for public procurement. This work has been funded from loans and IDF grants.

5.19 **Decentralization.** Decentralization involves the shifting of power to lower tiers of government or the granting of greater authority to line managers. Its effect on performance and corruption is ambiguous and depends in the individual situation. On the one hand, decentralization can help reduce corruption if it improves government's ability to handle tasks effectively while increasing transparency and accountability to local beneficiaries. On the other hand, decentralization may increase the overall level of corruption if local and regional governments have greater incentives (due, for example, to lower formal pay levels) and/or more opportunities or to carry out fraudulent activities, and are less constrained by financial management and auditing systems (which are often in even shorter supply in the regions than in the center). In many federal countries, more corruption is thought to exist in state and, in particular, local governments than in the federal government. This is not an automatic argument against any and all decentralization, which for many other reasons may still have positive economic impact. Rather what is needed is to *take into account the relative accountability and capacity of national and subnational levels of government, when considering the structure of power sharing, and to work with governments to develop the capacity of decentralized entities alongside the devolution of functions.*

5.20 **Service Delivery Surveys.** In a growing number of countries the Bank, through EDI, has helped governments carry out Service Delivery Surveys (SDS). Such surveys of program beneficiaries ask questions about the quality and reliability of government services, and in so doing may bring to light patterns of petty bribery. Although they are primarily used as a way of shedding light on program delivery performance, they may have the indirect effect of building demand for more accountable and better performing government. They also can provide a vehicle for beginning a substantive dialogue with the government on corruption. They are best carried out as part of a broader reform program, aimed at improving performance rather than specifically exposing corruption.

Legal and Judicial Reform

5.21 The legal system of a country, which comprises the laws and regulations as well as the processes and institutions through which they are applied, is vital for addressing corruption, just as it is for resolving civil conflicts, establishing property rights, and defining the limits of State power. On the substantive side, laws and regulations that delineate market-friendly policies are powerful anti-corruption tools (see Chapter 4). The Bank has long been involved in helping design macroeconomic and sector policies, and the laws through which they are implemented, in many countries in all Regions. On the procedural side, legal systems help reduce corruption when they effectively enforce these laws and regulations, open government processes to public scrutiny, hold government officials accountable for their actions, and require that government-held information be made available to the public on request. This is a newer field of Bank involvement.

5.22 **Judicial Reform.** Enforcement of anti-corruption legislation requires an efficient, predictable, and accountable judiciary. In recent years, the Bank has been building experience in judicial reform, especially in Latin America and Africa, and there is scope for

similar efforts in other regions. Bank-supported judicial reform has focused on judicial independence (including proper criteria for the selection and removal of judges, pay scales, training and judicial ethics); improved court administration and case flow management; procedural reform, including reducing *ex parte* communication between judge and litigants; better access to justice (through small claims courts, alternative dispute resolution mechanisms and legal aid); and legal education and bar entrance requirements. Steps also need to be taken in many countries not only to bolster the independence and impartiality of judges, but also to counter corruption by court staff who, as gatekeepers to the adjudication system, may extract bribes.

5.23 Assessing the effectiveness of the judicial system should be part of the diagnostic framework that Bank staff apply when asked to assist a country strengthen its capacity to combat corruption. But because this is a relatively new area for the Bank, like many of the institutional topics discussed in this chapter, we still have much to learn about how to judge effectiveness and which approaches to judicial reform work best. We need to build evaluation into our activities and use the Networks to debate new approaches, draw in outside expertise, and gather lessons from experiences elsewhere.

5.24 *Prosecutorial Capacity.* Effective judicial action against fraud and corruption requires not only efficient courts and procedures, both criminal and civil, and competent judges, but also the capacity of authorities to gather evidence to secure conviction. In addition to clear, comprehensive laws against fraud and corruption, prosecutorial capacity is needed to bring cases to successful conclusion in criminal courts. Heretofore, the Bank has restricted interventions in judicial reform to issues and institutions related to civil or commercial law reform -- based on the interpretation of the "productive purposes" test of the Articles of Agreement -- except in situations where courts were used simultaneously for both civil and criminal cases.

5.25 While the Working Group acknowledges that criminal justice is a highly specialized field and that there are bilateral and other agencies providing assistance, the rising costs of corruption and other forms of white collar crime suggest this may be an area where support should be given. Furthermore, effective detection, investigation and prosecution is, perhaps, the most telling way in which the "high profit/low risk" perception of corruption can be reversed. It is also what the public expect to see when they are told that reform is taking place. For these reasons, the Working Group recommends that the Bank should consider afresh whether its legal reform activities should be expanded *to include the financing of technical assistance in the area of prosecutorial capacity-building for white collar crime and associated criminal court reform.* This kind of intervention would also benefit the Bank's work on improving tax administrative capacity through effective criminal sanctions. Here, it should be noted, we are not recommending that the Bank become involved in supporting the criminal justice system in a general way. Rather it should limit itself to areas with an economic nexus, such as white collar crime. And since the proceeds of fraud and corruption may be "laundered" through national and international banking systems, *the Bank should be in a position to provide advice to countries on combating money laundering through improved banking regulations.*

5.26 ***Special Anti-Corruption Bodies.*** The Working Group reviewed the experience of independent bodies, typically set up on by statute, to improve integrity in public life. In particular we looked at ombudsman offices, inspectors-general, and independent corruption commissions. Experience in developing countries with ombudsman offices, which pursue allegations of abuse of official power, is mixed. In Sub-Saharan Africa and other regions the prevailing model has been an "executive" ombudsman, reporting to the head of the government rather than to the legislature, and thus lacking the independent status a true ombudsman should have. Inspectors-general can be powerful agents for controlling fraud and corruption within departments and agencies, depending on how they are established and operate, but they can also work at cross-purposes to accountability and performance.

5.27 Corruption commissions and special fraud units have been highly successful in Hong Kong, Chile, and New South Wales. However, they have been used as instruments of partisan politics in many developing countries, and this has undermined their effectiveness and public support.²⁹ Powerful anti-corruption legislation in the wrong hands can be abused.³⁰ Independent attorneys-general charged with the prosecution function have proven very effective in bringing charges against those at the highest level of government in some countries in Latin America.³¹ Had they been part of the executive branch, they would not have had the independence necessary to act decisively against high level corruption.

5.28 Special anti-corruption bodies seem to have worked well in a number of countries and appear a promising option, if they can be made truly independent of the executive and if there is a strong and independent judiciary. However, we need to understand better the experience of these bodies, where they have been effective and where they have failed, before recommending them to governments. *There is a need to build up our knowledge of the experience of such bodies so that we can advise our borrowers on the alternatives available and the circumstances in which they are appropriate.*

Civil Society and the Media

5.29 Civil society and the media are critically important to creating and maintaining an atmosphere in public life that discourages fraud and corruption. *Indeed, they are arguably*

²⁹ Interestingly, in a recent survey of public and private-sector participants from developing countries attending some high level training programs in the US, the creation of anti-corruption agencies was ranked low in the steps a country should take to counter corruption. (see D. Kaufmann).

³⁰ Such legislation may provide that where a public official is in a position to amass corrupt wealth, and when he/she has been shown to be in possession of assets which are out of line with known income, the judge may, *in the absence of any satisfactory explanation*, draw the inference that these assets have been acquired corruptly. Without a strong court system, a shifting of the "evidential burden" to the defence, under circumstances carefully defined by anti-corruption legislation, may instead become a reversal of the onus of proof.

³¹ For instance, Brazil, Colombia and Venezuela.

the two most important factors in achieving and maintaining the elimination of systemic corruption in public institutions. Governments are not the only stakeholders in the anti-corruption landscape. Private sector organizations, professional organizations, religious leaders, and civil society groups all have a stake in the outcome and an interest in the process. For the most part, the Bank, as lender to governments, can play only a limited role in supporting civil society in the fight against corruption. However, within its mandate and with the full support of governments, the Bank has undertaken, mostly through EDI, activities such as "integrity workshops" and the training of investigative journalists. More participatory approaches to project design and implementation also make a contribution, as do Bank efforts to help countries improve the legal framework for NGOs. And, as our understanding of what can be done grows, there may be scope for further activities involving civil society, such as public education programs.³²

5.30 National Coalitions. In countries where the government has sought Bank assistance in developing an anti-corruption strategy, policy makers may be interested in developing a non-partisan approach to corruption. *The "integrity workshops" that EDI has facilitated can be an effective way of assisting this process by providing a forum for the discussion of international experience and local alternatives.* This is a new and promising activity for the Bank, but it requires careful preparation.³³

5.31 Open and Transparent Government. Corruption thrives in the dark. The Working Group reviewed activities that the Bank might support to encourage open and transparent government. Publication of government budgets and their availability in easy-to-read summary form, frequent reports to the legislature on budget implementation that enable comparisons to be made between budgeted and actual revenues and expenditures, and timely preparation of public accounts and audit reports and their scrutiny by the legislature and the media are the foundation of open and accountable government. Government departments and agencies should also produce annual reports on their activities, achievements, and financial results, and, eventually, national governments. To the extent that performance information can be included, agency accountability should improve. In some countries "sunshine laws" (which require agencies to hold public hearings prior to making policy or program decisions) and "freedom of information" laws (which require governments to make available information unless there are supervening public policy measures for secrecy) may be appropriate. Court decisions should be published. And the regular publication of consultative documents when a policy change is contemplated is good practice everywhere. If the Bank develops a medium term fiscal support instrument (Chapter 7), *conditioning lending on more transparent budgeting and financial management would strengthen public accountability and help counter corruption.*

³² Public education is, for example, strongly emphasized in the anti-corruption strategy of Hongkong's Independent Commission Against Corruption (ICAC).

³³ EDI normally seeks both a government and a civil society partner.

External Agency Practices and Public Sector Management

5.32 Finally, the Working Group considered the effect of Bank lending on country efforts to control corruption. We concluded that Bank (and bilateral aid donor) modes of operation might work against national efforts in a number of respects, and *certain Bank practices associated with "enclaving" needed to change*. In a broader sense, it is also possible that high levels of aid to poor countries may, in ways not fully understood, slow the emergence of institutions of state accountability that otherwise might develop (as they did historically in industrialized countries) if states were more dependent on local revenue sources.

5.33 **Enclaving.** One concern we have is with the Bank's instinct to "enclave" – the safeguarding of Bank operations from the weaknesses of the borrower's public sector by insisting on an implementation environment different from the prevailing government management systems. A long acknowledged (and now less common) example is the project implementation unit (PIU), appropriate only in specified circumstances. Other examples include salary supplements (or "leave of absence" contracts), social funds, and free-standing public works agencies, if they are created for what properly are central government functions.³⁴ The reasons for enclaving are understandable, given the Bank's fiduciary responsibilities and staff desire for smoothly running projects in situations where government systems of budgeting, accounting, procurement and personnel management are weak. To some extent, they are inherent in any project-centered approach to lending.

5.34 *There needs to be more emphasis on the government's budgeting, accounting, auditing, procurement, and personnel management systems, and on what needs to be done for these systems to sustain Bank projects.* This would focus management and staff attention more explicitly on the condition of those systems and how they might be improved. In turn, this would help governments control fraud and corruption.

5.35 **Soft Budget Effects of Aid.** Concerns were voiced within the Working Group that the way aid has traditionally been provided by the Bank and bilateral donors may have undermined governance in high aid inflow countries, by expanding government's reach, by discouraging a rationalization of functions and redeployment of resources, and by softening budget constraints. Donor emphasis on funding projects in public investment programs (PIP), channeled through a dual budget structure, has had a powerful expansionary effect on government spending, when coupled with increasing aid flows. Although donor projects now focus on the rehabilitation of existing services more than

³⁴ It is appropriate to create a social fund or a public works agency if the activities to be performed are, in public management terms, best handled by autonomous agencies with separate governance structures at arms length from the government department with portfolio responsibility. Credit to small entrepreneurs or grants to community schemes without recourse to further government funding can be administered effectively by stand-alone agencies. But where the financing of an activity (for example, building a public primary school) results in recurring departmental staffing and maintenance responsibilities, or involves policy-making, a social fund will not be an appropriate mechanism.

their expansion, the *de facto* fragmentation of budgets in aid dependent countries resulting from dual budgeting still discourages a full consideration of trade-offs in the allocation of resources. Furthermore, the additionality of aid softens budget constraints, which should discipline policy choice.³⁵ When accountability is externalized, national accountability mechanisms are weakened and this may allow corruption to flourish.

5.36 One way to promote more discipline in policy making and better financial management in countries that are highly aid dependent would be *to shift a proportion of aid flows from project to program-based financing, and to conditional general budgetary support, within a Medium Term Expenditure Framework. This has long been politically difficult to achieve, given bilateral aid objectives, but the Bank should renew its efforts to build support among donors, and provide lending instruments to underpin such an approach.*

5.37 On the Bank's part, such budget support lending could be conditioned on the installation and operation of sound public management systems (with the control of corruption as one objective), just as earlier policy-based lending supported economic policy reform. The new form of lending would disburse more slowly, based on quarterly releases of budgetary spending reports, annual accounts, and audit reports.

³⁵ Faced with an offer of concessional project aid, a government in a poor country has every incentive to accept it even where it doubts the domestic budget can sustain project operating costs. Governments have been right so far in their assumption that donors will meet the shortfall, perhaps disguised in a "rehabilitation" project.

CHAPTER 6

INTERNATIONAL EFFORTS

6.1 The Bank's contributions to international efforts to control corruption -- in particular, to reduce bribery between developing country officials and businesses from the industrialized countries³⁶ -- are an important complement to its country-based work. Corruption is a global problem which requires complementary action by both the North and South. In the international area, we believe the Bank's objectives should be:

- to ensure that the Bank's initiatives in fighting corruption are understood in international fora;
- to take advantage of the Bank's unique position, as the only organization with near-universal membership whose *raison d'être* is economic development of poor countries to stress the importance of international action against corruption;
- to support initiatives among countries to control bribery in international-business transactions; and
- to demonstrate to our borrowers that we are complementing our advice on national efforts with action on the international front.

Current International Initiatives

6.2 Although corruption of national officials is a criminal offense in most countries, transnational bribery generally is not. To make international corruption a crime will require changes in laws or the adoption of new laws and mechanisms to enforce them. This in turn will require the necessary parliamentary support and enforcement machinery. Except for the United States, which adopted the Foreign Corrupt Practices Act in 1977, countries have been reluctant to act unilaterally for fear of jeopardizing the business interests of their nationals by subjecting them to more stringent standards of behavior than their foreign competitors. International organizations provide a forum to agree upon common definitions and standards and to coordinate actions. Regional organizations have sponsored international conventions making bribery (including international bribery) a crime.

6.3 ***The OAS Convention.*** The most advanced effort so far is the OAS Inter-American Convention Against Corruption, adopted at Caracas, Venezuela on March 29,

³⁶ A recent survey of developing country course participants at Harvard shows that they rate measures against domestically induced corruption as the most important, but they also consider that joint-foreign corruption is an issue which must be addressed if domestic corruption is to be tackled. (D. Kauffman, 1996 Draft).

1996. At present, 23 of 35 members of the OAS have signed the Convention. It is now in force between the first two countries that have ratified it, Bolivia and Paraguay. The Convention is open to ratification by all OAS Member States, and any other State may accede to it.

6.4 Building on the Convention, the OAS General Assembly will be considering a comprehensive Plan Against Corruption. Under the Plan of Action, the OAS would provide support to its member countries and cooperate with other international organizations, including the Bank, the Inter-American Development Bank (itself preparing a plan of action) and OECD, and with local populations in the prevention and control of corruption.

6.5 *OECD Working Group on Bribery.* The OECD initiative, begun in 1994, encourages member states to end the tax deductibility of bribes and criminalize the bribing of foreign officials. The focus of the work has been on defining common elements that could be reflected in national laws. In 1996 the OECD Council adopted a Recommendation on ending tax deductibility for foreign bribery, and member states, within the framework of their laws, are moving to amend existing legislation in this regard. Following this, the Working Group has explored ways in which the criminalization of foreign bribery could be introduced by member states in a coordinated way. It is due to submit its proposals to the OECD Council very shortly.

6.7 In related work, at the May 1996 High Level Meeting, the Development Assistance Committee of the OECD recommended to members that they "introduce or require anti-corruption provisions governing bilateral aid-funded procurement."

6.8 *The European Union.* The European Union has submitted to members a draft protocol to the Convention on the Protection of the European Communities' Financial Interests. The Convention criminalizes fraud against the Communities, and the Protocol would criminalize active and passive corruption by employees of the Communities.

6.9 *The Council of Europe.* The Council of Europe Programme of Action Against Corruption, prepared by the Multidisciplinary Group on Corruption (GMC) and adopted by the Committee of Ministers in November 1996, serves as the basis for the preparation of two conventions. The first is a Framework Convention on Corruption, which would contain broad principles, and the second is a Convention on Corruption, under which parties would agree to legislate (if necessary) to criminalize certain types of corrupt behavior. The GMC has also undertaken work on the administrative and civil law aspects of corruption.

6.10 *The United Nations.* In December 1996, the UN General Assembly adopted a Declaration against Corruption and Bribery in International Commercial Transactions, as recommended by the UN Economic and Social Council. Although not legally binding, the Declaration's wording on criminalization of foreign bribery and ending of tax deductibility signifies broad political agreement in the international community on this matter. In

February 1996, the United Nations General Assembly recommended that the Economic and Social Council take steps to prevent illicit payments.

6.11 **Money Laundering.** International organizations have been active in addressing money laundering and expanding the list of offenses, including corruption, that constitute money laundering. The forty Recommendations of the Financial Action Task Force on Money Laundering (FATF) include non-drug predicate offenses. They now require the criminalization of money laundering based on "serious offenses." This recognizes that it is practically impossible to distinguish between drug trafficking proceeds and their laundering and any other type of dirty money. Each jurisdiction is responsible for determining which serious crimes should be designated as money laundering predicate offenses. This opens the way for countries to include corruption as a predicate offense. Originally targeted for OECD countries, the 40 FATF recommendations are now being addressed also to middle income countries in the hope that governments adopt them and cooperate with other authorities in international efforts to control money laundering.

6.12 **International Business Initiatives.** In March 1996, the International Chamber of Commerce (ICC) issued revised Rules of Conduct to Combat Extortion and Bribery in International Business Transactions. The Rules prohibit extortion and bribery for any purpose. They also recommend implementation of the 1994 OECD recommendation on curbing bribery in international business. The Rules are not binding on ICC members, but corporations may endorse them voluntarily. To promote the new rules, the ICC will set up a standing committee of business executives, lawyers and academics. ICC national committees mobilize support for the Rules in their own countries.

6.13 **Non-Governmental Organizations.** NGOs around the world are participating in the efforts of local governments and other entities to curb corruption. Among the international NGOs, Transparency International, based in Berlin, Germany, aims to: (i) curb corruption through international and national coalitions encouraging governments to establish and implement effective laws, policies and anti-corruption programs, (ii) strengthen public support for anti-corruption programs and enhance public transparency and accountability in international business transactions and in the administration of public procurement, and (iii) encourage all parties to international business transactions to operate at the highest levels of integrity, guided by TI's Standards of Conduct. TI has established more than 70 national chapters that fight corruption at the national level. TI has contributed significantly to making corruption a public issue in the press and elsewhere and is cooperating with international organizations (including the Bank) in actions against corruption. In June 1996, the Bank invited TI to participate in a senior management seminar on corruption.

Bank Actions at the International Level

6.14 The Bank should increase its participation in and support of international efforts to fight corruption. As the Bank gains a better feel for the issues being confronted and the politics involved, the Bank may identify initiatives to lend its weight to or may make proposals of its own. Actions of the Bank may be looked upon as models for other MDBs. Specific international initiatives can be considered once the Bank has a firmer grasp of existing initiatives and their prospects of success. The Bank's support of international efforts at curbing corruption, could include:

- *Using conferences, meetings and interviews with the media to explain the Bank's position on the need to control fraud and corruption and to maintain public awareness of the Bank's contribution to this effort.* The Bank is well placed to articulate the economic costs of corruption in developing countries.³⁷
- *Continued cooperating with the IMF and other MDBs in this area.* These institutions have been briefed on the Bank's approach to corruption, and we have begun cooperating on staff training programs. We should also work closely with bilateral aid donors, as appropriate.
- *Contributing to the work of the OECD Working Group on Bribery* by ensuring that the Bank's technical expertise at its disposal.³⁸
- *Contributing to the work of the Council of Europe's Multidisciplinary Group on Corruption (GMC)* in which the Bank has observer status.³⁹
- *Developing and maintaining contacts with other agencies active in this area,* such as the UN Drug Control Program, the UN Centre for Crime Prevention and Control, the Commonwealth Secretariat, and professional bodies such as the International Commission of Jurists, the International Organization of Supreme Audit Institutions (INTOSAI), the International Bar Association (IBA) and the International Federation of Accountants (IFAC).

³⁷ As an example, the Bank will be participating at a high level in the Eighth International Anti-Corruption Conference in Peru on September 8-12, 1997. Teleconferencing should be used to broaden the reach of major anti-corruption conferences, and existing teleconferences by other organizations should be supported upon request (as the Bank is doing with USAID's Western Hemisphere teleconferences on anti-corruption).

³⁸ The Bank has already attended four meetings of the Working Group on Corruption, in July and November 1996 and February and April 1997, contributing its experience to technical discussions on procurement, accounting and auditing standards, and on public service issues in developing countries.

³⁹ The Council of Europe has invited the Bank to attend its meetings as an observer and to brief members on anti-corruption activities. Bank staff attended the most recent meetings of the GMC in Strasbourg, January and March 1997.

- *Consulting with the business community to understand better their perspectives on corruption and the feasibility of measures to control bribery in international business transactions.*

6.15 With regard to supervising or promoting (with the OECD or the WTO) a multilateral treaty to make international bribery a crime, we believe that, while the Bank should encourage such international efforts, it should not sponsor or promote a specific treaty. Many other organizations have already undertaken this work. Moreover, opinions are divided whether the focus of efforts should be on a convention, which would have the force of international law but might take longer to negotiate, or on recommendations for coordinated national actions.⁴⁰ Within the Bank, views differ on the best route forward for the international community. Conventions have a patchy record when important potential participants do not feel immediately threatened by the *status quo*, while national action that is not backed by co-ordinated international obligations is dependent on domestic political will to move a commonly agreed agenda forward.

6.16 The Bank is an observer, not a player, in these deliberations. However, it can contribute constructively to the outcome by making its knowledge of developing country conditions available, and by drawing attention to the importance of international actions to control transnational fraud and corruption. And we have a vital stake in the outcome.

⁴⁰ Business groups in some countries in Europe argue for the negotiation of a convention to criminalize bribery in international business transactions. This would come into effect only when a majority of signatories had ratified it. Other groups argue that the "soft law and peer pressure" approach being explored by the OECD Working Group will yield quicker progress in curbing the bribery of foreign officials, and that relying on a convention will slow international action on this critical issue.

CHAPTER 7

IMPLEMENTATION

7.1 This final chapter suggests how the Bank should move forward to bring a greater concern for corruption into the mainstream of Bank work. Four key thoughts should guide these efforts.

7.2 First, a Corruption Action Plan is best thought of not as a set of new initiatives, but rather the more explicit integration of the problem (of which staff and management have long been aware) in Bank lending, ESW, research, and country dialog. Therefore, the Report's recommendations are primarily about modifying and/or expanding existing approaches rather than launching whole new approaches. For this reason, *the cost implications are relatively modest, though the operational implications are far-reaching.*

7.3 Second, if the Bank is to help its member countries, it has some catching up to do of its own. It will have to learn what works and what does not in the fight against corruption. Notwithstanding mostly successful efforts over many years to control corruption within the projects it finances and a distinguished record of policy advice, the Bank is at an early stage in building up the knowledge it requires to help countries develop and implement anti-corruption strategies. This Report provides a framework, not a blueprint. This framework must now be filled in, with research, policy work, project design, country studies, open dialogue with governments, learning from country experience, participation in international efforts, and interaction with other bodies active this field. In gathering this information and disseminating it, the new "knowledge management" systems of the Bank will be crucial.

7.4 Third, while corruption has clear economic costs, corruption is also a dimension of the way power is exercised, and thus a sensitive issue of governance in many countries. Although many governments are more receptive to discussing the control of corruption than they were several years ago, the subject remains one that needs careful handling. Consequently, we are not making a blanket recommendation for "regional action plans." While this solution may be appropriate for some regions, it is by no means the choice for all. Such a decision should be left to regional managers. Corruption is no longer an embargoed subject, and the responsibility rests with country and regional managers to use that freedom in ways that support the borrower's development objectives.⁴¹

7.5 Fourth, institutions are central in the fight against corruption. Getting economic policy right, maintaining financial management systems, and practicing sound procurement across the public sector depends on well-functioning institutions. Seen in this way, corruption is a symptom as much as a cause of malaise. The Bank's needs to deepen its

⁴¹ There will, however, be reporting objections for the Statagic Compact, and regional management will be expected to move ahead strengthening skills in areas such as financial management and procurement.

existing understanding of how institutions evolve, and what external agencies can do to help countries develop strong institutions. It needs to put more emphasis on high-quality public sector management and governance work. This has implications for staff skills and the resources the Bank devotes to this area.

Economic Work

7.6 *Increasing Transparency.* The first requirement in mainstreaming a concern for corruption is for the Bank to bring the issue "out of the closet." To a significant extent, this is already happening. Discussion of corruption has been intensifying within the Bank in recent years, and the President's Annual Meetings Speech in 1996 has accelerated it. But corruption is still inadequately addressed in Bank analytical work. As long as this persists, the phenomenon will not be sufficiently understood nor integrated into management decisions. And the Bank is to some extent playing "catch-up," acknowledging that corruption poses a threat to development but doing so in the wake of media attention and international recognition of a major problem.⁴²

7.7 *Economic and Sector Work (ESW).* Nor will we be able to provide governments with sound policy advice if we do not make the required intellectual investment. Economic and Sector Work (ESW) has generally ignored the topic of corruption, referring to it elliptically with phrases like "rent seeking," "leakage," and "misappropriation." Staff reluctance to address the topic directly is easily comprehended in the light of perceived political sensitivity, the lack of hard evidence, the complexity of the subject, and, hitherto, lack of encouragement from management. Few, if any, Poverty Assessments (PAs) discuss the impact of petty corruption, even though the poor in many countries experience extortion by public officials daily. Public Expenditure Reviews (PERs), with their focus on the allocation of government spending, rarely confront the issue – even though corruption may mean that inputs are being used to produce "outputs" and result in "outcomes" quite different to those represented in budgets approved by the legislature. Most country economic memoranda (CEMs), sector studies, and environmental assessments also choose to ignore the issue. The only category of ESW that has a solid track record of surveying corruption issues regularly are Private Sector Assessments (PSAs). In select countries EDI's Service Delivery Surveys, which ask beneficiaries about the quality of government services, also yield information on corruption.

7.8 Formal guidelines and an instruction to staff to always address corruption in ESW, we believe, are neither necessary nor appropriate. Nor are we recommending new categories of Bank investigation, such as "Country Corruption Assessments" or new corruption reporting requirements for country staff. To do so would be to misunderstand the task ahead of us. Rather, with the lead given by the President at the 1996 Annual Meetings, with the greater openness surrounding the subject, and with appropriate staff

⁴² The most outstanding example of how open governments have become in acknowledging the problem and their preparedness to discuss it is the communiqué of the Summit of the Americas in Miami in 1995.

training on the subject, self-censorship should recede. Chief economists and country directors, however, should be prepared to guide staff on how the issue might best be addressed regionally and in individual country circumstances.

7.9 **Research.** Research outside the World Bank on corruption has grown considerably. There is now a substantial body of academic literature. Much of this is theoretical, but it has begun to shed light on the complexities of corruption and how it affects economic performance. There is also a growing body of work on how corruption might be controlled. Little of this work is empirical, but this is beginning to change as survey data accumulates (and will be given a boost by the 1997 WDR survey of 3500 firms in 67 countries). Inside the World Bank there is no explicit research under way on corruption. However, research in several areas, such as property rights and aid effectiveness, touches on the issue.

7.10 *The Working Group believes there is a need for the Bank to put more resources into research on corruption.* Our principal concern is whether there will be adequate funding. In recent years both PRD's own budget and the Research Support Budget have declined. This trend needs to be reversed if the Bank is to build the intellectual capital it needs to become a "Knowledge Bank." Budget resources allocated to research should be increased. DEC and the Research Committee, on their part, should be open to well-thought-out research proposals on corruption.

Country Assistance Strategies

7.11 We also carried out a review of current Country Assistance Strategy (CAS) papers. This showed that corruption is seldom adequately addressed either as a factor affecting Bank projects or as a development effectiveness issue. The reasons are similar to ESW – the lack of direct evidence, borrower sensitivity and, in earlier times, active discouragement by managers. In addition staff are uncertain how to deal with systemic corruption if its presence is determined. Bank staff feel professionally more at ease assessing a government's economic policy record than its integrity.

7.12 But failure to address corruption for countries where it exists diminishes the value of the CAS as a mechanism for both programming Bank lending and ESW, and for raising important matters with the government. This needs to be rectified, and future CASs should discuss problems of fraud and corruption in cases where they are serious and affect Bank projects and/or economic and social development generally.

7.13 The sensitivity of many borrowers to the subject is likely to be less than it was several years ago. There has been significant media coverage of the problem in both rich and poor countries, and governments are less likely to feel they are being singled out if the Bank discusses corruption in the CAS. Furthermore, even if some groups in the government are upset, others may welcome the Bank drawing attention to corruption problems. In many countries recently, elections have been fought on the issue of corruption.

The Lending Program

7.14 The Bank needs to take corruption into account more explicitly in decisions on country lending programs. In the past the Bank has been heavily criticized for continuing to lend to countries where corruption was pervasive and a clear obstacle to development. However, it would be unrealistic to go from a position where little notice of corruption was taken to one in which the level of corruption determined the size of the lending program. While this might satisfy some critics of the Bank, it would be at odds with the Bank's interest in addressing corruption not in moral terms but as a constraint to development. From this perspective, corruption, like inadequate skills, is something standing in the way of a well-performing public sector.

7.15 The attention given in the lending program to creating an "enabling environment" for the private sector obviously should continue. But it needs to be complemented with an approach that makes the performance of the public sector a central concern of the country dialogue and lending. Within the broad framework described in Chapter 3, the lending program should be calibrated according to the extent to which corruption affects both Bank projects and development objectives generally, and the efforts of government to control it. This can be done without changing existing IDA and IBRD allocation criteria, which are based on country and portfolio performance.

7.16 This Report has argued that projects need to be prepared in a way that integrates institutional considerations and assesses corruption risks more explicitly at the design stage. The professionalism of Bank staff means that many have been doing this already, but experience has not been widely shared, and institutional learning has thus been low.

7.17 As discussion and analysis of corruption becomes more explicit in ESW, in staff dialogue with country counterparts, and in project design, a body of best-practice knowledge will gradually be built. It will be important to capture this and disseminate it through the Knowledge Networks and in staff training. *A "Knowledge Centre" on corruption should be created in the PREM Network.*

Pilot Countries

7.18 In his Annual Meetings Speech, Mr. Wolfensohn pledged the Bank's support for countries that seek assistance in the control of corruption. In at least three regions (ECA, Africa, and LAC), countries have made approaches to the Bank. Whatever these initial country cooperation programs are called (the term "pilot" may have the wrong connotation), it is important that the experience is shared within the Bank and lessons are learned and disseminated. It will also be desirable to share lessons learned with other MDBs, consistent with the current policy of exchanging information on this issue.

Lending Instruments

7.19 The Bank should be prepared to use a wide range of lending instruments to support countries that are seeking to control corruption. The Institutional Development Fund (IDF) has been extensively used to finance innovative public management activities and we expect this to extend into anti-corruption work. TA loans, often accompanying SALs and SECALs, have been a mainstay of Bank efforts to help countries implement public management reforms.

7.20 SALs and SECALs can continue to be used to support economic policy reform. However, new lending approaches -- for example slow-disbursing fiscal support lending -- might also be considered to help the Bank more effectively support the broad institutional changes needed to improve public sector performance. Within a clearly articulated medium term framework, such loans could support the restructuring of government policies and programs consistent with a changed role of the state, and foster transparency and accountability in financial management and in the conduct of public business generally.

7.21 An important aim would be to impose a hard budget constraint on governments, and thus encourage the trade-offs and policy decisions that well-performing governments must routinely make (but poor countries find difficult, in part because of the effective fragmentation of budgets that results from high aid inflow). Such an instrument would require close coordination with other major donors. The existing public sector adjustment loan (PSAL)⁴⁴ could be the foundation, but it could be adapted to support a Medium Term Expenditure Framework (MTEF) and be released in measured installments over several years.⁴⁵ *We recommend that Legal, OPR, and the PREM Network explore the potential for introducing such an instrument for supporting longer-term public sector reform.*

Procurement and Disbursement Under Bank-Financed Projects

7.22 Two important initiatives are moving forward within the framework of Bank-financed projects. These are aimed at improving borrower accountability and thus complement the broader country measures described in this report. First, there will be a progressive shift of emphasis from pre- to post audits for all but the largest procurement contracts, to be carried out by local consultants. Second, the Loan Administration Change Initiatives (LACI) will make the Bank's own disbursement process more transparent and cost effective. By moving from a transaction-based disbursement system to lump-sum disbursements, based on a sound financial plan for the project and quarterly financial

⁴⁴ A PSAL rather than a conventional SECAL is appropriate because in budgetary terms PSM is not a sector but the operating system of government.

⁴⁵ This idea has much in common with the proposal, now being discussed in the Bank, to develop a Public Expenditure Adjustment Loan, but ties it expressly to a MTEF, emphasizes a hard budget constraint, and shifts the emphasis of policy conditionality to the processes of a transparent and well-functioning budgeting and financial management system.

reports submitted by borrowers, borrower accountability should be strengthened. In turn this will build the capacity to control corruption.

Monitoring and Dissemination

7.23 Any anti-corruption work undertaken by the Bank should be carefully monitored. A progress report on governance is due to the Board in FY99, and this could be one monitoring tool and could contain a substantive section on the control of corruption. In addition specific implementation indicators can be expected to be developed as part of the monitoring of the Strategic Compact.

7.24 The CAPWG Report is an internal report to senior management by a group of Bank staff. *The Bank should in due course set forth its approach to corruption in a document written for outside circulation, once senior management and the Board have approved a policy.* Such a document would explain why the Bank believes corruption undermines development, and how it will support efforts to reduce it. It will reiterate the Bank's willingness to help governments control corruption, its determination to keep Bank-financed procurement free from corruption, and the Bank's support for international efforts to control corruption.

Training

7.25 A theme of this report is that addressing corruption is not an additional set of activities but a central part of the Bank's mandate, and it should be integrated into Bank work. Thus, the training proposals for mainstreaming the control of corruption are mostly about adapting existing training courses rather than launching new courses. We propose the following:

- (i) Current training programs oriented to a particular sector should progressively include material showing how projects may be designed in ways to minimize scope for corruption. Case studies will need to be developed over time, building on regional experience and using the network anchors to assemble the material.
- (ii) Public sector management training programs should be modified to include a module on anti-corruption, to sensitize staff and to show how corruption can be addressed within a PSM and governance framework.
- (iii) Workshops on the analysis of corruption and the development of anti-corruption strategies should be organized, aimed initially at Bank staff working on countries where corruption is an issue of development effectiveness, or on countries which may approach the Bank to support an intensified effort to combat corruption.⁴⁵

⁴⁵ A pilot workshop took place in the beginning of February 1997, coordinated jointly by the PSM Unit and the LLC. This has been evaluated for lessons that can be included in future training events.

Staffing Implications

7.26 If the mainstreaming recommended in this report is accepted, the bulk of the responsibility for implementation will fall upon existing staff. Thus the additional manpower required to implement the recommendations is modest, and many needs can be accommodated through staff training.

7.27 However, in three areas staffing levels are inadequate and need to be improved.

- (i) The number of skilled financial management specialists in central VPs and the regions has declined in recent years, a trend the Financial Reporting and Auditing Task Force Report in 1994 drew attention to. Existing specialists are already overloaded, and new staff are needed to enable the Bank to assess borrower financial management systems and to provide assistance to countries seeking to improve them.
- (ii) The Bank also needs more procurement specialists. In theory, some relief may be obtained by shifting the emphasis from prior review to post-audits (as recommended in the Working Group's companion report on internal controls). But these, too, require budget funds to hire local external auditors. Furthermore, if the Bank is to help more governments improve their own procurement systems, there will be additional staff costs.
- (iii) Public sector reform expertise needs strengthening. Building better institutions helps control corruption. This means calls on the existing cadre of public management specialists and institutional and public finance economists are likely to grow, and an increase in their numbers will be necessary. This is particularly true for the central VPs, if lessons of experience and best practices are to be duly collected and disseminated through the Knowledge Networks.

Costs of Implementing the Action Program

7.28 Implementing the Action Program will require additional resources. It is the task of the budget process to provide precise estimates. However some preliminary indications of where costs will fall can be provided.

- (i) **Economic and Sector Policy Reform.** There should be no additional costs to the regions in providing economic policy reform advice to the government. Bank macroeconomists and sector staff already do this. Nor should incorporating a greater focus on corruption in ESW add significant costs. The principal area where more resources will be required is research, where the block funding should be increased. An additional \$500,000 annually is proposed in the Strategic Compact.
- (ii) **Institutional Strengthening.** A concern for corruption means a greater emphasis on the performance of public sector institutions. Over time this will require a

strengthening of public sector management staff in the regions in the Network and in DEC. We also anticipate an increased demand for short-term consulting support, above that provided for by regular PSM work, when the Bank has been requested by the governments to assist in the preparation of anti-corruption strategies. EDI is also expected to expand its "integrity workshops" and related work.

- (iii) **Control of Corruption in Bank Projects.** Costs are likely to be substantial in two regards. On the procurement side there is a requirement to fund the second cycle of surprise country procurement audits, a once-off cost (see companion report on internal control). On a more permanent basis, there is a need to increase the number of procurement staff and fund external auditors to systematically carry out post-audit work on both procurement and disbursement. Annual costs will be \$6.5 million approximately. Additional procurement staff are also needed if both the intensity and coverage of CPARs is to be broadened, and advice given to governments. A substantial funding increase, estimated at \$10 million annually, is required to reverse the declining trend in financial management specialists, as discussed earlier.
- (v) **International Coordination.** Costs are likely to be modest – the travel and subsistence expenses of Bank staff attending international fora and perhaps the sponsorship of selected conferences.

Personal Security and Risks

7.29 Finally, the Report ends with a warning on personal risks to Bank staff and counterparts working with them. Previous initiatives of the Bank - on poverty, participation, the environment, or private sector development - have not brought the Bank in close proximity with criminal activity. Anti-corruption work is different. Not only is the bribing of public officials illegal in all borrower countries, but in many countries there are close links between systemic corruption and organized crime, and the risk to the personal security of Bank staff and those working with them cannot be lightly dismissed. Close inspection of substandard construction, the persistent checking of project accounts that have been subject to large scale fraud, pressure on governments to abandon white elephant projects in which politically powerful figures have a financial stake, or work on the banking system in countries experiencing large scale money laundering can be hazardous activities for Bank staff and local counterparts. Managers need to be sensitive to these risks. They must avoid placing staff in potentially dangerous situations and be prepared to support them, if necessary by withdrawal, in the face of threats. Staff need to be aware of possible danger and to know that managers will support them.

Annex

LIST OF CAPWG MEMBERS

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The overall task force was coordinated by Mike Stevens, under the general direction of Sven Sandström. Sub-groups on Economic Policy, Institutions, Bank Projects and Internal Controls, and International Actions were led, respectively, by Cheryl Gray, Malcolm Rowat, Myla Williams, and Louis Forget. Paul Siegelbaum analyzed the findings of the informal staff survey. Participants were drawn from across the World Bank Group. Peter Calderon, Alejandro Escobar, and Karin Millett represented IFC, ICSID and MIGA respectively. The geographic Regions of the Bank were represented by Steve Weissman (AFR), Rohil Hafeez (S. Asia), Klaus Rohland (E. Asia), Paul Siegelbaum (ECA), Daniela Gressani (MNA), and Malcolm Rowat (LAC). The Chairman of Transparency International (TI), Peter Eigen, and Managing Director, Jeremy Pope, provided advice to the Working Group.

A L L - I N - 1 N O T E

DATE: 24-Apr-1997 00:35am

TO: MARK MALLOCH BROWN

(MARK MALLOCH BROWN@A1@WBWASH)

FROM: Mike Stevens, PGP

(MIKE STEVENS@A1@WBHQB)

EXT.: 37493

SUBJECT: JDW Briefing on Corruption

Mark,

1. Reflecting on this evening's meeting - in which, for the benefit of those copied this EM but not attending, JDW expressed dissatisfaction on what was happening on the anti-corruption front - I think the problem lies in different expectations of what tackling corruption entails. JDW is impatient, feeling what is being offered as progress is old Bank. He feels that, having raised the banner, he needs to report, if not early victories, some significant advances. We are saying the troops are mobilizing, but the enemy is wily and we need to take up our dispositions carefully. Churchill's generals had the same problem.

2. The differences are significant, and we should understand them before moving to solutions.

3. The Annual Meetings speech called corruption a cancer. Apt in one sense (no quick cures, many forms and some are terminal), the wrong metaphor in another - corruption is symptom, not the disease itself. Our identification of the immediate causes (rent creating policies and weak institutions) provides a target against which existing Bank instruments, suitably sharpened, can be deployed. More fundamentally, corruption is a reflection of deeper conditions in society. Seen this way, corruption is a manifestation of underdevelopment.

4. The Working Group's brief is to produce an action plan. We have done this, but it is a different action plan to what JDW probably expects. Instead of measures of immediate impact JDW can announce to the expectant press, we are proposing internal changes (re-skilling, research, ESW) that will put the Bank in better position to assist countries tackle corruption (or recognize better when we should walk away). With this comes the message: we do a lot already, we could do more, and we could do some new things with a specific anti-corruption focus. This comes with the warning that corruption actually is a very complex phenomenon, and we don't have all the answers.

5. Yes, the costs of corruption are high (but varied); Yes, the declaration of war was popular with NGOs and with opinion

makers within countries (according to Dani Kaufmann's survey work). But missing from JDW's equation is our borrowers, who are distinctly ambivalent. Push too hard and we raise the transaction costs of borrowing from the Bank, and quickly we confront the sort of lending program problems you were talking about in the second half of the briefing.

6. Some other tensions: the more we try to control corruption in Bank projects, the more we could undermine borrower accountability unless we change our systems (which is why LACI is important). The more aid we provide low income countries, the greater the risks of externalizing accountability. And as lender to governments, there is a limit to what we can do in civil society - ultimately the most important factor in sustainable reduction in corruption. For the Bank, anti-Corruption is full of paradoxes.

7. If this sounds like the old Bank, it isn't. The old Bank never felt the issue could be addressed outside Bank projects, except in some egregious African cases. Now we are seriously trying to get our hands round the subject as a development issue. Step 1 is to recognize the issue, in ESW, project design, country dialogue, lending program decisions, research etc. Step 2 is to mainstream a concern for corruption (and what lies behind it) in Bank lending without unduly raising transactions costs to governments. (Reviewing the Regions' Business Plans last week, I noted that buy-in is uneven - I kept that out of the brief).

8. Are there low hanging fruit? Probably few. Our change of rules (not of heart) on NBPs has been presented in the best light. We can't advocate it to borrowers since it is untested and not a single procurement professional in the Bank has a good word to say on the idea (and they are our front line troops at the project level). The best we can do is ensure it is tested well. ICC (if I recall it correctly) emphasizes codes of conduct as a condition for bidding. Fine if you are a US company which needs such a code to keep the right side of the FCPA, not if you are the Bank trying to broaden the range of countries bidding on Bank financed projects. Could we promote codes as a long term objective - possibly, but somebody has to do it, and the procurement people are too busy. Special pleading on the ICC's part? Make it stick and you both keep middle income country competitors out, and lower your own bidding costs.

9. So what to do? The Annual Meetings speech was a great opening salvo, sending a signal to borrowers, staff, media and critics. Now we have to gear up for a long and difficult campaign against a formidable opponent. This means the message has to change. I think there are successes we can begin to report, but we need to tease them out of the fog of operations. JDW should strongly emphasize the contribution of economic policy reform to reducing rents, since this is a distinctively

Bank contribution. I would guess that there are stories illustrating this at the sector as well as the macro level, though we have no systematic means of recording them. (Eastern Europe well illustrates the importance of carrying through policy reform from an economic point of view, relative to FSU, and doubtless also does on the corruption front). Institution building success stories are hard to find, but I surmise there are places where interventions at the agency level have reduced corruption (eg: tax or customs dept reform).

10. I appreciate the continuing problem you have with finding suitable success stories to illustrate the Bank's efforts (and the pitfalls of labelling a project a success). But it seems to me we could bring out enough ammunition for JDW to demonstrate to the press that we are moving forward at an increasing pace, and to deepen the message. The trick in moving beyond the Annual Meetings speech is to convey the complexities while at the same time showing that the Bank is mastering them.

11. More on procurement tomorrow, assuming I can contact the experts (Srini is in India, Chris Walser in China). Hope the above helps in thinking through presentation issues, and meeting JDW's concerns.

Mike

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TRANSPARENCY INTERNATIONAL
THE COALITION AGAINST CORRUPTION IN INTERNATIONAL BUSINESS TRANSACTIONS

COVER NOTE
FAX 8 PAGES

EMBARGOED
Not For Release Before Sunday,
June 2, 23.00 GMT

TO:

1996 Transparency International Corruption Perceptions Index

An Index of Perceptions of Business People Of Corruption Around The World

If you have questions about the TI Index then please contact:

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TRANSPARENCY INTERNATIONAL
THE COALITION AGAINST CORRUPTION IN INTERNATIONAL BUSINESS TRANSACTIONS**PRESS RELEASE****EMBARGOED**
Not For Release Before Sunday,
June 2, 23.00 GMT

1996 Transparency International Corruption Perceptions Index

An Index of Perceptions of Business People Of Corruption Around The World

June 2, 1996: At a time of growing public concern about corruption throughout the world, Transparency International (TI) releases its 1996 TI Corruption Perception Index. The Index, based on 10 international surveys of business people, reflects their impressions and perceptions of more than 50 countries.

"Inevitably, many developing countries emerge from an Index like this one as highly corrupt, but the research provides little comfort for the industrialised countries," stated Dr. Peter Eigen, Chairman of Transparency International (TI), the global coalition against corruption. He added that "most of the bribes on international contracts are paid by executives of corporations in the most advanced industrial countries and it remains an outrage that most of the governments of these countries have not legislated to curb international corrupt practices."

Research on the Index has been led by Dr. Johann Graf Lambsdorff and a research team of Göttingen University. He stated that "the Index is a poll of polls, putting together the subjective evaluations of business people. It provides insights into perceptions, which have an impact on how private companies, particularly in Japan, North America and Eastern Europe, operate in the rest of the world."

Dr. Lambsdorff said that many of the business people surveyed are from Western industrial countries and many of the surveys used in compiling the Index are run by Western organizations. These facts may lead to some bias in the results in favor of Western industrial countries and against the developing countries.

Transparency International is publishing its second Corruption Perceptions Index to highlight the damage that current corruption does and to try to galvanize action in all countries to curb corruption. The 1995 Index created widespread interest around the world, sparking debates in several parliaments and stimulating broader understanding of the issues of corruption.

The 1996 Index can not be directly compared to the 1995 Index as more countries and more surveys are involved this time. The data shows that in the case of some countries there was very considerable variance in perceptions, as recorded between the different surveys. Dr. Lambsdorff also pointed-out that since many of the surveys go back a few years it is impossible for the Index to accurately capture recent actions taken by governments to reduce corruption and create a healthier climate.

Press Release Page 2

The Transparency International Corruption Perception Index 1996											
R a n k	Country	Score 1996 (Max. 10.00)	Score 1995 (Max. 10.00)	Var. in 1996	S u r v e y s	R a n k	Country	Score 1996 (Max. 10.00)	Score 1995 (Max. 10.00)	Var. in 1996	S u r v e y s
1	New Zealand	9.43	9.55	0.39	6	28	Greece	5.01	4.04	3.37	6
2	Denmark	9.33	9.32	0.44	6	29	Taiwan	4.98	5.08	0.87	9
3	Sweden	9.08	8.87	0.30	6	30	Jordan	4.89		0.17	4
4	Finland	9.05	9.12	0.23	6	31	Hungary	4.86	4.12	2.19	6
5	Canada	8.96	8.87	0.15	6	32	Spain	4.31	4.35	2.48	6
6	Norway	8.87	8.61	0.20	6	33	Turkey	3.54	4.10	0.30	6
7	Singapore	8.80	9.26	2.38	10	34	Italy	3.42	2.99	4.78	6
8	Switzerland	8.76	8.76	0.24	6	35	Argentina	3.41	5.24	0.54	6
9	Netherlands	8.71	8.69	0.25	6	36	Bolivia	3.40		0.54	4
10	Australia	8.60	8.80	0.48	6	37	Thailand	3.33	2.79	1.24	10
11	Ireland	8.45	8.57	0.44	6	38	Mexico	3.30	3.18	0.22	7
12	Unit. Kingd.	8.44	8.57	0.25	7	39	Ecuador	3.19		0.42	4
13	Germany	8.27	8.14	0.53	6	40	Brazil	2.96	2.70	1.07	7
14	Israel	7.71		1.41	5	41	Egypt	2.84		6.64	4
15	USA	7.66	7.79	0.19	7	42	Colombia	2.73	3.44	2.41	6
16	Austria	7.59	7.13	0.41	6	43	Uganda	2.71		8.72	4
17	Japan	7.05	6.72	2.61	9	44	Philippines	2.69	2.77	0.49	8
18	Hong Kong	7.01	7.12	1.79	9	45	Indonesia	2.65	1.94	0.95	10
19	France	6.96	7.00	1.58	6	46	India	2.63	2.78	0.12	9
20	Belgium	6.84	6.85	1.41	6	47	Russia	2.58		0.94	5
21	Chile	6.80	7.94	2.53	7	48	Venezuela	2.50	2.66	0.40	7
22	Portugal	6.53	5.56	1.17	6	49	Cameroon	2.46		2.98	4
23	South Africa	5.68	5.62	3.30	6	50	China	2.43	2.16	0.52	9
24	Poland	5.57		3.63	4	51	Bangladesh	2.29		1.57	4
25	Czech. Rep.	5.37		2.11	4	52	Kenya	2.21		3.69	4
26	Malaysia	5.32	5.28	0.13	9	53	Pakistan	1.00	2.25	2.52	5
27	South Korea	5.02	4.29	2.30	9	54	Nigeria	0.69		6.37	4

Notes:

The rank relates solely to the results drawn from a number of surveys and reflects only the perceptions of business people that participated in these surveys.

Score 1996 relates to perceptions of the degree of which corruption is seen by business people - a perfect 10.00 would be a totally corrupt-free country.

Score 1995 the same approach was used in 1995, but fewer countries were included in the Index and fewer surveys were drawn upon - thus the 1995 column is at best a rough comparison.

Variance indicator different results from different surveys: the greater the variance, so the greater were the differences of perceptions of a country among the surveys used. Number of Surveys used: 10 surveys were used and at least 4 surveys were required for a country to be included in the list.

PRESS RELEASE Page 3

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Dr. Eigen stressed that: "the Index does not deal in certainties and facts. It does not state: 'These are the most corrupt countries.' And, while we are expanding the coverage, there are still more than 100 countries in the world that are not included in the Index."

The TI Chairman noted that TI is making major efforts to campaign for legislation across the industrial countries to criminalise the payment of bribes by corporations and to end practices that enable multinational enterprises to take tax deductions for their foreign bribe payments. "We are making progress, but much of the corruption in the developing countries is the direct result of corrupt multinational corporations and lax laws in the industrial countries. It was domestic pressures in the post-Watergate era that led to the passage of the Foreign Corrupt Practices Act in the United States almost two decades ago and the U.S. remains the only country that has tough criminal laws on the books today in the international bribery area."

Dr. Eigen stressed that corruption in major international contracting, often involving multinational corporations and known as 'grand corruption,' directly adds to widespread small-scale domestic corruption in many countries. The Index does not attempt to capture the levels of this kind of corruption, but TI and its national chapters around the world believe that this too is an area of critical concern.

Asked about the longer ranging historical perspectives, Dr. Lambsdorff remarked that "some countries have shown a remarkable increase in business confidence over the past 15 years. Portugal and Indonesia are noteworthy in this context. However, historical data shows that perceptions of corruption are increasing as far as Argentina, China and Russia are concerned, among others."

Attached are notes about corruption and the index.

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Transparency International Press Release - 4

Frequently asked questions

How do you measure the degree of corruption?

The index is not an assessment of the corruption level in any country as made by TI or Dr. Johann Graf Lambsdorff, rather it is an attempt to assess the level at which corruption is perceived by people working for multinational firms and institutions as impacting on commercial and social life. To the extent that any country has a problem with its ranking, this lies not with the index but rather with the perception that businessmen polled apparently have of that country. Their perceptions may not always be a fair reflection on the state of affairs, but they are reality. We are grateful to all corporations and individuals who supported us with their evaluations.

Is (e.g.) Nigeria the most corrupt country in the world?

No! Nigeria is perceived by business people to be the most corrupt country which has been included in our list. Keep in mind that some countries not included here are likely to score worse than Nigeria. Also the perception of corruption must not necessarily reflect the real level of corruption. Keep in mind furthermore that a low performance in the index does not make corruption a justifiable business in countries like Nigeria. Also in Nigeria corruption is sensed to be an illegitimate conduct leading to public dismay.

How should your results be interpreted?

There are four figures given for each country. The first is its overall integrity ranking (out of 10). A ten equals an entirely clean country while zero equals a country where business transactions are entirely dominated by kickbacks, extortion, bribery, etc. No country scores either ten or zero. The second column gives the old 1995 score. The third figure indicates the variance of the different sources. A high number indicates a high degree of deviating opinions with some placing the country much higher and others much lower on the overall scale. The fourth column indicates the number of surveys in which the particular country has been included (i.e. from 4 to 10).

What does the variance indicate?

The high variance of South Africa of 3.30 implies that 66% of the scores range between 3.9 and 7.5, likewise 95% of the scores range between 2.0 and 9.3. Apparently, the average score is only to a very limited degree an assessment of the observed degree of corruption. The low variance of Malaysia on the other hand indicates, that 95% of the scores range between 4.6 and 6.0. There seems to be a coherent impression of the degree of corruption in Malaysia. Deviating scores can on the one hand be due to diverging perceptions regarding what has to be interpreted as corrupt and to different experiences made with respective countries. It can however also be due to objective difficulties in assessing the "right" score. In countries where some institutions still resist corruption while others are openly engaging in illegitimate practices an assessment is facing practical difficulties. A high variance may in this respect also represent a heterogeneous state of affairs.

Has worldwide corruption increased or decreased?

Evaluations about worldwide trends are likely to bring about biased opinions. Cultural settings are likely to differ considerably between time and between different surveys and differing perceptions may be due to a change in awareness rather than real corruption. Since such trends are difficult to assess they have been neutralized in our data. All surveys are normalized to the same mean and variance, hence only their comparative cross-country information is used. This implies that with our data no "world-wide-trend" can be determined. In fact, a worse score of one country may be due to a situation, where all other countries have improved and vice versa. This procedure has also been applied to the historical data.

Transparency International Press Release - 5

Frequently asked questions (continued....)

Which sources did you use?

The index is a "poll of polls". It has been prepared using ten sources, including three from the World Competitiveness Report, Institute for Management Development, Lausanne, three from the Political & Economic Risk Consultancy Ltd. Hong Kong, one small survey by Peter Neumann, published in the monthly german magazine, Impulse, No. 4/1994, two assessments by DRI/McGraw-Hill Global Risk Service and by the Political Risk Services, East Syracuse, NY and at last the first incoming replies to the internet service (<http://www.uni-goettingen.de/~uww/iier.htm>) of Goettingen University which gives contributors the possibility for anonymous contributions and also directly approaches employees of multinational firms and institutions. A complete list of sources can be obtained via www.

How can the 1996 Ranking be compared to the 1995 Ranking?

Many countries scored comparable to the 1995 data. Since the number of countries covered increased from 41 to 54, the overall position in the ranking will alter. A worse or better performance is only indicated by the actual score. In case a country has not been included in the 1995 ranking, there is no number reported. A lower score indicates a worse performance, whereas a higher number indicates a perception of improvements. However, keep in mind the following reminders: Differences in the two scores which are close to zero are not capable of indicating a significant change. In case a different score is accompanied with a high variance, this may be due to a stochastic outlier (a misperception by one source). A different score does not necessarily indicate a different performance. It may also be due to a larger set of sources and a more precise measurement of the subjective evaluations provided by our contributors. A changing performance may be due to actual regime shifts and a trend towards increasing or decreasing corruption over time. We were able to obtain more historical data, and recheck for increasing or decreasing levels of perceived corruption (for additional technical data please contact TI).

How were your sources assembled?

The 1995 ranking was the starting point for assembling the new ranking. New surveys have been added after conducting the following adjustments: The countries considered in a new survey are normalized to the same mean and standard deviation these countries had in the 1995 ranking. Hence, the inclusion of a survey which only scores a subgroup of countries affects only the scores between those countries and not the performance of the subgroup in relation to other countries. This principle has also been applied when surveys included in the 1995 ranking have been deleted (Business International 1980, World Competitiveness Report 1992, Political & Economic Risk Consultancy Ltd 1992). An assessment may not be as accurate as a survey. Especially the surveys by WCR and PERC are considered to be very valuable. However, since three surveys each have been included from these sources, the importance of these contributors is naturally higher than that of other sources. Each of the ten sources have been assigned the same weight. According to the respective quality of the sources, this appeared plausible. However, there is no "objective" weight which can be applied to the sources and a different weighting may be justifiable. With equal weights, the simple average has been calculated from the normalized data. Since taking the average changes the mean and variance of the data, the final results have again been normalized to the mean and variance of the 1995 subgroup.

How precise are your figures?

The numbers of surveys and the variance of the results give a hint on how good the results are. The higher the number of scores and the lower the variance of the results, the more trustworthy is the score for a particular country. However the figures we produce cannot be regarded as objective. Rather they represent the subjective evaluation of business people. With a low amount of surveys and a high variance the figures become weaker and special attention has to be put to the interpretation. An indicator of the overall performance of the ranking is also given by the fact that most surveys are highly correlated with each other (for further technical details, please contact TI).

Transparency International Press Release - 6**Frequently asked questions (continued....)***How do you define corruption?*

Corruption is the misuse of public power for private benefits, e.g. the bribing of public officials, taking kickbacks in public procurement or embezzling public funds. The external surveys we included were mostly very close to this definition. The ranking tries to assess the degree, to which public officials and politicians in particular countries are involved into corrupt practices.

Which countries have been included?

Because of the nature of the index it has only been possible to include countries who have themselves been subject of a number of polls. To the extent that the list does not include many countries, it is because the polls surveyed did not include them. We required for a country to be included into the list that at least four sources were available. Malperformance of a single survey may hence be balanced by the inclusion of at least three more surveys. Since more surveys were available, the 1996 ranking includes 54 countries, considerable more than the 41 countries in the 1995 ranking. Still, we hope to broaden the scope of the index in future years.

Why does your ranking not produce objective figures?

An objective approach is almost impossible. On the one hand, corruption involves concealed actions and data are not revealed publicly. There exist objective data created by the justice system and the media. However, these data rather give an impression on how effective the media is in discovering and reporting about scandals and how independent and well trained the judiciary is in prosecuting. An efficient and incorruptible jurisdiction may bring about high numbers of convictions. Instead of acknowledging this, "objective" data would "punish" such a country with a bad score.

How up to date is your assessment?

We included up to date surveys, but also surveys dating back to 1993. The high amount of data which are necessary for reliable scoring, make it necessary to use also older data. However, the high correlation between the surveys indicate, that corruption is usually not changing quickly. Older data are therefore not necessarily worse. However, it remains a fact that when a fundamental change in government has taken place, the misdeeds of an earlier regime may shade that country's performance in the ranking in the first few years. This should be kept in mind when our results are interpreted.

Is corruption part of the culture in some countries?

No. Time and again people seeking to find excuses for paying bribes attribute their actions to local foreign cultures. TI is firm in the view that paying bribes is wrong and has no basis for ethical or legal support in any society. That bribery may be tolerated in some countries more than in others may say a lot more about the politics and the legal systems, than about deeper matters. In all environments corruption is an illegitimate behaviour. Neither is it sensed as legitimate by those delegating power to politicians and public officials. Nor can politicians or public officials claim to be legitimately empowered to corrupt acts. Therefore corruption is necessarily accompanied by secrecy. Corruption cannot prosper in highly transparent environments.

Transparency International Press Release - 7

Frequently asked questions (continued....)

How can you compare between countries?

Corruption is defined by some researchers as a particular public reaction to political/administrative behaviour rather than as an illegitimate act as such. Looking for appropriate definitions, this approach assigns a much more active role to the public perception and reactions towards corruption. A high degree of observed corruption may in such an approach reflect a high standard of ethics and a rigid application of rules rather than a high degree of real misbehaviour. Across-country comparison of levels of corruption would hence not be applicable since the underlying standards of ethics may not correspond between countries. However, the sources we included put a high effort on comparative judgements. People working for internationally operating firms and institutions are able to provide a comparative judgement and apply the same internalized definition to different countries. In this perspective a cross-country approach can contribute to a valid comparison of real degree of corruption.

How are the exporting countries contributing to corruption?

The ranking only scores the observed behaviour of public officials and politicians, that is, mainly the passive part of taking bribes. However, exporting industries highly contribute to the development of corruption abroad. This is not taken into account in the ranking. Therefore our index is not a fair assessment of the responsibility associated with corruption in international trade. Industrial countries which may be successful in keeping their homes clean and highly engaged in bribing foreign officials bear y much higher burden than our ranking can indicate. We will have to establish a ranking of active bribery in international trade, in order to bring some light into this part of obscure criminal activity.

Transparency International and Goettingen University

Press Contacts in the United States:

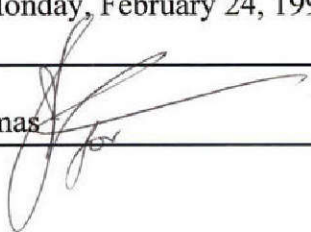
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THE WORLD BANK GROUP

ROUTING SLIP		DATE: March 5, 1997	
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☐	NOTE AND CIRCULATE	☐	NOTE AND RETURN
☐		☐	
RE: Overseas, Attacks on Corruption -- Cleaner Government is a Possible Dream			
REMARKS: Attached, for your information, is a copy of an article entitled "Overseas, Attacks on Corruption - Cleaner Government is a Possible Dream" which appeared in The New York Times on Monday, February 24, 1997.			
FROM Vinod Thomas 		ROOM NO. M-7-051	EXTENSION 36300

Editorial Notebook

Overseas, Attacks on Corruption

Nothing makes people more furious with their leaders than corruption. Yet nothing seems harder to stop. In Pakistan, accusations of corruption have brought down Prime Minister Benazir Bhutto twice. The new Prime Minister, Nawaz Sharif, who was himself deposed on charges of corruption, now promises to fight it.

Most new leaders make the same vow. But even those who mean it often limit their efforts to exhortations and the prosecution of a few political opponents. Corruption, the abuse of public power for private gain, exists because powerful people benefit from it. In some countries, corruption is so widespread that it has become the normal way of doing business and the main reason people enter public service.

In recent years, however, the idea that something can actually be done about corruption has begun to take hold. In 1988, Robert Klitgaard wrote "Controlling Corruption," which detailed several successful efforts. Even under the notoriously corrupt dictator Ferdinand Marcos, the Philippines cleaned up a crooked tax collection bureau. Singapore, now known as one of the world's cleanest nations, was famous for corruption in the 1950's, especially in its customs office. A new Berlin-based organization called Transparency International, which runs workshops around the world on corruption-fighting, has published how-to manuals on its Web site.

The most basic corruption-fighting steps require only firm leadership. Benjamin Mkapa, Tanzania's President, was elected in 1995 on an anti-corruption platform. He began his term by making public his financial assets and those of his wife, and is now getting rid of several cabinet officials. With the help of Transparency and the Economic Development Institute of the World Bank, Mr. Mkapa is now working on the larger challenge of changing a pervasive culture of corruption. Programs have

Cleaner Government Is a Possible Dream

been set up in villages to teach citizens about their rights. Judges and journalists are getting more training and resources. Meanwhile, other governments have encouraged citizens to form monitoring groups and publicize their findings.

Opening up government is essential to battling corruption, but civil service reform is also important. Officials with immediate, day-to-day powers over the public — the police, customs officials and tax assessors — need a living wage to reduce the temptation to behave dishonestly. In the last five years, Uganda has tripled the salary of teachers, which may reduce the widespread practice of selling grades and test results. The Philippine tax chief found that corruption dropped when employees got bonuses and better assignments based not on seniority, but on honest work. Stricter monitoring can help, too. As part of its cleanup campaign, Singapore began to record customs agents' petty cash each morning, then carried out surprise spot checks to insure that the sum did not increase.

Cutting red tape is essential. By reducing the number of permits a citizen needs, governments can narrow the opportunities for petty graft. By standardizing the laws, governments can reduce the temptation to impose arbitrary fees and fines. It is harder to prevent collusive corruption, like tacit agreements between customers and storekeepers to keep purchases off the books. But it is not impossible. Chile allowed people to enter sales receipts in a regular lottery for prizes like household appliances. When customers began to ask for receipts, they also began to pay sales taxes.

As democracy spreads, leaders are realizing that corruption, more than any other sin, is likely to cost them their jobs. Leaders bold enough to tackle corruption will find a crucial ally in their fed-up people.

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2/7
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REMARKS/MESSAGES

Attached is the article "Kuchma Launches Corruption Cleanup" published in the Ukrainian newspaper "Kiev Post".

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Kuchma launches corruption cleanup

Complaints by World Bank chief prompt action

By Natalia Petiakh

Kiev Post

Fresh from a trip to a top international forum where he had to field complaints about corruption within the top levels of Ukraine's civil service, President Leonid Kuchma used an appearance on the national television newscast Monday Feb. 3 to announce a major campaign against graft.

"Public employees must be people with spotless reputations," Kuchma said in the Ukrainian Television News broadcast.

According to the presidential press service, the corruption issue was raised during Kuchma's meeting with World Bank President James D. Wolfensohn at the World Economic Forum in Davos, Switzerland. Late last year, Wolfensohn sent Kuchma a letter expressing concern about widespread corruption among Ukrainian officials.

Kuchma told the UTN program his anti-corruption drive would be modeled on Poland's recent "Clean Hands" campaign. He said the presidential decree specifying anti-corruption measures would be drafted by a working group led by Justice Minister Serhiy Holovaty and including representatives from the Security Service of Ukraine (successor to the KGB) and other law enforcement agencies.

Holovaty told the *Kiev Post* Tuesday he first heard of the planned crackdown from Kuchma's television appearance. "Right now I am waiting for the president's instructions, and only after I see them will I reveal my own proposals for combating corruption," he said.

According to UTN, one measure already proposed by Kuchma is the creation of a National Bureau of Investigations (NBI), comprised of special task forces to monitor the progress of foreign investment projects, gas distribution deals and other matters.

The NBI would join a half dozen existing agencies charged with combating corruption, among other tasks. It is not clear how its jurisdiction would differ from those of the ministries of Internal Affairs and Justice, the Prosecutor General's office, the Security Service of Ukraine, the National Security Council and the presidential Coordinating Committee for Combating Corruption.

High-level government corruption received more press coverage in 1996 than at any time since independence. But few of the media scandals were followed by prosecutions. The nation's two most prominent cases have dragged on for the last two years.

One involves former acting Prime Minister Yefim Zviagilski, accused in 1994 by the prosecutor general at the time, Nikolai Datsyuk, of skimming \$20 million in public funds from a sale of aircraft fuel. Zviagilski was never arrested and has since moved to Israel. Last fall, current Prosecutor General Grigori Vorsinov said the case should be dropped for lack of evidence, but the probe has not yet ended.

The other case involves Viktor Bozhenar, a former economics advisor to Parliament Speaker Olexandr Moroz. Bozhenar went on trial last week in the regional capital of Mykolaiv on charges of pocketing funds intended for the construction of a veterans center. He has

See CORRUPTION, Page 2

Kuchma launches corruption crackdown

CORRUPTION, Continued from page 1
been under arrest since March 1995.

Security Service of Ukraine Chairman Volodymyr Radchenko told Parliament deputies in October that his agency was investigating 1,500 senior civil servants. Since then, however, the SSU has announced only a handful of solved cases, most of them involving low-level officials from the provinces. According to Ministry of Internal Affairs statistics, more than 3,000 civil servants have been punished for job-related crimes since 1991. Not one of them held a top-

level position in government.

Yet graft has become a serious irritant in Ukraine's relations with foreign aid donors. Last fall, U.S. Ambassador-at-Large to the former Soviet Union Richard Morningstar highlighted official corruption as a major obstacle to badly needed foreign investment in Ukraine. At about the same time, foreign firms started coming forward with tales of arbitrary regulation and outright extortion by Ukrainian officials.

Mykola Melnyk, consultant to the parliamentary Commission on the

Fight Against Organized Crime and Corruption, estimates that Ukrainian law enforcement agencies now catch just 1 percent of the instances of corruption and misuse of office by government officials. And only 10 percent of the officials caught have received punishments more serious than a reprimand, Melnyk said.

"More than likely, the president has lost faith in the effectiveness of the law enforcers and decided to entrust the fight against corruption to a Justice Ministry headed by an young, energetic minister," Melnyk said.

THE WORLD BANK
Washington, D.C. 20433
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JOHANNES F. LINN
Vice President
Europe and Central Asia
Tel: (202) 458-0602
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December 23, 1996

Messrs. Caio Koch-Weser and Sven Sandstrom

Re: **Work on Corruption in Latvia**

Caio, Sven,

The attached note gives you an update on the above matter. We will keep you informed of progress. In the meantime, it will be important to follow the Department's advice to keep publicity down from our side as regards the initiative.

Thank you.



Attachment

cc: Messrs. Malloch-Brown, Pakulski, M. Stephens, Kavalsky, J. Harrison, Siegelbaum

✓
1/27
cel. 12
1996

OFFICE MEMORANDUM

RECEIVED

96 DEC 20 PM 5: 25

ECAVP

DATE: December 20, 1996

TO: Mr. Johannes F. Linn, Vice President, ECA

FROM: James Q. Harrison, Division Chief, EC4C1 *JQH Harrison*

EXTENSION: 3-1476

SUBJECT: **Latvia: anti-corruption initiative**

As you know, Mike Stevens (PSP) briefed Mr. Wolfensohn yesterday on the anti-corruption initiative including Helen Sutch's report on her recent mission to Latvia that returned on Wednesday. It may be helpful to note the main points in advance of the more detailed material that is being prepared.

Background.

The Prime Minister designated Mr. Berzins, the State Minister of Labor, a dynamic and results-oriented Minister, to oversee this work and act as counterpart for the Bank. The State Minister is also in charge of the public administration reform component of the Structural Adjustment Loan, and sees the possibilities for cross-fertilization between the two activities.

Workshops: a two-stage approach.

At the wrap-up meeting, Mr. Berzins asked the Bank mission to facilitate a workshop for relevant Ministries and agencies (e.g. Economy, Finance, Interior, State Audit, Privatization Agency) in the first half of February 1997; depending on the outcome, this event would be followed by a broader workshop with representatives of private business and civil society as well as government.

Development of a program.

The aim of these workshops would be to help the Latvians develop a program of activities that corresponded to their particular needs and problems. In order to support the development of country ownership, the mission avoided making specific recommendations on the content of such a program at this stage. We will supply examples of problems and approaches from different countries which could help stimulate the Latvians involved to formulate their own assessment and corresponding program of anti-corruption activities.

Publicity.

The Prime Minister and Minister of Labor have given press interviews announcing that the Prime Minister 'has requested the Bank to assist Latvia in its efforts to prepare and implement anti-corruption and administrative reform.' However, this work remains very sensitive and there is a risk that the Prime Minister could cut it short if the Bank appeared to be publicizing it independently. At this stage, we would counsel silence, apart from repeating the Prime Minister's formulation if asked.

cc: Messrs./Mmes. Cadario, Jones (ECAVP); Kavalsky, O'Connor, Tsimbidis (EC4DR);
Siegelbaum (EC4EF); Gross, Farsad, Sutch (EC4C1), Stevens (PSP)

A L L - I N - 1 N O T E

DATE: 04-Dec-1996 04:44pm EST

TO: Daniel Kaufmann

(DANIEL KAUFMANN)

FROM: Anthony Gaeta, EXTIM

(ANTHONY GAETA)

EXT.: 31798

SUBJECT: Survey paper

Remarks on your Corruption paper:

Thank you very much for your paper, Listening to Stakeholders, which you sent to Mark Malloch Brown. Mark and I have both read your analysis and found it intriguing. After comparing notes, he has asked me to send you some brief comments.

I hope that you can expand on your survey. The fact that the survey was taken in an academic setting somewhat clouds the saliency of the findings. I would like to see the same questions asked to these and other elites in their home countries. Moreover, the next step is obviously to do similar research with non-elites to compare the responses. This is clearly a complex undertaking, but will really help put these data in context. In addition, it would be interesting for you to compare your analysis with the work being done for next year's WDR, which, as you know, will be dealing with the role of the state.

You have in any case identified some key questions, particularly on how the Bank is perceived, the prospect of tying conditionality to anti-corruption measures, and the popularity of structural adjustment lending. Certainly, as you suggest, the data are surprising and relatively encouraging, though you also point out some important areas where we as an institution need to improve. Of course, these responses raise many questions, particularly the old concern that structural adjustment, for example, benefits precisely these elites that you have interviewed; i.e., no wonder they favor it. Your analysis has confirmed that these questions remain critical and more work needs to be done.

We agree with your comments on the state of the literature. Although there is a growing collection of highly academic analyses of corruption--its sources and effects-- there is little in the way of hard study of how, in every day life, it affects, say, foreign investors, or NGOs working to deliver essential services. Your survey is an example of how useful such an investigation can be. It could be replicated to include business people and the aid community. This would help identify where corruption actually impedes these investments and services. Involvement of people on the ground, particularly outsiders, would help maximize the relevancy of anti-corruption programs designed by the Bank and other institutions.

Finally, we agree with your findings on the value of public education. This in some ways is the most intriguing section of your paper. As you well know, this is an area to which the Bank is devoting increasing attention and

resources, and one where we in External Affairs have an especially important role. We would welcome the opportunity to talk with you about your research and possible areas of coordination.

Again, we thank you for your study. It is, of course, making its way around the Bank and I m sure you will be receiving comments from others, particularly my colleagues on the corruption task force. Please call me or Mark if you have any questions.

A L L - I N - 1 N O T E

DATE: 04-Dec-1996 06:18pm EST

TO: Anthony Gaeta (agaeta@worldbank.org@INTERNET)

FROM: Daniel Kaufmann, (dkaufman@HIID.HARVARD.EDU@INTER

EXT.:

SUBJECT: Re: Survey paper

Anthony, thanks for your thorough and incisive comments. I am about to travel to Europe, will be back in a week and a half and will communicate more substantively. Concur with most everything you say, and would like to discuss and do more with EXT, including on public education (where we have collaborated with Mark in my Ukraine days there). The one point where we may not fully agree is on the academic unrepresentativeness of the sample, since I only gave this survey to high officials and reps of civil society who were visiting Harvard at their mid career and for short term programs. As acknowledged in the paper, non-representativeness of the sample may be still a problem, I agree, but more for reasons of regional representation of who comes to these courses in english (but the participants on these courses are not necessarily more academically inclined than elites overall).

If there are materials or reports (even if initial drafts) on the issues touched by you and the paper that have come across your desk, I would certainly appreciate receiving them. My address is at the bottom.

Thanks, Dani

Daniel Kaufmann Internet: DKaufman@hiid.harvard.edu
Mailing address:
Harvard Institute for International Development (HIID)
One Eliot St., Rm. 414, Cambridge, Ma. 02138 (USA)
tel. 617-496-9035 / fax 617-495-0527

THE WORLD BANK/IFC

4/18
 Tony: Quick
 Comments to
 Mark
 please
 Thank
 &

ROUTING SLIP				DATE: November 14, 1996	
NAME				ROOM NO.	
Mark Malloch Brown				U-11-185	
☐	URGENT	☐	For Action/Comment	☐	Per Your Request
☐	Appropriate Disposition	☐	Information/Discard	☐	Returned
☐	Approval/Clearance	☐	Note and Return	☐	See My E-Mail
☐	File	☐	Per Our Conversation	☐	Signature/Initial
RE: Listening to Stakeholders on Development Challenges and World Bank Instruments in their Countries					
REMARKS:					
Mark:					
I thought that the attached may be of interest to you. The paper is in draft, in order to incorporate comments and suggestions. They would be welcomed.					
Dani					
FROM: Dani Kaufmann			ROOM NO.:		EXT.: 617-496-9035

First Draft
Preliminary Results
Not for distribution or quotation
without author's permission.

Listening to Stakeholders on Development Challenges and World Bank Instruments in their Countries

Myths meet some Evidence on Corruption, Economic Reforms and Bank Programs

Daniel Kaufmann

HIID and The World Bank

November 1st, 1996

e-mail: DKaufman@hiid.harvard.edu

0. Introduction.

This is a preliminary paper, for internal discussion at this stage, based on a survey of stakeholders from over 60 countries. It revisits old issues for the Bank, suggests new issues, and discusses older and possibly newer instruments. We will argue, however, that there is not an *a priori* necessary mapping between an old/new *issue* and old/new *instrument*. Specifically, the focus on this paper is on the following issues: first on corruption and economic development; second, Structural Adjustment Lending (Bank SALs); third World Bank investment projects, and fourth, public education programs. At present, the section on corruption below, albeit still in draft, is at a more advanced stage of analysis and exposition, while the others are work-in-progress. The objective is to elicit frank discussion at this stage of the "change management" process, and in particular on the discussion of new initiatives. Further analysis and a revision of this paper will take place following these discussions.

The four sections in this paper are relatively free-standing, in that they are analyzed separately and each section contains some stand-alone discussion of operational implications. At the same time, however, the inter-linkages between the different components are brought out, particularly in the context of operational implications for Bank operations--as an input to the thinking about new instruments and objectives during the change management process. We start with the issue of corruption, where the overall data set we worked with, as well as the results from the survey carried out, are discussed in some detail.

I. Daring to Address a Controversial Developmental Objective? New and Old Bank Instruments to Tackle Corruption.

A. Background, and details on the sample of the Survey Instrument.

1. Introduction: On Corruption.

There is a considerable literature on corruption. Substantial scholarly writings have analyzed the issue from many angles, often utilizing rigorous analytical tools and deductive logic. By contrast the empirical literature on this topic is scant. This is understandable, given the nature of an issue where misinformation and lack of transparency is essential for it to survive and thrive.

Yet nowadays there is substantial discussion on corruption among policy makers in the industrialized and developing world, as well as among multilateral and donor agencies. Until recently, however, such discussions were of a rather timid and informal nature, and often behind closed doors. This stemmed in large measure from the widely held perception of sensitivity of even spelling out the C..... Word. There were also other justifications perpetuating timidity and often silence in tackling the problem of corruption in the international arena, such as perceived difficulties in defining ("exactly") what was meant by corruption, as well as the "cultural divide"

Further, there has also been a literature suggesting that there were a number of positive effects from corruption in developing countries.

Our ongoing research, summarized in preliminary fashion here, attempts to contribute to bridging the "empirical perception" gap. We provide fresh evidence related to the perceptions about corruption as communicated by stakeholders from developing and transition economies. By so doing, we try to contribute to the discussion of what can be done about it. In this draft paper, the focus is on possible strategies and instruments that the World Bank could deploy--if addressing corruption became a more explicit developmental objective. Nonetheless, that discussion also has implications for other key players in the international arena.

2. The Survey and the Data.

The approach in this initial contribution is straightforward. We report on the initial results of a survey questionnaire filled by over 150 members of various "elites" in over 60 developing countries. Thus, at the outset, we should emphasize that it is not a random sample. The respondents were drawn from eight different programs and seminars for high-level public officials and other senior representatives of civil society who came to Harvard University during the summer of 1996. The respondents do represent, however, a wide cross-section of the elites and leadership in their own countries. The questionnaires were distributed to the participants at the beginning of these programs, with a request for their return within days.

While these program participants represent a broad spectrum of key stakeholders from countries throughout the world, there is no *a priori* reason to expect that representativeness of each "elite" subgroup coming to Harvard would match the actual geographical, educational and socio-economic profile of elites throughout the world. This possible deviation is an empirical challenge that needs to be addressed in the course of the research. The analysis reported here ought therefore to be treated with caution, as research-in-progress. They are being reported in interim fashion in order to elicit comments and to rapidly communicate on *one* of the topics covered in the survey, namely corruption--given the ongoing debate on this topic in the international fora.¹

About one-half of the survey respondents come from the public sector spheres (high level government --mostly central government ministries-- and state enterprise officials). The other

¹ In addressing the issue of non-randomness of the sample (even within the "elite" universe), we need to account for the fact that representatives from Eastern Europe and the Former Soviet Union are still under represented in mid-career programs at Harvard, particularly when compared with African representation (Asian, Latin American and Middle Eastern representation falling in the middle). At the same time, within Africa, Franco-phone elites are under-represented. These empirical issues are being addressed by stratifying the overall sample into subgroups and exploring whether there are major differences among them. Equally important, in order to validate the robustness of these results, there are plans underway to expand sample coverage in the future, and to also survey "future elites," i.e. university students coming from developing countries.

one-half come from a wide range of occupations within civil society: Parliamentarians, NGOs, entrepreneurs, bankers, media, etc. The questionnaire focused on the respondents' own opinions on a variety of development-related issues. The survey covered four main areas:

i) World Bank projects and programs, as well as the respondent's own assessment of IFI effectiveness; ii) current impediments to economic reforms in the short term and to long-run development in their country; iii) corruption; and iv) public education programs.² The modules other than corruption are analyzed in later sections in this paper.

For simplicity of exposition, in this section of the paper we let the evidence stand against eight commonly encountered propositions about corruption. This does not mean that these propositions are universally held in every case, or that other pertinent evidence should not be used to address such propositions from other angles. Yet these conventionally-held notions (particularly in the West) may not necessarily concord with reality nowadays. To explore such possibility, we let the particular perspective of our "stakeholder" data set do the talking.

3. Stakeholders' Evidence on Eight Propositions about Corruption.

Proposition #1: The reticence to "talk" about corruption.

The respondents usually had only a few days before returning the questionnaires, which required time and focus to fill out, and dealt with sensitive questions. Nonetheless, the response rate was rather high, and more importantly, the questionnaires came back with few unanswered corruption-related questions. Of twenty corruption-related items in the questionnaire, 95% of respondents answered most of them, and almost 90% *all* of them.³ To assure candidness in their "anonymous" response, the preface to the questionnaire made it clear that they did not have to write their names in. Yet two-thirds of the respondents wrote in their names. For similar "reassurance" reasons it was optional to write in one's country of origin (they could just list their continent instead). Yet 90% chose to write their country of origin. It was clear that public officials and civil society were prepared to write about corruption, and mostly on the record.

² The breadth of coverage and time/space limitations in the survey questionnaire instrument (so as to ensure a reasonable response rate) precluded a fully exhaustive coverage on any single one of these topics.

³ Further, following response to the questionnaire, a number of the participants have at their own initiative sought to meet the author to discuss issues of corruption in their countries. And the seminar presentation of these findings and their implications to a dozen Ministers of Finance from Africa was not only devoid of "defensiveness" on the issue; it was met with broad agreement on the determinants and effects on corruption and the request to carry out more work on this issue.

Proposition #2: Sensitivity in acknowledging corruption in one's own country.

Almost half of the respondents (44%) are of the view that corruption has increased in their country over the past 10 years, and another one-third believes that it has stayed roughly the same. Only one-quarter thinks that it has declined. Over 40% are of the view that public sector corruption is more prevalent than in the private sector, while almost half believe that they are roughly comparable. Over one-half believe that corruption in their countries is roughly comparable to their neighbors'. When questioned how highly they would rate particular measures to tackle corruption in their countries, only 4% chose not to respond at all to such questions. And *all* other respondents rated rather *highly* at least some of the measures proposed to tackle corruption.

Proposition #3: It is *debatable* whether corruption is *pernicious* or *beneficial* to a country's long term development, and it depends on country-specific circumstances.

Representatives from the elites may be prepared to talk about corruption, and even acknowledge its prevalence in their respective countries. But a conventionally held view among some in academe was that there are some beneficial aspects to corruption.⁴ This proposition is soundly rebuked by the respondents. When asked to rate the severity of a list of possible impediments to long-term development in their country, among eleven choices of common determinants of development and growth, *public sector corruption was rated as the most severe obstacle* of all (Figure 1). Infrastructure constraints came as a close second, and ineffective government institutions and state enterprises follow closely behind. The other seven choices are further behind, as depicted in Figure 1.

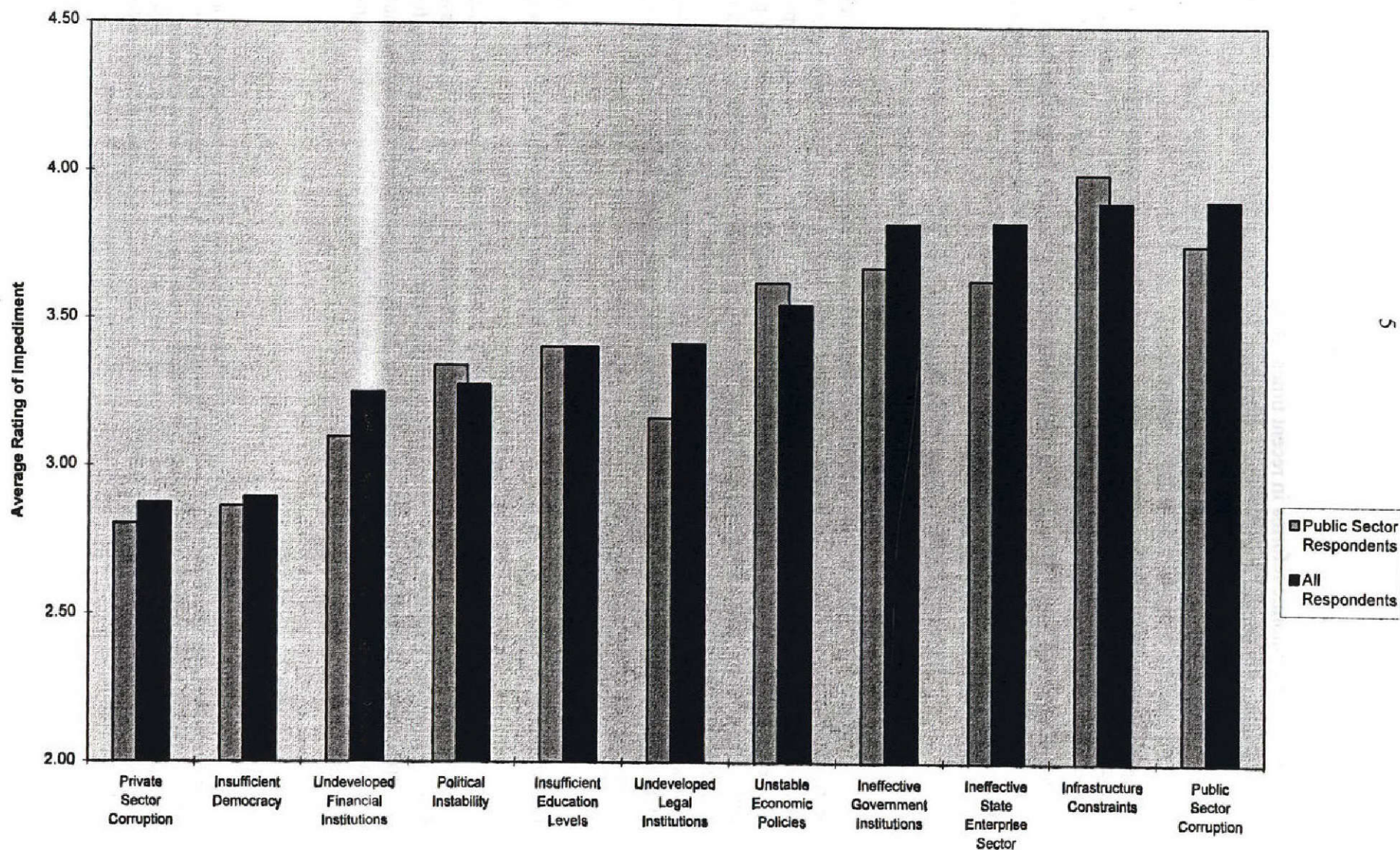
Proposition # 4: The adverse impact of Corruption is less severe in the shorter term which is relevant for economic reform.

The evidence presented on the previous proposition suggests that stakeholders believe that the long-term developmental goals of a country are impaired by the prevalence of corruption. But there may be less consensus as to the importance of corruption for attaining short-term objectives in general, and particularly in the operational context of implementing economic reforms. This notion is not supported by the evidence from the survey either, however. Overall, the respondents rated corruption/vested financial interests as a very severe impediment to

⁴ "Greasing the palms" to get things done in developing countries was one such strand (e.g. the writings by N. Leff; by Lui, and by S.P. Huntington). One key implicit notion was that the over-regulated environment was taken as a *given*, and "greasing" resulted in benefits-- compared to the absence of such "grease." The obvious fallacy here lies in taking the over-regulated environment as given. The less obvious point is one of endogeneity: since much over-regulation arises in order to extract bribes in the first place, greasing the palms also fuels additional incentives to over regulate. In turn, such (bribe-induced) over-regulation has negative effects on growth and development.

**Figure 1: The Long-Run Perspective:
Respondents' Assessment of Impediments to Development and Growth in their Countries***

(Rating between 1 [no impediment] to 5 [very severe impediment])



* Preliminary research based survey of senior public service and civil society representatives from 63 developing/emerging economies.

much-needed economic reforms in recent times. Among eight choices, on average *corruption* rates second only (to the not-unrelated) short-term *political* expedience factors (Figure 2a).

Almost 90% of the respondents are of the view that their country could have made more economic reform progress than it did in recent times. In explaining the reasons for insufficient progress in economic reforms, over *two-thirds* indicated that corruption had been an important impediment (by rating the impediment as a 4 or 5 in a scale of 1 to 5), *one-fourth* were neutral (rated it as a 3), *ten percent* gave it low priority (rated it as a 2), and *none* indicated that it was totally irrelevant (rated it as a 1). The comparison of percentages of respondents rating an impediment as severe is presented in figure 2b, suggesting the importance that respondents gave to corruption as an impediment to recent economic reforms.

Proposition #5: *Even when the seriousness of corruption is fully acknowledged, it is debatable whether something substantial can really be done about it.*

Contrary to this conventionally-held proposition, the evidence from the survey suggests a considerable degree of consensus that something could be done about corruption, and even on the types of measures which may be particularly effective. With over 80% high approval rating the respondents chose: the country's own leadership setting the tone/example; stiff penalties and enforcement for public sector corruption, and increasing public sector salaries. At the other extreme, creating or strengthening "anti-corruption" domestic watchdog institutions rated the lowest with only about one-third approval rating (and one-third negative ratings as well). Between these extremes there are other economic and institutional reform measures with relatively high ratings (Figure 3).⁵

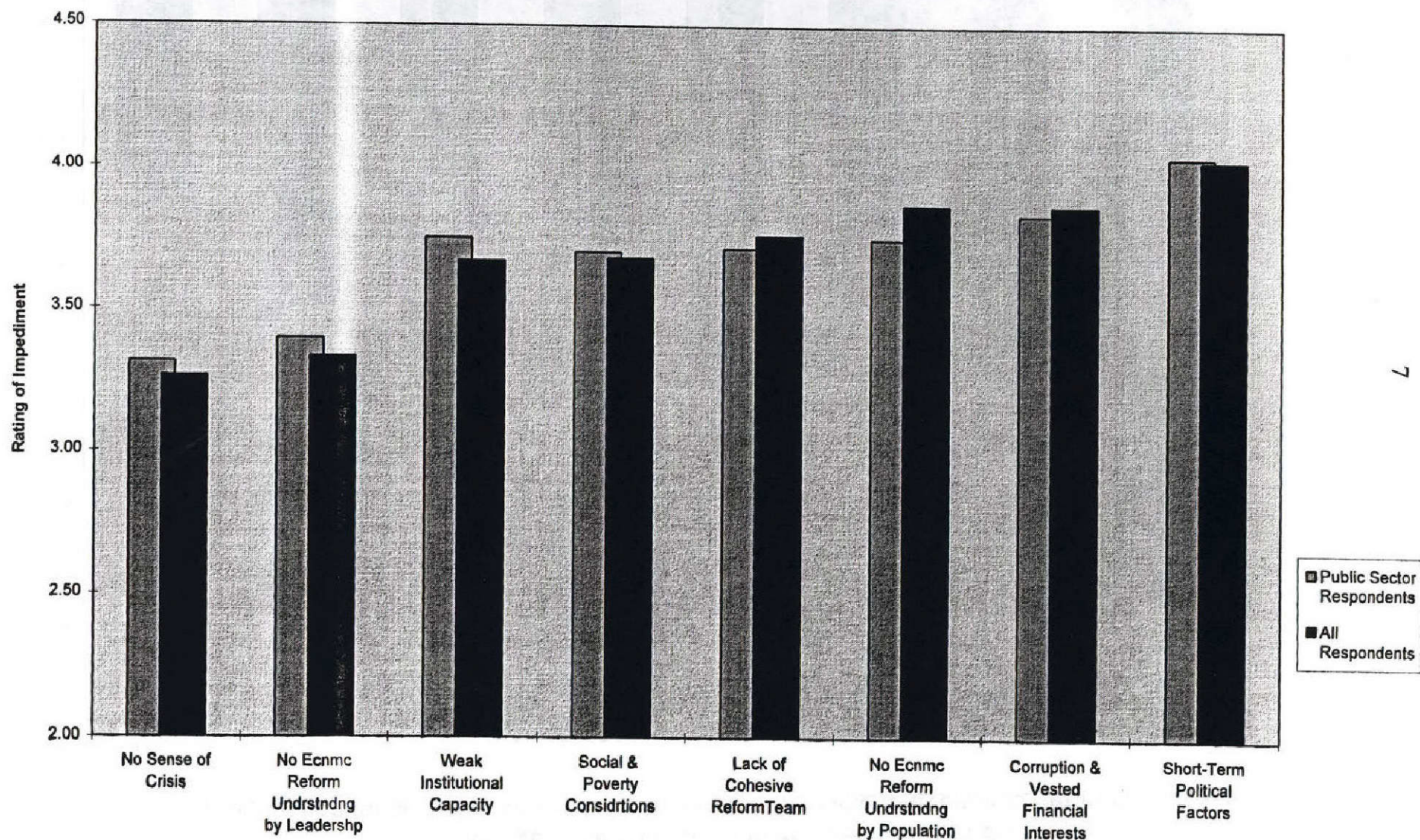
Proposition #6: *Ultimately the foreign firm and investor are more to be blamed in instigating corrupt practices in developing countries (than domestic factors alone).*

In contrast with the previous five relatively straightforward propositions, where the evidence is rather clear, in this case the reality is more nuanced. At one level, the assertion that foreign firms and investors have more responsibility than domestic factors alone in fueling corruption is challenged by the survey evidence. Many more respondents believe that domestic considerations alone drive corruption in their country (37%), rather than joint foreign-domestic interests (21%).

⁵ The survey results on the various domestic actions that could be taken to fight corruption (depicted in Figure 3) appear broadly consistent with the few in-depth writings by Western analysts who have made specific proposals on how to combat corruption (e.g. Klitgaard and Rose-Ackerman). Further, in assessing the intensity of views on what needs to be done on the issue, it is also telling to assess the extent of *negative* responses in the survey: with the exception of "watchdog" institutions (33% negatives, i.e. rated as 1 or 2 in scale of 1 to 5), of military procurement/expenditures reform (26% negatives) and of lowering inflation (20% negatives), the other domestic strategies have negatives of 15% or less.

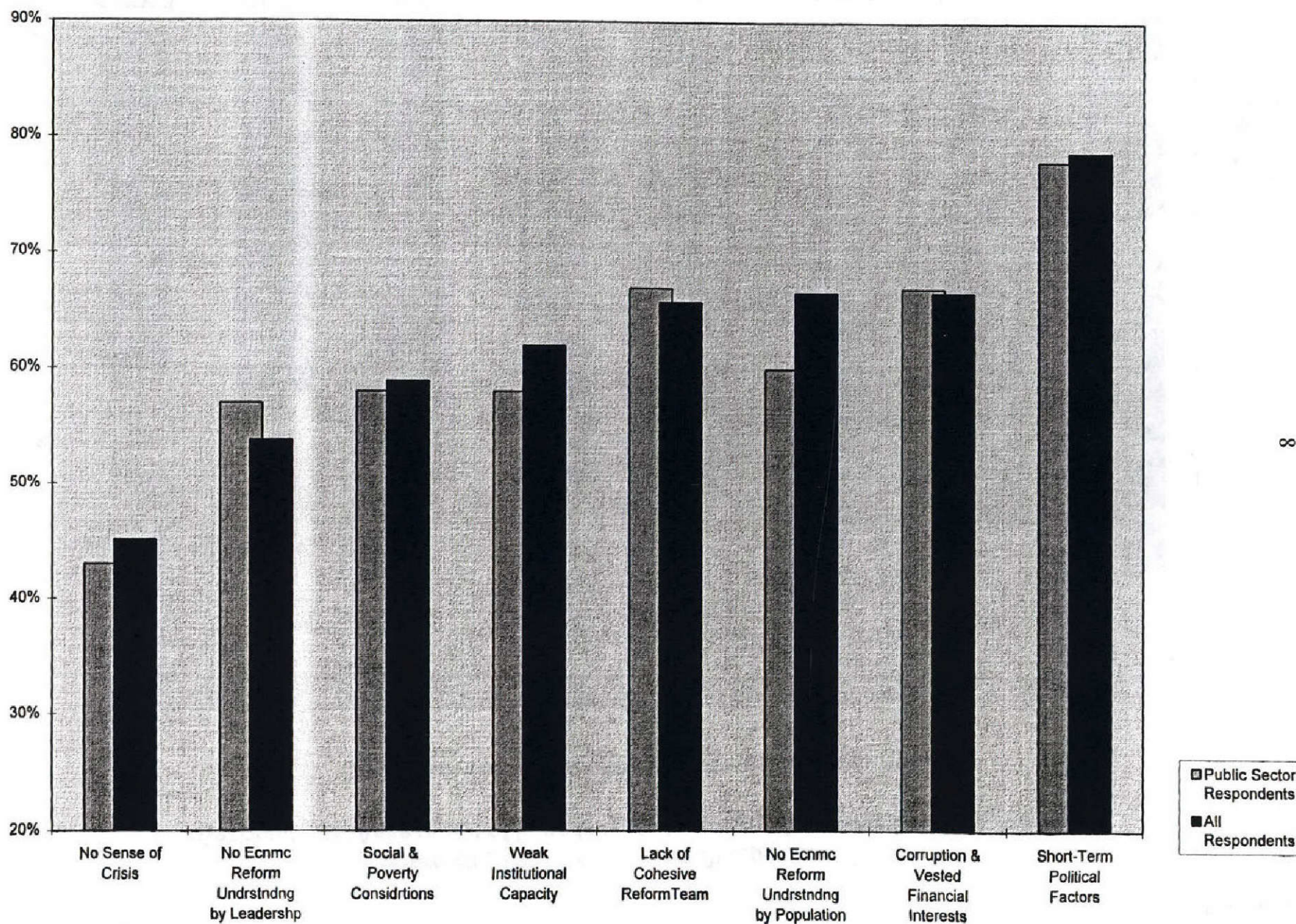
**Figure 2a: The Shorter-Term Perspective (Part A):
Respondents' Assessment of Impediments to Recent Economic Reforms Progress***

(Rating between 1 [no impediment] to 5 [very severe impediment])



* Preliminary research based on survey of senior public service and civil society representatives from 63 developing/emerging economies.

Figure 2b: The Shorter-Term Perspective (Part B):
% of Respondents Rating Impediment as Serious Obstacle to Economic Reforms Recently*



* Percentage of respondents who rated impediment as a 4 or 5 in a scale of 1 to 5.

While acknowledging that in many cases domestic factors may dominate, at another level the evidence also suggests that respondents, in measured fashion, consider jointly induced foreign-domestic corruption a very serious issue as well. In addition to the 21% of respondents who believe that foreign-induced corruption dominates, 43% of respondents answered that both domestic-alone *and* joint-foreign corruption are roughly equal in prevalence in their countries. In sum, *two-thirds* of respondents regard joint-foreign corruption at least as much of a problem as corruption which is domestically-induced alone.

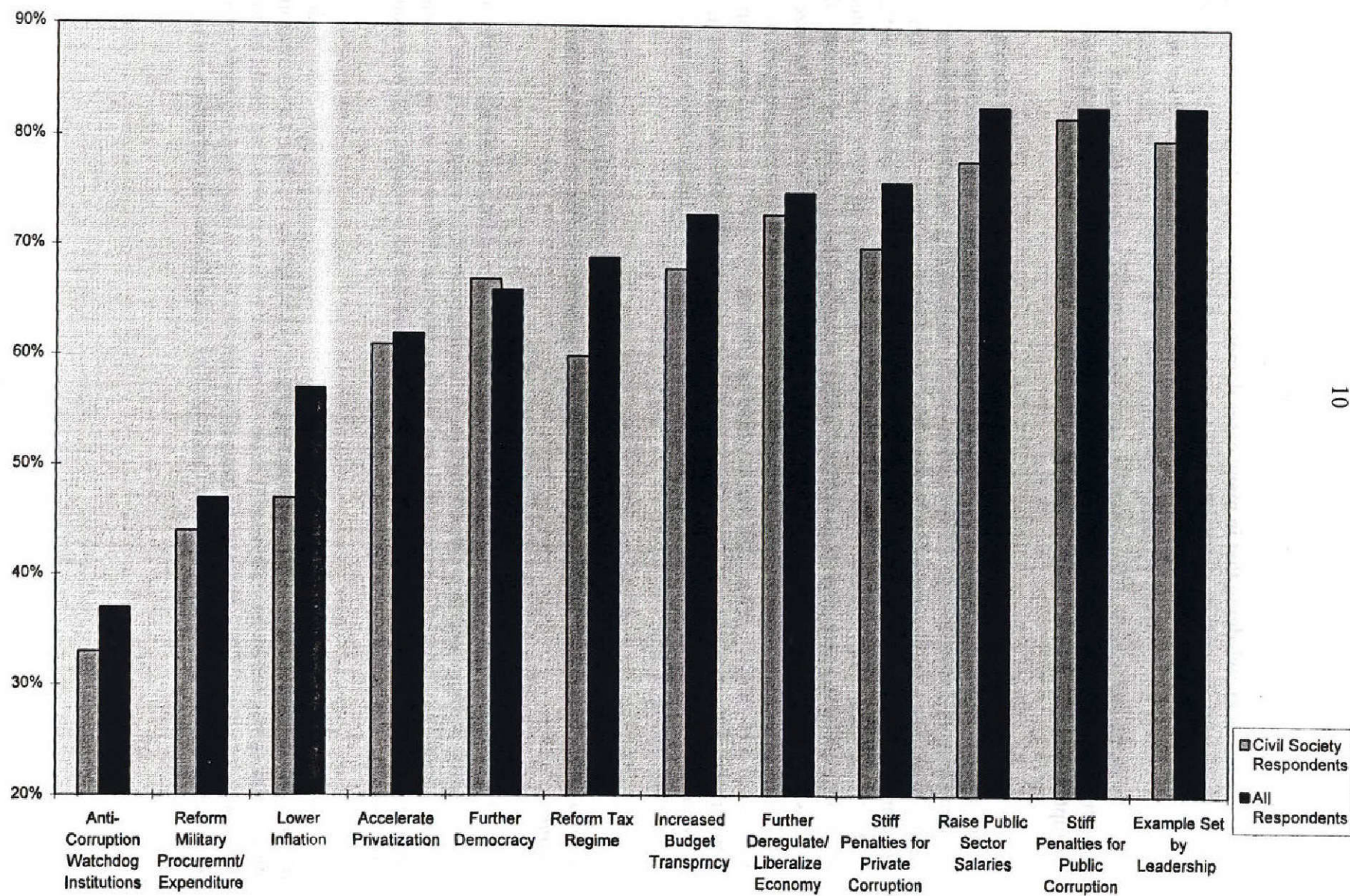
Against the backdrop of other writings, as well as our observation of the corruption reality around the world, these survey results on the relative (but not overwhelming) predominance of domestic-induced corruption--while emphasizing that foreign influences play an important role as well--, suggest a healthy dose of realism from the respondents. This sense of balance and realism is also evident from the survey responses on possible anti-corruption measures to address the problem. When asked to rate the proposed measure: "OECD countries imposing stiff penalties on their own citizens/firms if pursuing corrupt practices abroad", the average rating (at 3.5 in a scale of 1 to 5) ranks low when compared with most of the dozen *domestic* anti-corruption measures. Yet in themselves the ratings for this measure are not low: a *majority* of respondents (58%) think that it would be effective for OECD countries to implement anti-corruption measures for their business abroad, and over one-fifth are neutral about it. Only 20 percent do not rate as potentially effective for OECD countries to take decisive steps to combat corruption abroad.

Proposition #7: *It is unrealistic to consider that corruption-alleviation conditionality from institutions like the World Bank may be acceptable in the IFIs client countries.*

Often the view is expressed that institutions like the World Bank, who have heretofore been uninvolved in helping to tackle corruption in its client countries, should stay that way. Political, legal (e.g. "charter"), procedural, and implementation difficulties are usually called upon to justify such stance. It is also said that such interference in domestic problems would be unacceptable.

As with the previous "proposition" on OECD measures, the data suggests that addressing this proposition on World Bank-style conditionality is a complex issue. The survey responses suggest that this is not an uncontroversial issue: 28 percent of respondents cast doubt on the desirability or potential effectiveness of institutions like the World Bank making their lending programs (such in Structural Adjustment Lending [SAL]) conditional to corruption-reducing

**Figure 3: What to do about Corruption:
% Respondents Highly Rating Domestic Solutions to Corruption***



*High rating is given when respondent graded measure as a 4 or 5 in scale of 1 (ineffective) to 5 (very effective).

measures in the country. But, conversely, it is striking to note that a plurality (41%) think it would be desirable to impose World Bank-style conditionality to reduce corruption in their own countries.⁶

Even if *on balance* respondents appear to favor use of the bluntest of Bank instruments (SAL-conditionality) to address corruption in their own countries, the divided nature of responses points to the need to delve deeper into the possible determinants of embracing or opposing such type of World Bank involvement. Preliminary statistical analysis on the basis of this sample survey suggests that depending on the type of country and “elite-association” characteristics the respondent comes from, there are significant differences in the degree of support for this type of conditionality. For instance, representatives from *civil society* in countries where public sector corruption is perceived as a major impediment to development, and where there has been a substantial *World Bank presence* (SAL or conventional projects), are estimated to give an extremely high approval rating to Bank-conditionality on corruption (close to 80 percent). *Public sector officials* from a *similar* type of country would give an approval rating of about 60 percent. At the other extreme, *public sector officials* in countries where *they* do not rate corruption as a major obstacle, and where the Bank presence has been minimal, are estimated to give an approval rating of only about 20 percent.

In sum, Bank involvement in its bluntest form to address corruption in client countries does not appear to enjoy universal support *a priori*. Yet there seems to be preparedness to support it from important groups in corrupt-prone countries where the Bank is well known.

Proposition #8: Perceptions about corruption are highly volatile and depend on whom one asks.

The analysis of the Bank-conditionality “proposition” may unwittingly give the impression that the nature of the results on perceptions about corruption is highly volatile and depend on who happened to respond to the survey. That would constitute a mis-representation of the analysis. With the possible exception of the Bank-conditionality issue (where a diverse --yet explainable-- range of opinions exists), there seems to be remarkable consensus across subgroups on the majority of corruption-related issues touched upon in the survey. To delve deeper into this issue, the sample from the survey has been broken down by public official/civil society; by region; by years of educational background in finance and in economics; by how well the Bank is known in the country, etc. Few dissimilarities arise, and when they do these differences are of degree, not of kind. An illustration of this point is provided in Figures 1, 2a and 2b, where public sector perceptions are presented alongside the overall averages, and in Figure 3, where the results for civil society stakeholders are presented against overall averages. The rankings of particular

⁶ The remaining one-third of the respondents fall in the middle category (rating of 3 in the scale of 1 to 5 in assessing how effective such Bank-style conditionality would be).

obstacles or solutions may in some cases move one place upwards or downwards, depending on the subgroup, but not much further.⁷

4. Concluding on Stakeholders' Views about Corruption: Implications for Institutions like the World Bank.⁸

This section discusses preliminary implications for an institution like the World Bank. It will not belabor on long recommendation lists of a possible World Bank action plan, which would be expected in other writings in the near future. Neither I address here the admittedly important specific legal and accountability aspects of contractors/suppliers in Bank projects, or Bank staff itself. These are also being covered elsewhere. The emphasis here instead is on the direct implications *emanating* from the survey's analysis summarized above.

Before turning to the implications, it is worth reiterating that the nature of the data in our survey warrants further statistical investigation of the results, as well as expansion of the sample coverage. The results reported here should be interpreted as orders of magnitude within a confidence range, rather than precise point estimates, and should be used as only one empirical angle among a few in addressing the issue of corruption.

This cautionary caveat, in fact, leads to the first implication: one objective of the present exercise would be considered as achieved if the preliminary results and analysis reported here, in conjunction with other ongoing work, culminated in the implementation of a comprehensive research effort on this topic. In an expanded research effort we would need to focus on improved coverage, questions and measures of the many dimensions of corruption throughout the world. Many of the variables used in the scant empirical literature on the topic are amenable to major improvement, in fact. Further, in an expanded research effort we could address questions that arise from these survey results, which are far from fully answered here--such as much more specificity and depth on the types of corruption-alleviation measures that would be both effective and acceptable in the countries. *Inter alia*, an expanded research effort would permit country differentiation, which is particularly important in this context, since significant "tailoring" to country-specific conditions in designing and implementing corruption-alleviation measures would be essential. For instance, some of the corruption-related causes and consequences, their

⁷ For instance, *public* officials, not surprisingly, do not rate *public* corruption as high an impediment for their country's development as their civil society counterparts--who ranked it number *one* by a margin. Yet the ratings on this issue even from *public* officials still place such constraint as number *two* among eleven possible impediments, after infrastructure constraints (figure 1). Further, we note that as a developmental impediment *public* officials also rate *private sector corruption* lower than their civil society counterparts themselves rate private sector corruption as an impediment (although the margin is not large).

⁸ This section is of a particularly preliminary nature. It is being expanded, with further details on the recommendations (also relating it to international organizations and institutions other than the World Bank). Further analysis will also be presented on the linkages with the rest of the survey results--including the other (than "corruption") modules.

related institutional aspects, and the possible solutions, are likely to differ substantially between countries in transition in former soviet block countries (which were in any case under-represented in our survey) from the reality in many emerging economies.

But notwithstanding the caveats about avoiding overly precise point estimates inferences, the survey results argue against perpetuating conventional notions about “taboos” (or extreme sensitivity) in addressing the problem of corruption with stakeholders in client countries. A wide spectrum of high level representatives from emerging economies acknowledge the extent of the corruption problem. In most cases they are prepared to frankly discuss it, and evidently to address it. Their perceptions as recorded in the survey provide empirical support to focusing on the notion of “abuse of public office for private gain” as a workable definition of corruption (as per results in Figure 1). Generally, their own views on corruption does not appear to differ substantially from the views of foreign investors, analysts or staff in international organizations.⁹ And under well defined circumstances they are prepared to even support anti-corruption instruments as blunt as *direct Bank-style conditionality within their country*--which could encompass the specific incorporation of conditionality into Structural Adjustment Loans (SAL), or more broadly into the overall lending program as a lever, and/or as a condition to be eligible for the ambitious debt-reduction initiatives underway.

However, regardless of its clout, *one* international organization’s clarity of purpose in intending to use existing instruments at its disposal to address corruption may well be a *necessary*, yet in itself would not be a *sufficient* condition for even partial success. In addition to the own country leadership having to take the initiative¹⁰ --obviously paramount in this context--, other international organizations (such as the IMF, WTO, some other UN agencies, Regional Development Banks, etc.) would need to work in tandem with the World Bank in addressing corruption. The survey results provide a hint in this area: the relatively positive (even if not unanimous) reception of respondents to the option of World Bank conditionality on corruption could be extended to other IFIs as well, since the question asked their views on the issue of conditionality “...from institutions *like* the World Bank” (*italics for emphasis here*).

Conditionality in instruments from the World Bank (and other similar institutions -- grouped as “IFIs”--), in settings where explicit corruption-reducing measures may still be an overly sensitive issue can focus on related institutional and economic measures, at least initially. *Public sector and civil service reform, the detailed review and restructuring of public expenditures, as well as tax reform*, are natural candidates in this context-- given that under those

⁹ One very relevant ongoing survey of Tasks Managers within the World Bank will shed further light on perceptions about corruption, and on possible differences of view between different regions and types of economies (Siegelbaum, forthcoming).

¹⁰ Strategies towards internalization and client ownership, akin to those prevalent for economic reform and restructuring, would be as relevant in the context of anti-corruption strategies. See discussion on public education.

“headings” many of the seeds of corruption are hidden. Proper analysis, design and implementation IFI-program lending conditionality in these institutional and policy reform areas would support anti-corruption measures, however indirectly. But the resolve by the IFIs and the country to act on difficult governmental institutional reform issues will have to be mustered—an extremely difficult task, particularly in corrupt settings. Further, IFIs may need to earmark *resources* to these tasks.

Standard conditionality on *macro-economic stabilization, exchange rate and trade liberalization, and domestic deregulation* would also indirectly (yet significantly) help address the problem. This is due to the links between credit issue and exchange rate, trade and regulatory restrictions, on the one hand, and illicit rents, on the other.¹¹ This is particularly the case nowadays: not only corrupt practices appear to be more prevalent than in the past, but also the past *ideological* divide regarding what constitutes appropriate macro-economic, exchange rate and trade policy is essentially over. Hence, aside from short-term political expediency, a central factor nowadays in delaying standard macro-economic, trade and exchange reforms appears to be vested financial interests (figures 2a/2b). Ideology rationales now ring empty.

The importance of increasing awareness of the links between vested interests and the unwillingness to implement urgent reforms in some countries also points to the *need for a more candid discussion* of the real “whys” of lack of reform progress in Country Assistance Strategy papers and country dialogue discussions. Further, given the need to address corruption in a technocratic and integrated manner into the country strategy, the case for devoting Economic and Sector work resources to it would be strong. This would allow a more in-depth analysis of the issue, placing corruption within the overall institutional and socio-economic context of a particular country. Further, it would permit a genuine integration between its many interlinked causal components, as well as between the various possible incentive-related solutions—the multi-faceted “carrots” and “sticks” needed to raise the costs and lower the benefits of corrupt practices. Given the substantial analytical demands entailed in covering such topics, economic and sector work could generally focus on issues of restructuring of public sector institutions, and civil service and expenditure reform.¹²

¹¹ Relevant contributions also include Aslund, Boone and Johnson (1996), Ades and DiTella (1996), Kaufmann and Kaliberda (1996), Mauro (1995), Rose-Ackerman and Stone (1996), Shleifer and Vishny (1995). Further, our ongoing research based on the macro-evidence points to lack of stabilization, liberalization and privatization as determinants of the evolution of “unofficialdom” in transition economies, while our micro-enterprise research suggests a link between tax and regulatory burden on new enterprises, on the one hand, and the bribes to officials that such enterprises need to pay, on the other (See Kaufmann; and Johnson, Kaufmann and Shleifer, forthcoming).

¹² An integrated approach will also be required when considering the range of instruments of a particular IFI like the World Bank. It is often said that an IFI should at most circumscribe its treatment of the corruption issue to ensure that its own direct operations are not tainted. This is an inadequate stance, however, even from a narrow “Charter” standpoint. First, country creditworthiness may be affected by overall public sector corruption, and not just from corruption in a particular IFI investment operation. Second, focus on isolated case-by-case investments would beg the importance of the IFIs as program/BOP lenders—necessitating a broader view on public sector corruption. In essence, there is also a “fungibility” argument about corruption

A country's preparedness to welcome "softer" and more collaborative instruments from the Bank to address corruption would be expected to be more universal than to conditionality-driven instruments. In fact, at a more general level, the survey results also indicate considerable support for the Bank in collaborating with local authorities and institutions *in implementing public education efforts*.¹³ Analysis of corruption causes, consequences and possible remedies could be naturally integrated within such broad-based public education efforts, as well as in *specific economics and finance training programs*. The technocratic foundation for such integration lies in the (albeit belated) recognition of the negative effects of corruption – both for effective implementation of economic reform and for long-term development and growth. Similarly, expansion *dedicated* workshops on corruption in the international fora, as recently carried out, would be warranted--to the extent possible in collaboration with NGOs and domestic state and non-state institutions.

Moreover, in countries prepared to address the corruption problem in earnest the IFIs and other donor agencies could further develop *TA-style operations*, with one of its key objectives/components being tailored to address corruption-related challenges. The need to revamp *customs* institutions, to develop transparent and effective *Treasury Departments*, and to spearhead *accounting and auditing* institutional reform and development would be examples. Pilot programs in countries ready to collaborate could be initiated rapidly.

The effectiveness of having selected IFIs involved in addressing the challenge of corruption within a collaborative approach with the country itself would be greatly enhanced if it could successfully muster broad support from *OECD countries to take measures penalizing corrupt practices abroad* (as the US, and to an extent, Scandinavian countries, have done in the past). The survey indicates that respondents acknowledge the need to deal first with their own corruption-related problems at home, yet they would be significantly aided in their own efforts if incentives from foreign traders and investors "to grease palms" were removed (such as removing tax deductibility of bribe expenses abroad, instituting "no bribe pledges" from contractors, etc.).¹⁴ Similar collaborative institutional initiatives to develop and implement anti-corruption strategies should take place between the IFIs, WTO, and Transparency International.

(akin to the fallacy in "earmarked" donor funds when the overall structure of public expenditures are subpar). And third, evidence has emerged on the link between corruption and: i) lack of economic reforms or misguided policies, and, ii) impaired longer-term development prospects.

¹³ See further discussion on the Bank's role on public education in Section IV below.

¹⁴ A country intent in making a dent in corrupt practices within its own public sector has a set of options at its disposal. Yet they would be impaired in their efforts if there is no cooperation from OECD countries. For instance, some countries are exploring the possibility of imposing a much reduced penalty in a corruption case to the party of such transaction which is prepared to come first forward and be a witness for the prosecution (provide evidence on the other party). Naturally, that could be an effective deterrent to two domestic parties carrying on a corrupt transaction, particularly if the lesser penalty may apply even long time after the corrupt transaction took place. However, the potential impact of these type of proposals would be much less in settings where many corrupt transactions are the outcome of deals between foreign investors and domestic official. Unless, of course, OECD countries, WTO and other international organizations instituted an enforceable international business code of conduct.

Further, *participatory approaches* within the countries, in order to build consensus for the World Bank or other IFI involvement in this area is paramount. *Public outreach and education programs*, with roundtables involving members from civil society and the media, can play a role in this context. The case for participatory approaches transcends the conventional benefits of participation in Bank projects and programs: our survey results suggest that *civil society* would be an important *ally* in addressing corruption as a major developmental challenge. An ally which may welcome multilateral institutions like the World Bank actively helping them help themselves tackling corruption in their countries.

II. Improving Existing Bank Instruments, Part One: Structural Adjustment Lending.

Focusing on a new Bank initiative, such as corruption alleviation --particularly in light of the recent recognition that it is a development challenge-- would not necessarily mean that new instruments for the Bank need to be devised. Suitably adjusted, the plethora of instruments that the Bank has at its disposal nowadays can accommodate a number of new initiatives. For the issue of corruption, for instance, a number of existing instruments were discussed in the previous section. A crucial instrument that the Bank has is Structural Adjustment Loan (SAL), especially given its "conditionality" content, and the fact that many of the policy reforms it usually contains would indirectly (yet effectively) address some of the most glaring corruption problems in client countries. This type of SAL-rationale could be extended to other non-conventional objectives that the Bank may have, such as for instance improved governance.

More broadly, however, at this juncture of evaluating the various World Bank instrument options it has at its disposal, it is important to ponder question what is the stakeholder view on SALs. This is relevant not only for possibly incorporating new challenges into SAL objectives, but also to assess whether the remaining "older" (yet valid) challenges are still being well served by SALs -- and even if so, whether SALs are as needed in the late nineties and beyond as it has been the case until the recent past. Much has been made externally, and even internally, about the lack of "popularity" of SALs in many countries in the world. Such criticism has come from all "ideological" camps, ranging from the evils of the socio-economic outcomes of the draconian conditions in SALs, to the softness in ensuring implementing the agreed conditions in practice (thereby undermining the attainment of its originally intended objectives). Somewhere within the extremes in this spectrum lies the oft-heard criticism that SALs could be a very useful instrument in principle, and that its objectives and rationale are laudable, but the Bank has not been focussed and rigorous enough in their design (e.g. has not prioritized sufficiently, accounting for the limited implementation capacity in the host countries, to focus squarely on the selected areas that are crucial for a growth-oriented strategy in the short-to-medium term).

Consequently, we asked the respondents to give us their assessment of SALs in their countries. The survey instrument was not sufficiently detailed to be able to shed light on all

issues that have drawn criticism about SALs in the past. Yet the overall results are telling. First, a large segment of the elites in the countries knew about SALs: fifty eight percent knew about SALs that were received in their countries, 16 percent knew that their country had not received one, and 26 percent did not know whether his/her country had received one or not. Of those that knew about SALs, *over one-half rated them as very important for their country, and another 40 percent rated them as relatively important*. Only 9 percent were of the opinion that SALs were either marginal (5%), or counterproductive (4%) for their countries.

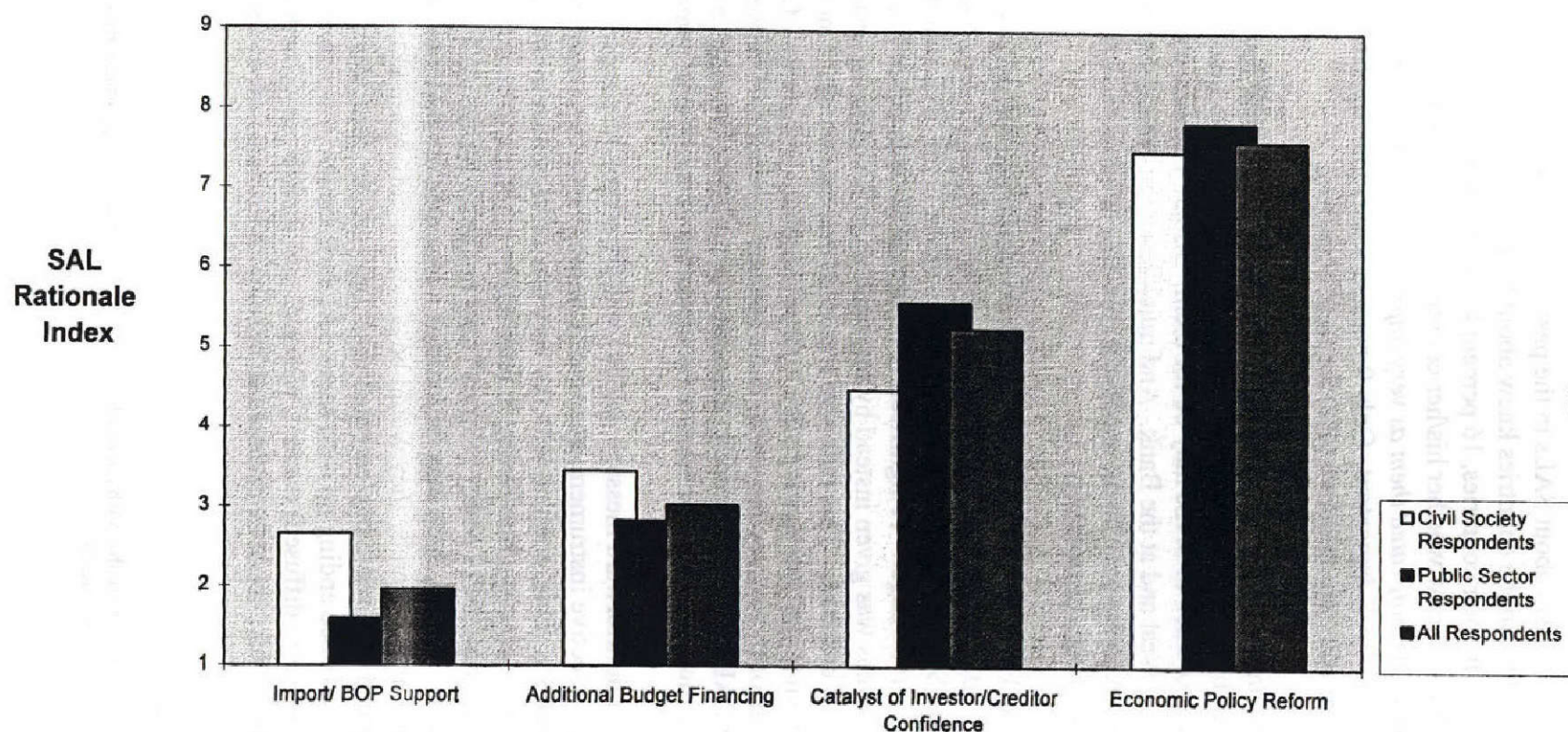
It is thus clear that at least the elites in the client countries where the Bank has had SALs are overall both aware about them, and support them. The question that arises next is what the "rationale" for such importance of SALs may be for them. Much has been written about the rationale of SALs in the West and at the Bank. And much has been heard from NGOs and some client countries about SALs not only being unpopular, but also about SALs being secured by the country only out of dire financial necessity.

Against such background, the responses from this stakeholder survey provide surprising answers. As summarized in Figure 4, by far the *least important* rationale for a SAL in their view is *import/BOP support*. Second from last in order of importance is the SAL rationale of *additional resources for the budget*. A significantly higher rating than either of these two financial-infusion rationales was given instead by respondents to SALs being seen as *catalysts for foreign investors and creditors*. This rationale was rated second overall. Finally, by far the highest ratings was given to the "*economic policy reform*" rationale (Figure 4). Consequently, it is clear that on the basis of this survey responses there appears to be no gulf between donor and recipient rationale for SALs. Put it differently, the notion of the Bank "buying" reforms through its financing-cum-conditionality does not seem to be supported in the overall sample.¹⁵

A simple and straightforward message comes from the survey respondents: do continue to focus on SALs, it is an effective instrument, and mostly because it furthers economic reforms (and secondly as a catalyst). This, coupled with the very low rating given to import support as a rationale, also means that excessive fine-tuning in relating the amounts to be disbursed under a SAL to a "commensurate amount of policy reforms" may not be as warranted a commonly thought in many settings. Instead, there may be more of a rationale for SALs to be subject to stricter "zero-one" guidelines, whereby they would be given out only when a "critical mass" of required reforms is agreed (and some implemented up-front) -- rather than leaving excessive leeway to discretion, and hence ending up with some SALs (or similar instruments) of significantly "softer" (or more diffused) content, which do not further pro-growth economic reforms. In other words, SALs could be revisited to become more focussed on the crucial

¹⁵ Although we should not rule out that such approach is relevant in some countries, particularly where initial adoption of reforms is very contentious politically.

Figure 4: Rationale for Structural Adjustment Loans



SAL Rationale Index on a scale of 1 to 10. Constructed on the basis of respondents' ranking of first and second most important reasons (among the four choices) for having SALs in their countries. A theoretical maximum of 10 if all respondents ranked it the the most important reason-for-SAL. A minimum of 1 if none of the respondents ranked the rationale as 1st or 2nd. 58% of respondents said that SALs had been obtained by their countries. Among them, those who thought that SALs are important for their countries (92%) responded to this question.

components for growth, under stringent guidelines that would lead to less discretion in yes/no decisions.

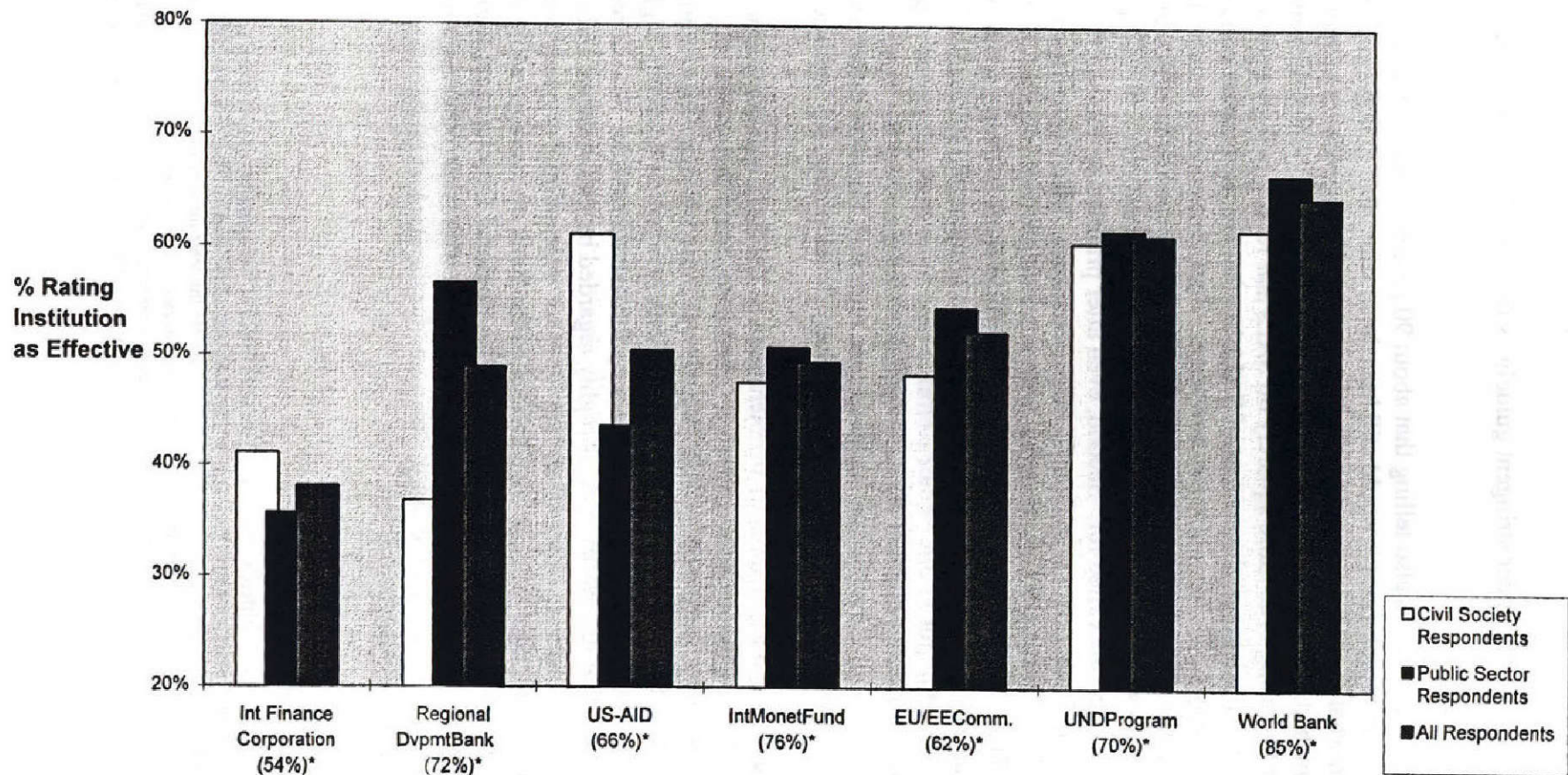
In this context, it is also telling that about 90 percent of the respondents thought that in their countries in recent times it would still have been warranted to implement further economic reforms than what they had managed to do in actuality. The agenda for economic reform is clearly unfinished, according to the respondents from the country elites themselves. Hence, the rationale for focussing even more squarely on SALs and its key policy conditions is still very much alive. Yet the issue of the content of SALs in what the "key policy conditions" that need to be included may be far from obvious nowadays. First, this is because there has been some concern expressed that SAL conditions are often too numerous and insufficiently prioritized. A focus on what is essential to generate growth, without over-stretching limited institutional capabilities, is therefore called for. Second, even after prioritizing, the specific content of "key policy conditions" will differ significantly across countries. Many countries are entering into third or fourth stages of economic reforms, with increasingly sophisticated financial market challenges. There is an obvious challenge for the World Bank to meet such new demands with the appropriate skills and institutional response. Among these, the Bank may increasingly have to address issues of major Public Sector Reforms (and more in-depth public expenditure review and conditionality), economic and legal deregulation (not merely at the more aggregate --and conventional-- level of the trade and exchange rate regimes), financial sector and capital market development, and policy issues related to technology development, for instance.

Transcending one particular instrument such as the SAL, and more broadly, is the Bank perceived as effective in the client countries? And if so, could this be due to other Bank activities and possibly in spite of SALs? We address these two questions briefly by analyzing the survey results. First, as seen in Figure 5, the Bank is regarded relatively highly, with over a two-thirds "approval" rating as being effective by the overall sample. And decomposing the responses we note that its effectiveness is highly regarded by public sector and civil society stakeholders. Its ratings are also higher than for other international organizations--although some, such as UNDP, enjoy similar high ratings as the Bank on average, while there is also significant variance within others. For instance, the Regional Development Bank category was highly rated for Latin American respondents, in contrast with some other regions.¹⁶ It is nonetheless telling to note that the rating responses for the Bank exhibited significantly *less variance* than for any other institution.

¹⁶ There are also some differences that may be due to issues of "recognition" of the institution in the country. Significantly more respondents knew about the Bank for instance, than about many of the other institutions (see bottom of Figure 5 for the "recognition" percentages for each institution). By far the least number of respondents knew about IFC. While only those who knew sufficiently about the institutions were asked to rate it, chances are that there was a link between how well they knew a particular institution and the ratings given to it. For that reason, coupled with the observation that the public sector by definition would not have rated IFC very highly, such IFC results in particular ought not be subject to "over-interpretation".

Figure 5: Effectiveness Rating of International/Donor Agencies

(by Public Sector and Civil Society Stakeholders in Client Countries)



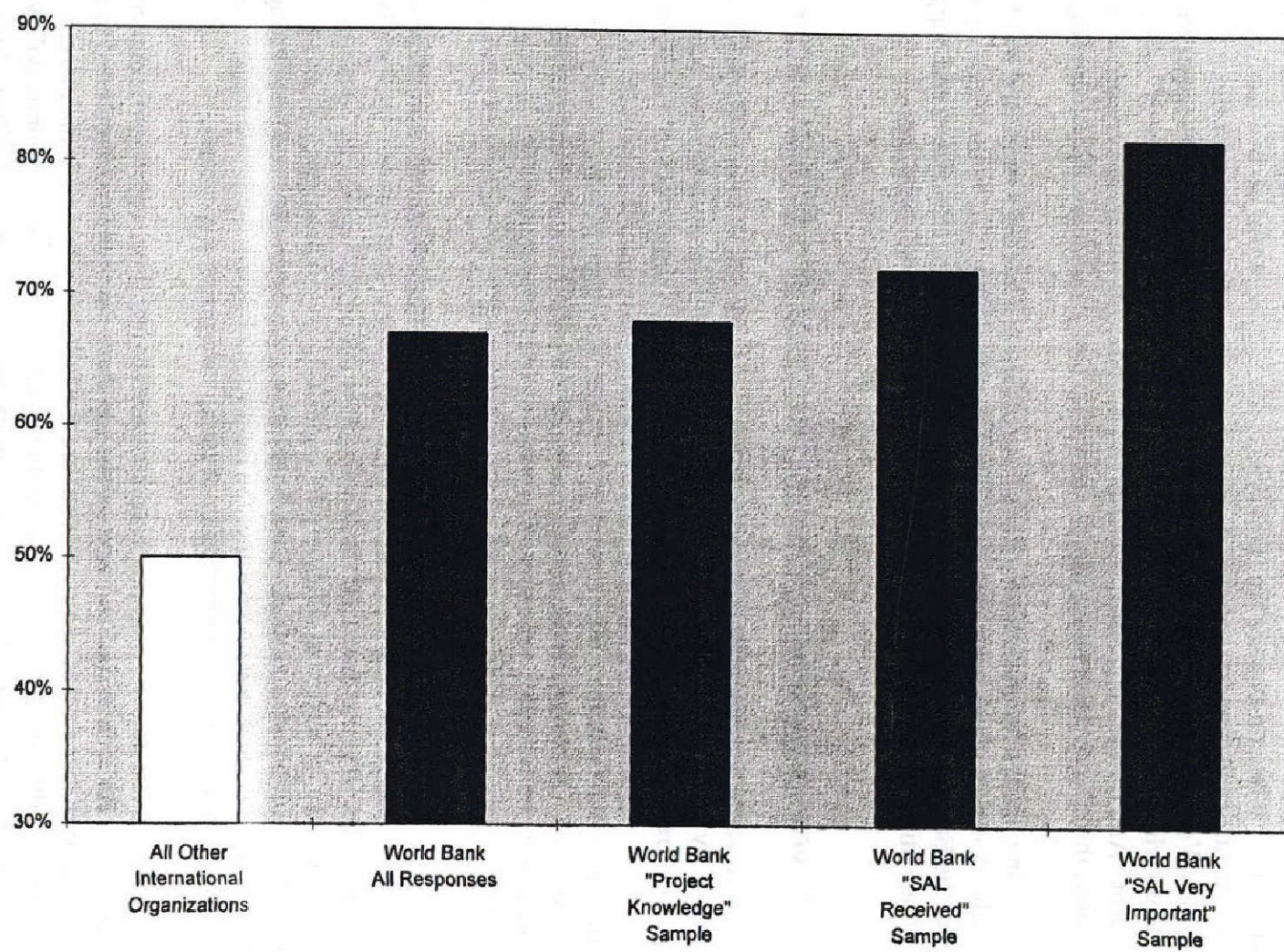
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* Figure in bottom parenthesis is the % of Respondents who know the institution's work in their country well enough to rate its effectiveness.

Note: Ratings are given only by those who knew the work of the international organization in their country. "Effective" rating when given a score of 4 or 5 in a scale of 1 to 5.

Figure 5a: World Bank's "Effectiveness" Ratings and SALs

(for different sample populations)



Investigating the relationship between the clients' perception about the Bank and the nature of the Bank's presence in the country offers some insights. First, we investigated what the relationship with SALs is. Figure 5a presents the approval ratings for the Bank for different subgroups. While on average the Bank enjoys the high approval of two-thirds of all respondents, such support increases by a couple of percentage points for those that knew about specific World Bank projects in their country. And the increase is much larger for the subgroup of those who knew about SALs in their countries, where the "effectiveness" rating becomes 72 percent. And for the subgroup that was of the opinion that SALs are very important for their country, the effectiveness rating for the institution overall becomes 82 percent (Figure 5a).

In sum, the rationale for continued use of SALs is not only supported by client stakeholders nowadays, but it also seems to be inextricably linked to the views of stakeholders about the Bank in the countries. And such views are, on balance, positive and supportive to continue utilizing such tool—even where modifications may be called for.

III. Improving Bank Instruments, Part Two: Conventional Project Lending.

It would be misplaced to interpret the above results on the generally positive ratings of the Bank by stakeholders as a license to instill a sense of over-confidence or complacency. While it is reassuring to hear that in terms of these client country "elites" the Bank is seen as an effective institution overall, and that such effectiveness is perceived as linked to a positive view of the role of SALs in their own countries, this does not mean that changes and improvements are not called for. In reviewing the survey results, in fact, the balance struck between an overall positive view of the Bank, yet coupled with strong recommendations to improve performance, is particularly striking in their responses about *conventional Bank investment projects*.

Over eighty percent of respondents knew about Bank-financed projects in their countries, half of them intimately. Only 17 percent were not aware that there were such projects, or knew very little or at all about them. Of those who knew about Bank projects, 10 percent rated them as very successful, 70 percent as relatively successful, 18 percent as marginal, and 2 percent as overall a failure in their countries. Clearly, there is a similarity between these ratings and the various Bank/OED ratings (if anything, the Bank/OED has tended to rate success rates as somewhat lower, although comparability of rating categories is an issue).

Their answers regarding proposed measures to improve project performance are enlightening. As seen in figures 6 and 6a, the top three measures recommended to improve project performance (out of about a dozen) are the following, and by some margin: better Bank staff understanding of local conditions, an improved country-wide economic policy environment, and the recruitment of more local experts to work on Bank projects. Neither of these highly rated recommendations ought to come as a surprise. But it is significant how keenly aware

stakeholders are of the links between good economy-wide policies and performance at the project level.

This is the more remarkable because until relatively recently, in fact, there was no full consensus *within* the Bank about how critical was to have non-distortionary economic policies for project-level success. In fact, the much heralded Wapenhans report, and its immediate follow up, to an extent underplayed such factors. And although there was much discussion of this issue within the Bank following the preparation of the World Development Report 1991 ("The Challenge of Development" which investigated the links between economic policies and project performance)¹⁷, there was still a view within the World Bank Group (including IFC) that believed that Bank projects could be insulated from poor macro-policies. More recently, OED has come out explicitly analyzing and discussing the importance of good economy-wide policies, a view supported already within research and by WDRs for some time. But furthermore, in spite of the gradual progression in awareness about the importance of these macro-micro (project level) linkages, it is still unclear the extent to which such links have been translated into country strategy and policy and operationalized in the actual lending programs of the Bank. For some countries with inadequate economic policy environments there still seems at times that the choice is made by the Bank to have a lending program in place, including new projects--even if the prospects for improved economic management in the short term are uncertain at best. The rationales given vary between the explicit admission of political pressures, to "safeguard a seat on the ("policy dialogue" table), to the already debunked notion of being able to generate successful projects in certain sectors or settings even if economy-wide policies are poor.

Against this background, it is sobering to encounter these explicit views by the client country stakeholders on this issue. It suggests that the "political" rationale to lend in countries with poor policies may not accurately reflect the views of key constituencies within the country after all, but the interests of a very narrow group (and/or some other external influence) instead. Or it may just be misplaced understanding of the political economy in the country, coupled with the old age anxiety about "losing a seat in the table" in the country dialogue. In fact, the above results on the high regard that most stakeholders have for the Bank as an institution, as well as the "catalytic" perception of one of its roles (through the SALs), suggest that such anxieties may be misplaced, in fact. And one can carry this argument one step further in expecting that the country will have a commitment to decent economic policy management for precondition for Bank project lending, by linking SALs and project-level instruments. Indeed, the "unscathed" role for SALs that emanate from the analysis in the previous section is further strengthened by the stakeholders' recommendations for improvement in Bank projects: a powerful additional rationale for SALs is that it could raise the productivity of public and private investments in general, and of Bank/IFC investments in particular.

¹⁷ See the author's background paper on "The Forgotten Rationale for Economic Reform: The Productivity of Investments" (1991, and with J. Isham, 1995).

Further reviewing the remaining list of rated measures to improve project performance, we note that involvement by NGOs, by local governments, and by the private sector also rate high, not substantially below the top three mentioned above (Figures 6 and 6a). Others follow, with somewhat lower ratings.¹⁸ Particularly striking, however, are the categories ranked low in priority to improve project performance: lighter project conditions (lowest among all choices), additional Bank staff preparing and supervising the projects (second lowest), and additional resident Bank staff in country. The very low rating to additional Bank staff being devoted to preparation/supervision is also in contrast with the recommendations of the Wapenhans report and many other internal Bank memoranda and decisions, and deserves further review. Similarly with regard to the recommendation of moving significant numbers of staff from Headquarters to the Resident Missions.¹⁹ These responses about resident missions ought to be seen in perspective, however, because at the same time the respondents are emphasizing the need to have many more local recruits working on Bank programs, and they are also recommending much more in-depth understanding by Bank staff of local conditions. Hence, the role of the Resident Missions per se does not appear to be questioned, but instead any wholesale transfer of expatriate staff into the field offices in the client countries.²⁰

It is no secret that the Bank is at times perceived as somewhat arrogant, and that is an issue that has been brought to the author's in a number of instances by outsiders in recent months as well. Against such background, it would be unfortunate if an instinctive institutional reaction from some quarters were to discount some the responses given by stakeholders due to mistaken perception that they may not know the reality of Bank projects in their countries (even if it is acknowledged that they know their countries very well). To anticipate this line of questioning, we selected the sub-sample from the survey which had been involved in World Bank projects. A comparison between this sample and the overall sample is presented in Figure 6a. The differences between the groups are relatively small, and point in the same direction.²¹

¹⁸ It is worth noting that in rating various project performance enhancing recommendations "additional focus on social and environmental aspects" did not rate particularly high as compared with some others (although over 50% percent rated it highly). This does not mean, however, that such objectives are not important for the respondents, but it may reflect the substantial focus the Bank has already placed on such components on its projects in recent years.

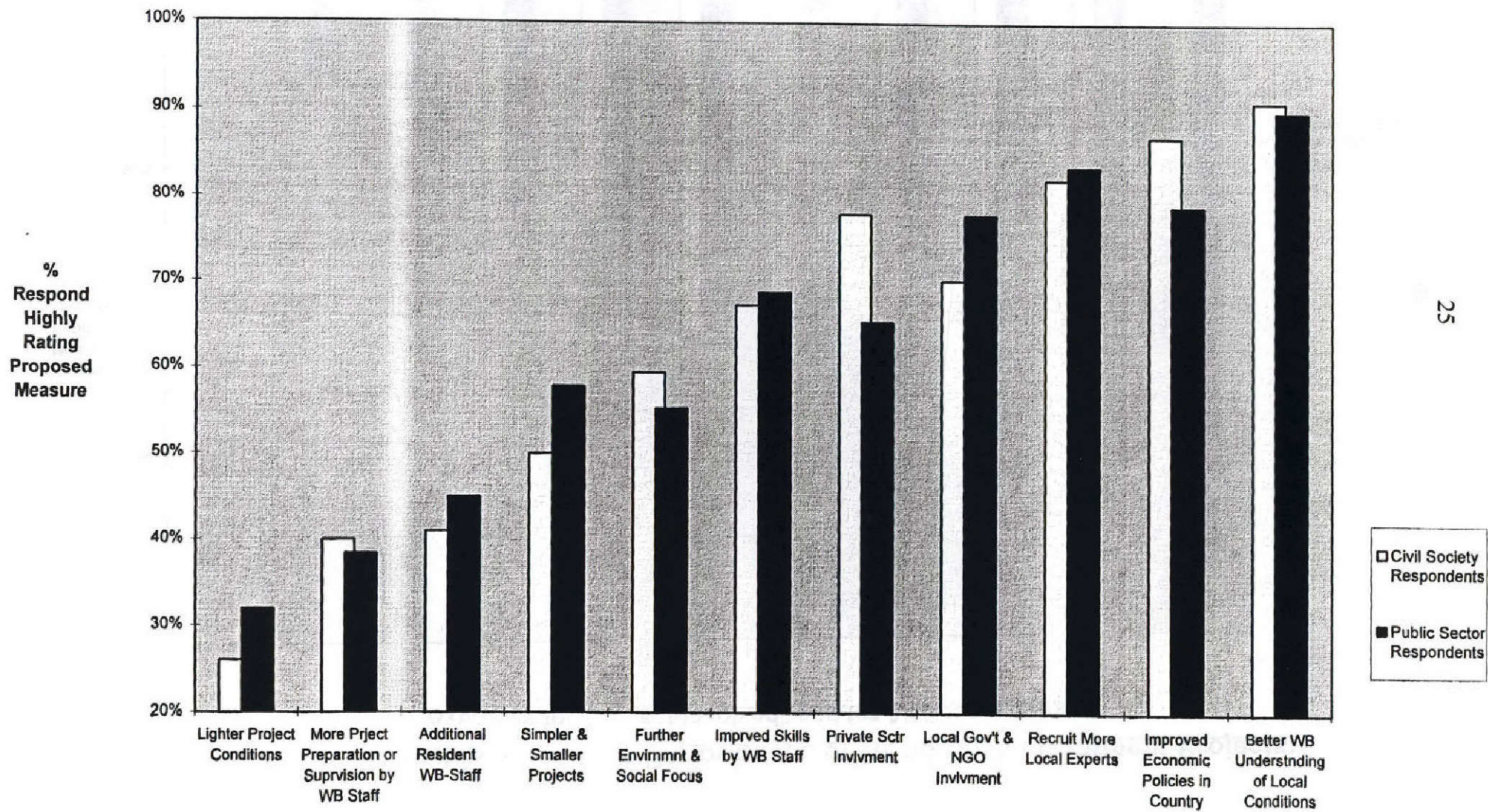
¹⁹ On the latter, in part the answer may reflect a particular negative experience of respondent with the field office in the country (in fact, a few "volunteered" written comments pointed in that direction).

²⁰ These thoughts are decidedly speculative, for the sake of discussion, on the basis of initial analysis and incomplete information--since the questionnaires of stakeholders themselves do not provide with relevant data to address this issue empirically here.

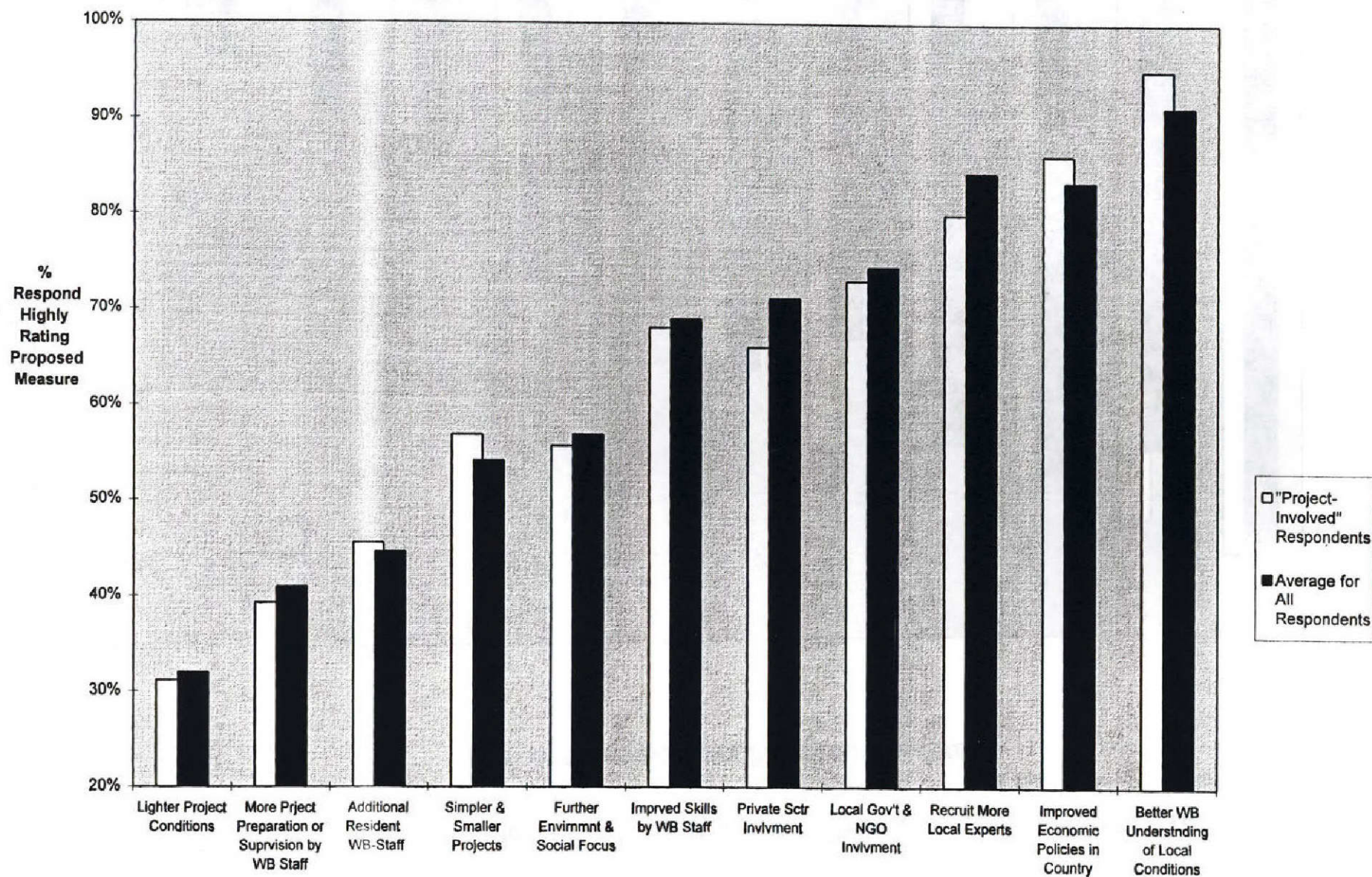
²¹ The comparisons between the public sector and civil society respondents are also telling (Figure 6), and will elaborated upon in the next version of this paper.

Figure 6: Measures to Improve Performance of World Bank Investment Projects

Civil Society and Public Sector Respondents



**Figure 6a: Measures to Improve Performance of World Bank Investment Projects:
Averages for "Project-Involved" and for All Respondents**



Note: A proposed measure to improve project success is highly rated when given a 4 or 5 in a scale of 1 to 5. 57% of all respondents had (at least) some involvement with World Bank projects.

IV. Institutionalizing a New Bank "Instrument"?: Public Education Programs.

One of the important reasons respondents say that their countries did not implement as much economic reforms as in their view they should have is linked to economic education deficiencies. Two-thirds of the respondents thought that inadequate economic reforms understanding by the population was an important factor, and over one-half thought the same about the economic understanding of their leadership/policy makers (Figure 2b at the outset of the paper). It is not surprising, therefore, that there were very clear views by the respondents on the need to implement public education programs. More specifically, the majority strongly supported the World Bank involvement in such programs: 51 percent said that the Bank should be definitely involved, and 39 percent said that it should "possibly" be involved. Only 10 percent said that it was not for the Bank to be involved in these type of endeavors. Interestingly, in terms of the "SAL goodwill nexus" discussed previously, for the subgroup that had viewed SALs as very important for their countries, Bank-supported public education programs had even higher support: 60 percent strongly supported such notion, while virtually all the others possibly supported it--with practically no negatives about World Bank-supported Public Education programs.

V. Conclusions.

We can conclude in brief, since the implications and interlinkages have been largely spelled out within each separate section. We generalize in terms of issues for the World Bank by suggesting that the survey responses point to possible rethinking of some the instruments and priority developmental objectives. In terms of the latter, we focussed on one in particular, namely addressing corruption. This appears to have become a developmental and anti-growth impediment, and it has hampered further progress on economic reforms. The World Bank has a plethora of instruments at its disposal to help address the corruption challenge. Salient issues regarding such instruments were discussed in this paper.

Then we analyzed the respondents' answers regarding perceptions about Structural Adjustment Lending (SALs), which revealed a significant degree of support for such instrument in their countries, and largely due to, first, its role in spearheading economic reforms, and second, as a catalyst for further investments and credits. Additional budgetary and BOP support rate significantly lower as rationales for SALs, in their view. We then explored more broadly the perceptions of respondents about the World Bank as an institution, and within it, the role of SALs in such perception about the institution.

The analysis of the stakeholders' perceptions about Bank investment projects was analyzed next, and their recommendations for improving their prospects for project success. Their recommendations focus on issues such as improved economy-wide policies, and also question the high profile given by the Bank in the past to attempts to increase supervision resources as a key component.

We ended with a brief discussion on the perceived need for the Bank to deepen its involvement in a new "instrument" of sorts: Public Education Programs. The rationale and potential acceptability appear to be clear from the responses. And they could be expected to productively cross-fertilize with conventional investment projects, with the new generation of SALs, with anti-corruption measures, and with other Bank new instruments (such as guarantees, etc) which are lesser known and thus necessitating enhanced dissemination.

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Presentation on
"The Role of the World Bank in Combatting Corruption"

By Ibrahim F. I. Shihata

Before the Conference "After Caracas: Anti-Corruption Strategies in
Latin-America"

Woodrow Wilson International Center for Scholars
September 25, 1996

Mr. Chairman, Ladies and Gentlemen,

You have been discussing corruption since the early morning. You realize of course, that scholars and experts from many disciplines have long debated the nature and impact of this phenomenon. What emerges from the literature is that corruption constitutes a highly complex set of interlocking economic, political, social, moral and historical phenomena. This suggests that attempts to deal with it must commence with analysis of local circumstances

and the ways in which they affect values and behavior in a given country.

Some theorists have argued, or at least have implied, that corruption should be accepted as too deeply rooted in social norms to be ineradicable; or, alternatively, as a "second-best" way of getting things done in a world that is far from perfect. My personal view, informed by years of experience with a number of development institutions, is that corruption in its varied manifestations is very negative on the society as a whole. Its distributional effects discriminate against the poor and the underprivileged, who may accept it as a fact of life but cannot compete in reaping whatever benefits it may bring forth. Even for those who gain from it, corruption increases the cost of transactions and, at a wide scale, can retard the pace of development. It creates a law in practice different from the one in the books. It turns the rule of law to a rule of individuals pursuing their private interests, thus allowing special interests to prevail. It

distorts economic choices. And it disrupts public confidence in government, leading over time to social and political tension. This view is consistent with a growing consensus, not just within the public arena in western countries, but perhaps more strongly within the emerging civil societies in developing countries, which are becoming increasingly open about this matter.

Economic and political liberalization in recent years may have increased the cases of corruption which became publicly exposed. They have also given rise to conditions that make corruption much less tolerable; hence, we have arrived at an opportune moment in history to make a concerted effort towards its significant reduction. We must realize, however, that corruption is not the monopoly of heavily regulated systems. Loosely regulated systems with weak supervisory institutions likewise invite corruption and, at the extreme, even organized crime. Periods of transition (from command to market economies and from closed to open societies) are also conducive to the spread of corruption. The latter thrives

on the conflict of values, then turn onto them to distort them and destroy them.

Both in theory and practice, many ways have been proposed to reduce corruption. However, these amount to so many empty gestures unless there is (i) real commitment from political leadership, (ii) a broad and sustained campaign by civil society to keep that commitment alive, (iii) institutional capacity to implement and enforce, (iv) public disclosure and a free flow of information, (v) a social enabling environment of norms and values supportive of anti-corruption measures, (vi) the adoption by multinational corporations and international agencies of standards and practices which address corruption with a view to fighting it in their work, and (vii) international cooperative efforts to deal with trans-boundary corrupt and fraudulent practices.

Although the World Bank is limited in the extent to which it can intervene against corruption, it recognizes that its mission of

attacking poverty through spurring economic growth and supporting social development can be impeded by corrupt practices. The Bank has therefore taken serious action on a number of fronts. We are also working out a general policy towards corruption that we anticipate will go far toward helping our borrowing countries in their efforts to reduce corruption.

The World Bank is required by its Articles of Agreement to ensure that the proceeds of its loans will be used only for the purposes for which they are granted, and to disburse its loans only as expenditures on the projects it finances are actually incurred. It is also required by these Articles to finance such expenditures "with due attention to considerations of economy and efficiency, and without regard to political or other non-economic influences or considerations." The Articles of Agreement do not specifically include "curbing corruption" among the Bank's purposes or functions. They generally prohibit the Bank from taking non-economic considerations

into account in its decisions and from interfering in the political affairs of its members.

For these reasons, the Bank has traditionally been active and explicit in ensuring that procurement under its own loans is done in a transparent manner and on a competitive basis but has avoided, until very recently, adoption of a full-fledged anti-corruption strategy. Since the early 1990s, the Bank has however identified corruption as an issue to be taken into account in its work on governance and, in a few cases, began to raise it in the country dialogue. While the Bank was not in this way explicitly involved in fighting corruption, it was aware that reforms related to governance have a direct positive effect not only on the growth prospects of the borrowing countries but also on the level of corruption in their societies.

The Bank's involvement in corruption issues beyond the specific projects it finances is based on the fact that as the world's major development finance institution and the coordinator of foreign

aid to many of its members, the Bank cannot realistically ignore issues which significantly influence the effective flow and appropriate use of external resources in its borrowing countries. It has already been able to deal with a large number of governance and institutional issues which have direct relevance to its development mandate, without entanglement in partisan domestic politics. Its concern with public sector management and with improving the enabling environment for the private sector in its borrowing countries has been an important part of its operational and research work through the years. Any intervention by the Bank would, at any rate, take the form either of a financial instrument to which the country involved would be a contracting party, (as a borrower or guarantor,) or advice which must be related to the Bank's development mandate. In neither case can the Bank take a coercive stance or impose a particular direction on a borrowing member. It can only play a facilitating role, the effectiveness of which would depend largely on the borrower's full cooperation.

The World Bank can hardly insulate itself from major issues of international development policy. Corruption has become such an issue. Its prevalence in a given country increasingly influences the flow of public, and at times private funds for investment in that country. The Bank's lending programs and in particular its adjustment lending take into account factors which determine the size and pace of such flows. From a legal viewpoint, what matters is that the Bank's involvement must always be consistent with its Articles of Agreement. The only legal barrier in this respect is that in looking into the corruption factor, the Bank and its staff must be concerned only with the economic causes and effects, and should refrain from intervening in the country's political affairs. While the task may be difficult in borderline cases, its limits have been prescribed in detail in legal opinions endorsed by the Bank's Board.

To date, the World Bank has been actively taken measures to curb corruption on three fronts: (1) within the Bank itself; (2) with

respect to Bank-financed contracts; and (3) in its policy dialogue and lending for adjustment and technical assistance.

On the internal front, the Bank attempts to maintain the highest ethical standards among its staff. Measures have included:

- financial disclosures by senior staff;
- the screening of any outside activity for incompatibility with Bank principles of staff employment;
- the termination of employment in case of corrupt and fraudulent practices resulting in a misuse of Bank or other public funds;
- periodical circulation of a statement on staff ethics;
- improved internal investigation of corruption-related complaints by an Ethics Officer.

On the second front, i.e. with respect to corruption under Bank-financed contracts, the following measures are noteworthy:

- participation of affected people and NGOs, in the design, preparation, appraisal, and monitoring of project implementation;
- access for affected parties before the Bank's Inspection Panel;
- serious discussion of any alleged corruption under Bank-financed projects, in the on-going dialogue between the Bank and its borrowers;

- tightened rules regarding the borrowers' compliance with audit and other financial covenants in the loan agreements (new OP/BP 10.02 - Financial Management);
- suspension of loan disbursement in cases of prolonged non-observance of financial/audit covenants in loan agreements;

The most important improvements to curb corruption under Bank-financed contracts have recently been made in the Bank's rules applicable to the procurement of goods and services under its loans.

Under the new rules and procedures:

- the Bank may reject a proposal for the award of a contract by the borrower upon determination that the bidder recommended for the award has engaged in corrupt or fraudulent activities in competing for that contract;
- the Bank may cancel a corresponding amount of a loan if it determines that corrupt or fraudulent practices were engaged in by representatives of the borrower or a beneficiary of the loan during the procurement process or the execution of any contract under the loan without the borrower having taken action satisfactory to the Bank to remedy the situation;
- the Bank may declare ineligible to be awarded a contract for a specific time or indefinitely any supplier/contractor/consultant who is found by it to have engaged in a corrupt or fraudulent practice;
- the Bank has the right to inspect accounts and records of contractors/suppliers/consultants engaged in Bank-financed contracts; and

- contractors/suppliers/consultants have to disclose any commissions or other payments paid to local or foreign agents in the context of the procurement or execution of Bank-financed contracts.

The main vehicle for assisting its members in their fight against corruption as a general phenomenon is the Bank's lending instruments and its technical assistance loans. The Bank has, in particular, financed:

- economic policy reform measures such as deregulation, liberalization and privatization, including trade and investment laws reform, tax and customs reform, and financial sector reform.
- specific civil service reform and public sector reform for streamlining, downsizing and pay increases;
- legal and regulatory reform; and
- judicial reform.

More importantly perhaps, the Bank has started to take up the issue of corruption in its lending strategy (Country Assistance Strategy) when the level of corruption is high, its adverse impact

on the effectiveness of Bank assistance is established and no satisfactory measures are being adopted to address it.

No doubt, the Bank has to address issues of corruption in this context with great caution, acting on the basis of established facts and only to the extent that the issues clearly affect the economic and social development of the country. It cannot, however, ignore such issues at a time when they have become a major concern, not only to the sources of international financial flows but also to business organizations and indeed to the governments and peoples of most of its member countries.

Thank you.

THE WORLD BANK GROUP

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FACSIMILE COVER SHEET AND MESSAGE

DATE: October 29, 1996 **NO. OF PAGES:** 2 **MESSAGE NO.:** {Message #}
(including this sheet)

TO: Jean-Louis Sarbib **DESTINATION FAX NO.:** 477-0380
Title: V-P
Organization: Africa Region
City/Country: Washington D.C.
cc: C. Madavo, V-P (o/r) :477-0380
M. Malloch Brown, EXT :522-2644
E. Chinje, AFR :473-7917
Robert Blake, AFCOS :472-8262
Kenichi Ohashi, AFCOS :473-8262

FROM: Harold E. Wackman **DIVISIONAL FAX NO.:** 720652
Title: Country Director, Kenya & Djibouti **Dept./Div. No.:** 22712
Division: World Bank - Kenya
Room No.: 502 **Telephone:** 260441

SUBJECT/
REFERENCE: CORRUPTION AND THE BANK'S POSITION/STRATEGY

MESSAGE: The attached article appeared in the Sunday edition of the Nation on October 27. Although I have so far not had contacts with any media during my first week here, I have had enquiries regarding the Bank's new position and strategy from various sources including private sector, donors and staff referring to the President's statement on corruption.

As you know, this is a hot topic in Kenya which will get even hotter during the next year leading up to elections. As you also know, there are various ways in which we are addressing this, e.g. through our efforts on transparency in public expenditure under PFP, pursuing adherence to our procurement guidelines and looking into details of the recent contracts awarded to private power suppliers.

We are interested in developing a strategy on how we approach this subject in Kenya, but before embarking on this I would appreciate some guidance regarding the Bank's position/strategy on corruption, i.e. what specifically do we do, as well as on contacts with external stakeholders on the subject, including the media.

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Open letter to new World Bank chief

Last week the World Bank's new Country Director for Kenya, Mr Harold Wackman, took up his post in Kenya. ROBERT SHAW writes an open letter to the representative of arguably one of the most important players in the Kenyan economy.



Mr. Wackman: World Bank's new boss for Kenya.

Dear Mr Wackman,

Congratulations on your appointment as the World Bank's Country Director to Kenya. By reporting directly to the World Bank's Vice-President for Africa, you have more opportunity than your predecessor to influence and implement World Bank policy in this country.

Whether we like it or not, the World Bank is one of the key determinants as far as Kenya's economic and political health, development and growth are concerned. You may be surprised that I use the word "political", but more on that later.

Over the past few years, many Kenyans have followed ever more closely the workings of the World Bank as far as Kenya is concerned. However, there is scepticism about the institution you represent. This is not only because of some of the policies it pursues. It is also because it often conveys a public image and stance which are more rosy than the actual position and concerns that would be expressed in private. This sometimes leads to the impression that the World Bank is often more interested in its relationship with the government of the day than with the people of this country.

But the bulk of the scepticism undoubtedly lies in the feeling that the major driving force within the World Bank is the urge to lend money and that, when push comes to shove, this will override many economic governance concerns and anxieties. Many Kenyans were surprised to see both the World Bank and the IMF keen to resume or enhance flows of money to Kenya earlier this year in spite of such irregular and questionable Government projects and purchases as the virtually completed Eldoret Airport, the Presidential jet, the second-generation IDs and the ammunition factory.

The World Bank and the IMF have successfully projected an image of being sticklers for good governance and transparency. But deeds do not often match the words both in lending conditionality and in full accountability of some of its own projects.

In all fairness, World Bank President James Wolfensohn has made some tough and uncompromising statements on corruption in the recent past and we hope that this will result in the stiffening of the institution's spine in this regard.

A related concern is that often institutions such as yours are led down the garden path with promises of improved or good behaviour only to be let down when it is too late.

Take, for example, the subject that you personally have much experience in: Energy and power supply in Kenya. In the 1980s and early 1990s, donors, including the World Bank, pulled out of the energy sector because of the mismanagement and corruption in that sector. Aid and investment in this sector ground to a halt and this has been the major cause of Kenya's increasingly acute power supply crises.

Over the last couple of years, we have been assured that this sector was being cleaned up. The World Bank joined this spirit and hosted a major energy conference on Kenya for donors and investors and started negotiations to enhance Kenya's geothermal supply. Now, we hear that the KPLC and, by deed, the Government, have awarded two very smelly

contracts to supply 875 megawatts of power to two international companies, including one from Indonesia. You are undoubtedly aware of the several questionable aspects of deals ranging from the queries over the tendering procedures to the status of actual awardees, to how much money has already been paid upfront.

Where does that leave the World Bank, Mr Wackman? Is this just another passing cloud like Eldoret Airport or will the World Bank put its money where its mouth is as promised by your tough-talking President? Even more important, will the World Bank do anything to ensure this deal is completely revised or cancelled altogether?

Many believe that the root of such aberrations and corruption lie as much in the body politic as in the economic arena. They argue that only when there is major political momentum towards improved political governance and accountability will such scourges as corruption be contained and reduced.

Corruption is as much a political as an economic phenomenon. Such institutions as the World Bank will only have limited success in its endeavours if it continues to cocoon itself largely in the world of the latter.

Indeed your colleagues, the bilateral donors, are increasingly critical of the way the World Bank invariably passes the buck on political governance issues and leaves it up to them to raise. There is concern that the World Bank, which chairs the Consultative Group (CG) of donors, uses its position to reinforce its bias towards the economic and the technical at the expense of the political.

Last, but not least, is the actual direction of the World Bank. If the fundamental role of your institution is to use its resources and influence enhanced development, then is it doing enough in that direction? Shouldn't the World Bank become much more proactive in helping and encouraging countries like Kenya to attain annual economic growth rates in excess of eight per cent? Is it not time for a much bolder set of faster growth-oriented policies such as fast-tracking privatisation, drastically shrinking the tentacles of government, including the number of ministries, spurring investment and savings, including privatising the NSSF and radical tax reform? But maybe these latter questions and suggestions delve too much into the political for the World Bank. Over to you, Mr Wackman.

Robert Shaw is a businessman and commentator on the Kenyan economy.

The World Bank

1818 H Street NW, Washington, DC 20433, USA



THE CORRUPTION ISSUE

Corruption is not a new concern for the World Bank. For decades the Bank has sought to ensure that the funds it lends to countries are used for their intended purposes, and that contracts for goods and services are awarded in a transparent and cost-effective way.

The Bank is undertaking a renewed approach to helping countries prevent corruption and its negative impact on development effectiveness and economic efficiency. We know that corruption and fraud hurt economic efficiency and slow the provision of services and resources to the people—often the poorest—for whom they are intended. Corruption's impact on development is an increasingly important issue in donor countries; with official assistance for development under mounting pressure, greater attention is being paid to how these funds are being used. Moreover, corruption is also an obstacle to foreign investment and is a growing concern for the Bank's partners in the private sector.

The Bank's Approach to Controlling Corruption

The Bank recognizes that corruption needs to be addressed to achieve good governance, and is working to help governments establish safeguards. The Bank's efforts are focused on four broad areas:

- Economic policy reform
- Institutional reform
- Fiduciary control
- Multilateral partnerships

Economic Policy Reform

This relates to the Bank's work in helping governments undertake economic, policy, and regulatory reform.

- **Economic reform:** Through the reform of trade regimes and investment laws and the financial sector, countries can mitigate the effects of "rent-seeking" by replacing administrative mechanisms (for example, export licenses, foreign exchange, and bank credit allocations) with market mechanisms.

- **Tax reform:** By helping countries simplify and strengthen tax systems and strengthen collection capacity, the Bank contributes to the reduction of corruption in customs and tax administration.
- **Regulatory reform:** The Bank helps eliminate price controls, simplify government regulations, and strengthen the regulation of private and state-owned enterprises operating in non-competitive markets.
- **Privatization:** The Bank is helping many developing and transition economies manage the transfer of state-owned assets to private ownership. Because this transition presents corruption risks of its own, the Bank works especially closely with its client governments to help make the process open and transparent.
- **Sector Policies:** How policies are designed in areas like the environment and social services may determine the opportunities for corruption in their implementation, and the Bank can provide a country with best practice experience from others which have improved sector performance.

Institutional Reform

This second area of the Bank's anti-corruption strategy is concerned with building institutional strength inside and outside the public sector.

- **Government financial management reform:** In recent years there has been a rapid increase in the number of countries where the Bank is assisting in the modernization of government budgeting, financial management, accounting, and auditing systems.
- **Civil service reform:** In the past decade the Bank has supported civil service reform in more than 40 countries; emphasis has been on reforming pay and employment conditions, training, and personnel management.
- **Public procurement:** The Bank works with governments toward greater transparency and competition by providing assistance in drafting new procurement laws and regulations, and training officials to implement them.
- **Governance:** On a broader front, the Bank helps countries control corruption through legal, judicial, and regulatory reform. In addition, programs such as EDI's training workshops for journalists help strengthen the ability of the press to scrutinize all fields of public administration.

Fiduciary Control

The third area of the Bank's strategy is the effort made to maintain the highest level of transparency in Bank loans and credits, and ethical standards among Bank staff.

- **Guarding against corruption in Bank projects:** The Bank has long-established procedures for procurement, disbursement, reporting, and auditing, based on principles of

economy, efficiency, and transparency. Financial reporting under Bank loans has recently been strengthened to tighten the time frame for borrower completion of audits.

- **Maintaining the highest ethical standards among bank staff**—Long-standing staff rules on outside interests and disciplinary measures have been and are continually updated and reinforced.

Procurement Guidelines

In recent weeks the Board approved the following important reinforcements to the Bank's loan documents and procurement guidelines.

The new guidelines provide that the Bank:

- may cancel a corresponding amount of a loan if it determines, with respect to any contract to be financed out of the proceeds of the loan, that corrupt or fraudulent practices were engaged in by representatives of the borrower or of a beneficiary of the loan during procurement or during the execution of the contract without the borrower having taken timely and appropriate action satisfactory to the Bank to remedy the situation;
- will have the right to inspect accounts and records of suppliers and contractors relating to the performance of the contract, and to perform a complete audit by Bank-appointed auditors; and
- may bar firms from Bank-financed contracts, either indefinitely or for a specified period of time if the Bank determines the firm engaged in corrupt or fraudulent practices in competing for, or in executing, a Bank-financed contract.

- **Changes in internal Bank procedures:** Greater attention is being given to portfolio management and supervision, and performance measurement. This includes public access to Bank project documents, the creation of the Independent Inspection Panel, and a more participatory approach in the design, preparation, implementation, and appraisal in Bank projects.

Multilateral Partnerships

The fourth area of the Bank's approach to reducing corruption involves coordinating its action with governments, other multilateral institutions, and its partners in the private sector and civil society.

The negative effects of corruption reach across borders and therefore require the concerted attention of the international community. Important international organizations such as the OECD, the Council of Europe, and the OAS are also taking steps toward fighting corruption, including the use of international instruments such as international conventions and formal recommendations to their members. Anti-corruption initiatives are also being undertaken by global business organizations and NGOs. The Bank intends to coordinate its efforts with other bilateral and multilateral initiatives to ensure that the broadest support is given to countries fighting corruption.

Produced by External Affairs, September 24, 1996.

-###-

A L L - I N - 1 N O T E

DATE: 17-Sep-1996 10:35pm EST

TO: SVEN SANDSTROM (SVEN SANDSTROM@A1@WBWASH)

FROM: Mike Stevens, PSP (MIKE STEVENS@A1@WBHQB)

EXT.: 37493

SUBJECT: ANNUAL MEETINGS SPEECH - Corruption

Sven,

Here are some first thoughts on what the corruption section of the speech might contain. I had not thought greatly about what should go in until you called. I am sure it could be refined a great deal.

Sorry not to have gotten back to you earlier this evening. (I had some difficulty logging in from outside - the airwaves are getting crowded - signs of the time).

JDW's Annual Meetings Speech:

1. Start with a reference to last year's speech, when JDW (reportedly - I don't have it at hand) mentioned corruption. JDW raised it then because he believed it was an important issue that those engaged in development needed to confront. Since then, in the past year, JDW has travelled to many countries, both industrialized and developing, and is convinced even more that despite the complexities of the phenomenon, the control of corruption is central to sustainable development as the world approaches C21. Add that corruption challenges all countries, both rich and poor, but is especially burdensome on the poor.

2. JDW has heard:

- NGOs in LDCs explain how good policy through corruption becomes bad environmental practice, how the goals of social programs are diverted, how the lives of the poor are affected.
- Businessmen - how bribery raises the cost of establishing and running a business, creates uncertainty and may cause foreign investors to shun a country.
- Government ministers - ask how they can meet

the demands of a more informed population for better services, freedom from petty harassment, fair judicial systems, and how their countries can survive economically in an increasingly competitive world.

- Leaders in industrialized countries who see corruption eroding the political and social consensus for aid programs and assisting poor countries other than through humanitarian relief.
- Bank staff - talking to staff within the Bank who have no doubt that corruption is a crucial issue, standing in the way of the Bank achieving its development objectives, and, particularly, poverty alleviation and sustainable growth.

3. Whatever may have been the reasons in the past for agencies like the Bank to sidestep the issue, these have passed and JDW is convinced the Bank must address the control of corruption as a central issue of governance and development.

4. What will the Bank do? The Bank stands ready to work with governments and people of any borrowing country which seeks to control corruption in public business, assisting them devise and implement a national strategy. There is no blueprint for a national strategy, it has to be developed individually, with governments and civil society actors within each country devising local solutions to problems. Role of the Bank is to respond with advice, technical and financial resources. Support of the Bank could comprise such things as:

- Helping governments review economic and sector policies to ensure that they promote not only economic efficiency but also limit the scope for rents.
- Building a strong, fairly paid, ethical and professional civil service.
- Revise laws on the control of corruption and strengthen judicial systems.
- Increase the capacity of government departments and agencies to procure goods and services efficiently, effectively and accountably.
- Modernise tax administrations, and strengthen government financial management systems, with transparent budgets, accounting and auditing.
- Through workshops, conferences, and training programs and visits, expose politicians, officials, the media and others in civil society

to other countries' experience building what TI has called a "national integrity system".

5. On the international front, some wording could be developed that JDW and the Bank will continue to speak out on the issue, and lend its weight to international initiatives. NB. Best to keep this general - our leverage in OECD fora is limited, and we didn't start these initiatives, and we don't have anything specific to promote at this point.

6. The above is a soft, cooperative message - the Bank will work with governments. For consideration is whether JDW brackets it with a harder message - where corruption persists and development objectives are adversely affected, and governments don't want to change (or pretend to change) the Bank will curtail lending. While this is the corollary of working with governments to develop national strategies, and might please some critics of aid in Part I countries, it risks a backlash - that control of corruption is a new version of governance conditionality.

7. Finally, JDW should end with the steps that are being taken within the Bank to ensure fraud and corruption is minimized. While he has every confidence in the professionalism and probity of staff, large organizations everywhere are vulnerable to fraud and corruption, and the best systems need to be in place if the Bank is to avoid the risk of being distracted from its primary tasks.

Mike

CC: MARVA ANGUS

(MARVA ANGUS@A1@WBWASH)

cc: T. Gata

THE WORLD BANK

ROUTING SLIP		DATE:
FROM THE OFFICE OF THE SENIOR VICE PRESIDENT AND GENERAL COUNSEL		
NAME		ROOM NO.
Messrs. Mallach-Burn,		
Stevens, Bergen		
APPROPRIATE DISPOSITION		NOTE AND RETURN
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COMMENT		PER OUR CONVERSATION
FOR ACTION		PER YOUR REQUEST
INFORMATION		PREPARE REPLY
INITIAL		RECOMMENDATION
NOTE AND FILE		SIGNATURE
REMARKS:		
Attached is the text of the actual presentation I made at the Conference in Cambridge, England. The detailed paper was circulated to the near 500 participants from around the world.		
FROM:	ROOM NO:	EXTENSION:
Ilsehim Shihata		

Oral Presentation on Corruption

By Ibrahim F. I. Shihata

Before the International Symposium on Economic Crime,

JESUS COLLEGE, CAMBRIDGE, ENGLAND

on September 9, 1996

Mr. Chairman, Ladies and Gentlemen,

I wish to begin by congratulating the organizing institutions of this symposium. The subject matter is timely. Addressing it is gaining momentum at the international level. This symposium will add to this momentum.

It is a great pleasure for me to be with you today and a great honor to be among the first speakers in this symposium.

I have prepared for circulation a detailed paper on the phenomenon of corruption: how it has been addressed by different disciplines, how I see it from my vantage viewpoint, what efforts have been and could be taken to curb it, and how the World Bank is handling it. In view of this detailed treatment in my paper, I wish mainly to emphasize a few points in this presentation:

1. As you know, scholars and experts from many disciplines have long debated the nature and impact of corruption. What emerges from the literature, is that corruption

constitutes a highly complex set of interlocking economic, political, social, moral and historical phenomena. This suggests that we must avoid simplistic solutions and the narrow approaches advocated by this or that social discipline; any attempt to deal with corruption must, in my view, commence with analysis of local circumstances and how they affect values and behavior, and hence the nature and level of corruption in a given country.

2. Some theorists have argued (and may still argue here), or at least have implied, that corruption should be accepted as so deeply rooted in social norms as to be ineradicable; or, alternatively, as a “second-best” way of getting things done in a world that is far from perfect. My personal view, informed by years of experience with a number of development institutions, is that corruption in its varied manifestations is negative on the society as a whole. Its distributional effects discriminate against the poor and the underprivileged. It increases the cost of development and, at a wide scale, can retard its pace. It creates a law in practice different from the one in the books. It allows special interests to prevail over the public interest. And it disrupts public confidence in government, leading over time to social and political tension. This view is consistent with a growing consensus, not just within the public arena in western countries, but also within the emerging civil societies in developing countries, which are becoming increasingly democratic and open.

3. Since the end of the Cold War, both economic and political liberalization have given rise to conditions that make corruption much less tolerable; hence, we have arrived at an opportune moment in history to make a concerted effort towards its significant reduction. We must realize, however, that corruption is not the monopoly of heavily regulated systems. Loosely regulated systems with weak supervisory institutions invite corruption and even organized crime. Periods of transition (from command to market economies and from closed to open societies) are also conducive to the spread of corruption. The latter thrives on the conflict of values, then turn onto them to distort them and destroy them.
4. Both in theory and practice, many ways have been proposed to achieve the reduction of corruption. However, these amount to so many empty gestures unless there is (i) real commitment from local leadership, (ii) a broad and sustained campaign by civil society to keep that commitment alive, (iii) institutional capacity to implement and enforce, (iv) public disclosure and a free flow of information, (v) a social enabling environment of norms and values supportive of anti-corruption measures, (vi) the adoption by multinational corporations and international agencies of standards and practices which address corruption with a view to fighting it in their work, and (vii) international cooperative efforts to deal with trans-boundary corrupt and fraudulent practices.

5. Although the World Bank is limited in the extent to which it can intervene against corruption, it recognizes that its mission of attacking poverty through spurring economic growth and supporting social development can be impeded by corrupt practices. We have therefore taken serious action on a number of fronts, which we believe can have a real impact. We are also working out a general policy towards corruption that we anticipate will go far toward helping our borrowing countries in their efforts to reduce corruption.

Ladies and Gentlemen

6. While I have outlined in my paper the many initiatives the World Bank is taking in this respect, I wish to conclude here by explaining the rationale for the World Bank's concern with corruption as a general development issue, that is beyond the specifics of a project financed by the Bank, where its concern with corruption is self-evident.

The World Bank is required by its Articles of Agreement to ensure that the proceeds of its loans will be used only for the purposes for which they are granted, and to disburse its loans only as expenditures on the projects it finances are actually incurred. It is also required by these Articles to finance such expenditures "with due attention to considerations of economy and efficiency, and without regard to political or other non-economic influences or considerations." The Articles of Agreement do not specifically include "curbing corruption" among the Bank's purposes or functions. They generally prohibit the Bank from taking non-economic considerations into account in its decisions

and from interfering in the political affairs of its members. For this reason, the Bank has traditionally been active and explicit in ensuring that procurement under its own loans is done in a transparent manner and on a competitive basis but has avoided, until very recently, any full-fledged attempt to adopt an anti-corruption strategy. Since the early 1990s, the Bank has however identified corruption as an issue to be taken into account in its work on governance and, in a few cases, began to raise it in the country dialogue. It has also sought to assist its borrowing countries in introducing economic, administrative, legal and judicial reforms through a series of structural and sectoral adjustment loans, technical assistance loans and grants, and sectoral investment loans. While the Bank was not in this way directly involved in fighting corruption, it was aware that these reforms have a direct positive effect not only on the growth prospects of the borrowing countries but also on the level of corruption.

The Bank's explicit concern with corruption as a general development issue came with the assumption of James D. Wolfensohn of its Presidency in mid-1995. Soon thereafter, he highlighted the issue in his first speech before the Annual Meeting of the Board of Governors (in September 1995). He then asked me, as General Counsel, to review all proposals and consider initiatives for possible actions by the Bank. Detailed discussion of such proposals and initiatives at the senior management level led to specific action which has been approved by the President and, as needed, by the Board of Executive Directors. Such action covers a number of different fronts, all related to measures deemed to be within the Bank's competence. In the meantime, a

comprehensive strategy to address corruption, both as an issue of the Bank's own effectiveness and more generally as a development policy issue, is being prepared for consideration by the Bank's Board before the end of this year.

The Bank's involvement in addressing corruption issues beyond the projects it finances has not been free from controversy. On the one hand, it has been argued that the World Bank is not a world government for the borrowing countries; its mandate as an international institution for the financing of reconstruction and development is defined by its Articles of Agreement. Being subject to a weighted voting system and limited in its operations to the borrowing countries, the role of the Bank as a world reformer beyond its defined purposes would inevitably carry the marks of rule by the rich countries of the poorer ones. In any event, the Bank should only be concerned, under this argument, with the functions provided for in its Articles of Agreement, the main among which is to help finance specific projects for productive purposes. It should, in particular, avoid involvement in a subject matter which has obvious domestic political connotations and could otherwise entangle the Bank in complex political considerations which it is explicitly prohibited from taking into account under its Articles.

It should nonetheless be stated that as the world's major development finance institution and the coordinator of foreign aid to many of its members, the Bank cannot realistically ignore issues which significantly influence the effective flow and appropriate use of external resources in its borrowing countries. It has already been able to deal with

a large number of governance and institutional issues which have direct relevance to its development mandate, without entanglement in partisan domestic politics. Its concern with public sector management in its borrowing countries has been an important part of its operational and research work through the years. Any intervention by the Bank would, at any rate, take the form either of a financial instrument to which the country involved would be a contracting party, as a borrower or guarantor, or advice which must be related to the Bank's development mandate. In neither case can the Bank take a coercive stance or impose a particular direction on a borrowing member. It can only play a facilitating role, the effectiveness of which would depend largely on the borrower's full cooperation.

As a practical matter, the World Bank can hardly insulate itself from major issues of international development policy. Corruption has become such an issue. Its prevalence in a given country increasingly influences the flow of public and at times private funds for investment in that country. The Bank's lending programs and in particular its adjustment lending take into account factors which determine the size and pace of such flows. From a legal viewpoint, what matters is that the Bank's involvement must always be consistent with its Articles of Agreement. The Bank can in my view take many actions to help the fight against corruption without violating these Articles. It can conduct research on the causes and effects of this world-wide phenomenon. It can provide assistance, by mutual agreement, in the areas of economic reform, civil service reform, legal and regulatory reform, judicial reform, and other institutional reforms, to

enable its borrowing countries to curb corruption. It may take up the issue of the effect of corruption on development as a subject of discussion in the dialogue with its borrowing members. And, if the level of corruption is high according to factual and objective analysis and the government is not taking serious measures to combat it, the Bank can take this as a factor in its strategy towards the country. The only legal barrier in this respect is that in doing so the Bank and its staff must be concerned only with the economic causes and effects, and should refrain from intervening in the country's political affairs. While the task may be difficult in borderline cases, its limits have been prescribed in detail in legal opinions endorsed by the Bank's Board.

According to one such legal opinion ("Governance Issues and their Relevance to the Bank's Work" issued in December 1990), the concept of governance in the sense of the overall management of a country's resources cannot be irrelevant to an international financial institution which at present not only finances projects but also is deeply involved in the process of economic reform carried out by its borrowing members. Clearly, the concern here is not with governance in the broad sense of the exercise of state powers in all its aspects, but specifically with the appropriate management of the public sector and the creation of an enabling environment for the private sector. It is a concern for rules which are actually applied and institutions which ensure the appropriate application of these rules, to the extent that such rules and institutions are required for the economic development of the country and in particular for the sound management of its resources.

No doubt, the Bank has to address issues of corruption in this context with great caution, acting on the basis of established facts and only to the extent that the issues clearly affect the economic and social development of the country. It cannot, however, ignore such issues at a time when they have become a major concern, not only to the sources of international financial flows but also to business organizations and indeed to the governments and peoples of most of its member countries.

Thank you.

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col. T. Gaeta

CORRUPTION

A GENERAL REVIEW WITH AN EMPHASIS ON THE ROLE OF THE WORLD BANK

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at

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Corruption

A General Review with an Emphasis on the Role of the World Bank

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I. Different Perspectives on Corruption

Societies may differ in their views as to what constitutes corruption, although the concept finds universal manifestations. Experts have different perspectives on the meaning, causes and effects of this universal phenomenon. While a few take an interdisciplinary approach, positions are more often influenced by the respective discipline. The literature on the subject is vast and diversified. Any attempt to summarize it here would not do it justice. It may be useful, however, to begin this lecture by sharing with you what I have learnt from that literature.

Some economic writings tend to define corruption as a situation where the benefit (to a corrupt agent) of acting against the expectation of a principal outweighs the cost, or where a public good, service or office is sold for personal gain.¹ Others describe it in terms of the exploitation of economic rents which arise from the monopoly position of public officials.² In either sense, to quote one economist, corruption “provides a market price where a market is not allowed.”³ Economists find the causes of corruption embedded in the country’s economic and administrative

¹ See, e.g., R. Klitgaard, *Controlling Corruption* 22 (1988); A. Shleifer & R. Vishny, *Corruption*, 108 *Quarterly Journal of Economics* 599 (1993); M. Naim, *The Corruption Eruption*, II *The Brown J.W. Aff.* 245, 248 (1995).

² See, e.g., M. Beenstock, *Economics of Corruption* (1977).

³ R. Klitgaard, *Bribes, Tribes and Markets that Fail: Rethinking the Economics of Underdevelopment*, 11 *Development Southern Africa* 481 (1994).

structures.⁴ They note its prevalence where discretion in the allocation of public goods, services or subsidies is great, the risk of punishment is low and the pay-offs are sufficiently attractive. A broader view takes into account the honesty and integrity of both public officials and private individuals but, holding these factors constant, determines the incidence and size of corruption by the level of benefits available, the riskiness of corrupt deals and the relative bargaining power of its source and beneficiary.⁵ Economists are also concerned about the effect of corruption on growth and development. They see bribery, when freely offered and accepted, as serving the immediate interest of the parties to it. As for the interests of the society, some writers have found corruption an important source of capital formation, which could promote flexibility and efficiency in the market and advance entrepreneurship.⁶ Others concluded, on the basis of questionnaires and interviews with businessmen, that lack of political credibility (faith in the stability of government policies) was much more harmful than corruption, which they viewed "more as a variable cost than

⁴ See, e.g., R. Klitgaard, *supra* note 1, at 38-47; E. Mason, Corruption and Development 17-30 (Harvard Institute for International Development Discussion Paper No. 50, 1978).

⁵ See in particular S. Rose-Ackerman, The Political Economy of Corruption - Causes and Consequences (World Bank, Viewpoint Note No. 74, 1996) (hereinafter The Political Economy of Corruption) and S. Rose-Ackerman, Corruption 9 (1978) (hereinafter Corruption).

⁶ See, e.g., J. Nye, Corruption and Political Development: A Cost-Benefit Analysis, 61 American Political Science Review 421-22 (1967). Professor Nye, a political scientist, who approached the subject from an economist's point of view, is one of the most quoted sources for the argument that corruption can be useful for a country's economy.

as uncertainty factor.”⁷ Other economists distinguish between “efficient” and “inefficient” bribes depending on the underlying regulation, arguing that a bribe to avoid regulations which restrict competition increases efficiency.⁸ Beyond this efficiency argument, and in spite of the dearth of empirical research, an emerging consensus in modern economic writings seems to suggest that the long term effects of corruption on the market and on the people’s welfare are disruptive and inequitable and that such negative effects tend to increase with the degree of monopoly in the provision of goods and services.⁹

Political science speaks of corruption in different patterns of the exercise of power and of outsiders’ political influence on public offices. For many political scientists, the main causes of corruption are to be found in political structures. Some attribute it to those structures which are characterized by the lack of democratic rule.¹⁰

⁷ S. Borner, A. Brunetti & B. Weder, Political Credibility and Economic Development 58-61 (1995) (distinguishing between different forms of corruption and suggesting that some forms while having potentially serious distributional effects, may not be too damaging to economic activity as a whole).

⁸ See, e.g., N. Leff, Economic Development through Bureaucratic Corruption, in Bureaucratic Corruption in Sub-Saharan Africa: Toward a Search for Causes and Consequences 325 (M. Epko, ed., 1979) (hereinafter Bureaucratic Corruption in Sub-Saharan Africa).

⁹ See, e.g., S. Rose-Ackerman, Corruption, *supra* note 5, at 88; A. Shleifer & R. Vishny, Corruption, 108 Quarterly Journal of Economics 599, 600 (1993); P. Mauro, Corruption and Growth, 110 Quarterly Journal of Economics 681 (1995) (representing one of the few empirical studies finding a correlation between corruption and economic growth in the sense that the less corruption there is, the higher the GDP growth rate); P. Ward, Corruption, Development and Inequality 170 (1989) (emphasizing the negative effect of corruption on the income distribution in developing countries).

¹⁰ See, e.g., G. Myrdal, Corruption - Its causes and Effects, in Asian Drama: An Enquiry into the Poverty of Nations, Vol. II, 951, 952 (1968); C. Friedrich, The Pathology of Politics: Violence, Betrayal, Corruption, Secrecy and Propaganda 127, 128 (1972).

They are aware that widespread corruption can be found under democratic governments, but find assurance in the checks and balances inherent in a democratic system.¹¹ They also seek to develop ways to reduce the opportunities for political corruption, including collusion between legislators and bureaucrats and to increase the awareness and participation of voters in the democratic process especially through the efforts of civil society.¹² Political scientists differ on the effects of corruption, with some distinguishing between "integrative" (positive) and "disintegrative" (negative) forms of corruption.¹³ However, a growing consensus is also emerging among political scientists on the adverse impact of corruption on political and bureaucratic stability and efficiency. To quote one of them, "[corruption] privatizes valuable aspects of public life, bypassing processes of representation, debate and choice."¹⁴

Legal literature generally treats corruption in the context of the deviation (for private gains) from binding rules, the arbitrary exercise of discretionary powers and

¹¹ See M. Johnston, Public Officials, Private Interests, and Sustainable Democracy: Connections between Politics and Corruption, Paper presented at the International Institute of Economics' Conference on "Corruption in the World Economy," Washington, DC, April 17, 1996, at 38.

¹² *Id.* at 24-7; S. Rose-Ackerman, Corruption, *supra* note 5, at 12.

¹³ See M. Johnston, The Political Consequences of Corruption: A Reassessment, 18 Comparative Politics 459, 464 (1986).

¹⁴ D. Thompson, Mediated Corruption - The Case of the Keating Five, 87 American Political Science Review 369 (1993).

the illegitimate use of public resources.¹⁵ Lawyers address it in the implementation of economic, administrative and criminal law and in the performance of fiduciary duties in particular, noting its spread when law enforcement is weak and the probability of detection and punishment is low.¹⁶ They agree on its devastating effect on the rule of law which, through corruption, is substituted for by the rule of whoever has the influence or the ability and willingness to pay.¹⁷ They are particularly concerned when corruption reaches the ranks of the judiciary and distorts the system of justice.¹⁸

Sociology finds corruption a “social relationship” represented in the violation of socially accepted norms of duty and welfare.¹⁹ Social scientists speak of it at times in patron-client terms. Some describe it as a form of “patrimonialism” which is

¹⁵ See, e.g., Black’s Law Dictionary 345 (6th ed. 1990) (defining corruption as “[t]he act of an official or fiduciary person who unlawfully and wrongfully uses his station or character to procure some benefit for himself or for another person, contrary to duty and the rights of others”).

¹⁶ See, e.g., R. Ogren, The Ineffectiveness of the Criminal Sanction in Fraud and Corruption Cases: Losing the Battle against White-Collar Crime, 11 The American Criminal Law Review 959, 987 (1973); A. Morice, Corruption, loi et société: quelques propositions, 36 Tiers Monde 41 (1995).

¹⁷ See, e.g., Rose-Ackerman, Corruption, *supra* note 5, at 81-3; A. Block, American Corruption and the Decline of the Progressive Ethos, 23 Journal of Law and Society 18 (1996) (noting that “there is a loss of faith in the United States of America today in public institutions because of the sense that they do not work as intended for they ... have been corrupted ...”).

¹⁸ See, e.g., M. Zalman, Can We Cure Judicial Corruption, 66 Michigan Bar Journal 365 (1987); J. Ramsyer, The Puzzling (In)Dependence of Courts: A Comparative Approach, 23 Journal of Legal Studies 721 (1994).

¹⁹ See, e.g., M. Defleur, Corruption, Law and Justice, 23 Journal of Criminal Justice 243 (1995) (defining corruption as a “colonization of social relations in which two or more actors undertake an exchange relation by way of a successful transfer of the steering media of money or power, thereby sidestepping the legally prescribed procedure to regulate the relation”).

strongest in societies where communities are small and interactive relationships are highly personal, and the need to accumulate "social capital" is great.²⁰ Others consider it an indicator of a dysfunctional society. They generally attribute it to historical and socio-cultural factors resulting from conflicts between different groups and varied values within the society.²¹ It thrives, they say, in the conflict of values. While they also recognize negative and positive effects of corruption, their more recent studies emphasize such negative aspects as adverse effects on development and on national integration.²²

Public administration specialists are concerned with bureaucratic corruption, even though they realize that this is but one form of a more complex phenomenon. They see corruption in the abuse of public resources and the use of public offices for private gains contrary to prescribed norms.²³ They say that it undermines the implementation (and sometimes the making) of public policy. They attribute it mainly to poor pay of public officials, monopoly of public services, wide personal

²⁰ See V. Tanzi, Corruption, Governmental Activities and Markets (International Monetary Fund 1994).

²¹ See, e.g., J. Scott, The Analysis of Corruption in Developing Nations, in Bureaucratic Corruption in Sub-Saharan Africa, *supra* note 7, at 29, 31; R. Braibanti, Reflections on Bureaucratic Corruption, in Bureaucratic Corruption in Sub-Saharan Africa, *supra* note 7, at 11.

²² See, e.g., Introduction to Part III, in Bureaucratic Corruption in Sub-Saharan Africa, *supra* note 7, at 307-09; W. Easterley & R. Levine, Africa's Growth Tragedy: Policies and Ethnic Divisions 2 (World Bank Draft Working Paper, 1996).

²³ See, e.g., G. Caiden & N. Caiden, Administrative Corruption, 37 Public Administration Review 301, 302 (1977).

discretion, weak financial control systems, excessive regulation and procedures, and the failure to build a strong internal culture of public service and ethics.²⁴ They also agree on its overall negative impact where the allocation of public goods and services becomes the privilege of who pays first or most.²⁵

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Business organizations treat corruption mostly as a trade and investment policy issue. While they are concerned about its impact on the volume and cost of transactions, their major worry is the uncertainty it brings to business dealings and their inability to predict the outcome of competition when corruption is widespread.²⁶ Some, especially in developed countries, worry about its impact on company values and financial controls.

²⁴ See, e.g., A. Bent, *The Politics of Law Enforcement: Conflict and Power in Urban Communities* 3-6 (1974) (particularly discussing the cause of too broad discretionary powers of public officials); B. Schaffer, *Access: A Theory of Corruption and Bureaucracy*, 6 *Public Administration and Development* 357 (1986).

²⁵ See, e.g., Introduction to Part III, in *Bureaucratic Corruption in Sub-Saharan Africa*, *supra* note 7, at 308.

²⁶ In its 1977 and 1996 Rules of Conduct, the International Chamber of Commerce (ICC) an international non-governmental organization having 7,000 member companies and business associations in more than 130 countries, condemns corrupt practices by member enterprises in connection with international commercial transactions because of their negative impact on international trade and international competition. See F. Heimann, *International Corruption and Corporate Codes of Conduct*, presentation at the Institute for International Economics' Conference on "Corruption in the World Economy," Washington, DC, April 17, 1996 (not published). In 1995, under the auspices of the World Economic Forum in Davos, Switzerland, a "Davos Group" was formed to work on an agenda to catalyze the adoption of international standards for business ethics and regulation.

Practically all people who publicly address corruption condemn it, even though it would not exist at a wide scale without the participation of many. In the poor countries, most people take it as a fact of life, an unalterable part of the rules of the game which they have no choice but to accept. Their perception of its scope may even exceed its real dimensions.

Most people recognize corruption as an additional cost, which some consider necessary to get things done (and by doing so, contribute to making it necessary). Some see corruption broadly as a violation of human rights and, at the extreme, as a "crime against humanity."²⁷

All agree it may increase the wealth of those practicing it but almost certainly reduces the revenue of the state and the welfare of society as a whole.

Yet corruption in one form or another exists in varying degrees in all human societies. Like other immoral practices, its egregious manifestations have been recognized and condemned since old times in practically all cultures; it continues nonetheless to be widely practiced at all social levels.

²⁷ Corruption in Government 24 (United Nations 1990), TCD/Sem. 90/2, INT-89-R56 (Report of an Interregional Seminar held in the Hague, the Netherlands on December 11-15, 1989).

II. Corruption as I See It

I use the word "corruption" here in a broad sense encompassing different forms of behavior. This behavior usually results from two types of situations. The first is where, in the allocation of benefits or even the mere allowance of opportunities, the temptation to realize private gains prevails over the duty to serve other interests which are usually common interests. And the second is where, in the application of rules, the opportunity to grant special favors undermines the general obligation to apply public rules without discrimination. In situations where rules are being circumvented, are applied with unwarranted differentiation, or are simply non-existent, a corrupt agent typically chooses to give preference to special interests over the interests he is legally required to serve. The resources put at his disposal or the office he holds are being used, or rather abused, in ways different from those set out by his principal. The principal varies according to the situation. It may be the agent's supervisors, the institution for which he works, the owners of such an institution or the public at large.

In this broad sense, corruption occurs when a function, whether public or private, requires the allocation of benefits or the provision of a good or service. The agent may have the opportunity to perform this function in the absence of any or adequate prior rules, substantive or procedural, and may thus have great discretion

and a vast opportunity to make personal choices. He may also be acting when pre-established rules exist but chooses to violate them to achieve private profit for himself and his bribers. Alternatively, he may apply the rules as written but selectively, to benefit himself, his family, friends or whoever pays him for the favor. In all cases, a position of trust is being exploited to realize private gains beyond what the position holder is entitled to. Attempts to influence the position holder, through the payment of bribes or an exchange of benefits or favors, in order to receive in return a private gain or special treatment is also a form of corruption, even if the gain involved is not illicit under applicable law. The absence of rules facilitates the process as much as the presence of cumbersome or excessive rules does.

Corruption in this sense is not confined to the public sector and, in that sector, is not confined to administrative bureaucracies. It is not limited to the payment and receipt of bribes. It takes various forms and is practiced under all forms of government, including well established democracies. It can be found in the legislative, judicial and executive branches of government as well as in all forms of private sector activities. It is not exclusively associated with any ethnic, racial or religious group. However, its level, scope and impact vary greatly from one country to another and may also vary, at least for a while, within the same country from one place to another. While corruption of some form or another may inhere in every human community, the system of governance has a great impact on its level and

scope of practice. Systems can corrupt people as much as, if not more than, people are capable of corrupting systems.

Some cultures seem to be more tolerant than others when it comes to certain forms of corruption, particularly favoritism and petty bribes. In some societies, favoritism is so pervasive in human behavior that those who, in the performance of their public functions, decline to favor friends and relatives are generally criticized as being unhelpful or unkind. Petty bribes are also seen in many countries as a charity, an advance incentive or expression of gratitude, or an acceptable substitute for the low pay of public officials - not the extortion it is recognized to be in other countries. Such cultural variations, though real, should not be taken as acceptable excuses for what is basically a corrupt behavior.

In all societies, however, corruption has devastating effects.

- In the application of law, it creates a different law in practice from the one in the books. It transforms public rules and procedures based on democratic or meritocratic principles into ad hoc practices based on the willingness and ability to pay or on personal connections and reciprocated favors.
- In the practice of government, corruption turns the rule of law to a rule of individuals pursuing their private interests. It gives special interests priority over

the public interest represented by majority rule. Its spread undermines public confidence in government and the government's ability to implement policies, leading to the weakening and possible disruption of democratic systems. While it tends to destabilize democracies, spreading its benefits has been used as a stabilizing tool, especially under non-democratic governments.²⁸

- In the working of most economies, the impact of corruption is not less harmful, whether we look at market or non-market economies. While the phenomenon is complex and the cost may fall on other areas and in future times, corruption can endanger the use of economic choices, increase the costs of transactions, penalize law abiders and produce adverse distributional effects. It is likely to tax the system in its entirety, although it works in particular against the poor and the underprivileged. Its scope and adverse impact or at least the eruption of cases of corruption²⁹ tend to increase in the periods of transition from non-market to a market system, and from a totalitarian to an open political system.
- In all cases, and however you look at it, corruption deepens inequities. In doing so, it sows the seeds for social and political tensions, threatens the very fabric of society and undermines the effectiveness of the state and the political legitimacy of government.³⁰

²⁸ See Rose-Ackerman, Corruption, *supra* note 5, at 80-1.

²⁹ See M. Naim, The Corruption Eruption, *supra* note 1, at 246 (1995) (arguing that the greater disclosure of corruption in recent years is a sign that democracy and markets are working).

³⁰ See Rose-Ackerman, The Political Economy of Corruption, *supra* note 5.

Once corruption finds its way in a certain place or sector, like a virus, it tends to spread out to other areas and sectors. It does not stop at political boundaries and it grows faster in environments of under-regulation or over-regulation. Corrupt and corrupting individuals have a vested interest in spreading the perception that corruption is dominant and prevalent. Through them, it becomes self-perpetuating. Foreign business, especially in developing countries, often contributes to the spread of corruption by assuming that pay-offs and connections are inevitable facts of doing business - an attitude which often turns out to be a self-fulfilling prophecy.³¹ If unchecked, corruption eventually distorts the values of the society, except the few who manage to insulate themselves through strong moral shields, often based on strict religious and ethical values. Its effect on the society and on individuals in that society is thus as destructive as it is far reaching. Any short-term benefits it may bring (such as practically deregulating a heavily regulated economy or "greasing the wheels" of business transactions) will most likely be outweighed by the collective damage corruption is bound to bring about beyond the specific transaction at hand. Even at the transactional level, corruption often increases inefficiency in government projects and may raise the cost of public and private procurement alike. Quite often, large illicit payments, far from being invested in the country, are transferred abroad or diverted into other illegal business. Corruption may also increase the public debt of

³¹ Naim, *supra* note 1, at 255.

the country as a result of the higher cost of externally funded contracts secured through corrupt or fraudulent practices.

In short, corruption, in spite of some returns for its beneficiaries, retards the overall development of societies and their systems of governance. Historically, it declined with the rise of civilizations and increased with their fall. Its level and pace of growth may thus have an inverse relationship with the degree of development.

III. Efforts to Combat Corruption

Attempts to combat corruption may have a greater chance of success if they recognize from the outset the complexity of this phenomenon and the impossibility of eliminating it altogether. Those who are determined to fight corruption must realize that it results from forces which have accumulated over a long period of time and that it takes strong commitments as well as laborious and lengthy efforts to overcome such formidable forces. They are best advised to avoid simplistic solutions and the narrow approaches typically advocated in different social disciplines. A comprehensive approach encompassing the experiences of different disciplines and countries will inevitably consist of short-term and long-term measures which may have both domestic and international dimensions. It should address the economic, political, social, legal, administrative and moral aspects of the phenomenon and recognize the close linkages among these aspects. It must recognize that different types of

corruption may need to be addressed by different strategies and methods. It cannot ignore that the prevalence of corruption is often based on deeply rooted causes related to the values with which people grow up and the system which governs their relationships, both among themselves and with their government. For this reason, a successful approach must also take into account the educational and mass communications' processes which influence such values and system of governance. The synergistic effects of all the measures included in this approach are likely to produce positive results over time. However, curbing corruption requires continued commitment by an adequate number of people as well as an *a priori* acceptance of possible frustration and failure.

A comparative survey of the literature, including different attempts by governments to combat corruption, leads me to place the emphasis on certain areas of reform which may have particular relevance in this respect. Although these relate mainly to government action, there is also a need for complementary efforts by business groups such as the adoption of international and domestic codes of conduct and internal systems for compliance with applicable law and codes against extortion and bribery. Nor should the measures stated below obscure the fact that efforts to combat corruption have a much greater chance of success when they are not confined to the high ranks of government but become the responsibility of the largest possible

numbers of individuals, acting individually and collectively through non-governmental organizations.

1. Economic Reform

Although macro- and micro-economic reforms may not necessarily target corruption as a specific objective, they do have a major positive effect on the situations which give rise to it.³² On the general level, the adoption of sound development strategies creates an environment of hope in the future in the economy as a whole. The loss of such a hope contributes to the shift towards corrupt practices for many of those who see in them the only chance for the betterment of their own conditions. Liberalization of markets, demonopolization of services, and deregulation (i.e. reducing regulations to the necessary minimum to protect competition and ensure transparency and accountability) certainly decrease the opportunities for arbitrary and corrupt practices on the part of public officials. The positive effects of these measures, especially in areas such as foreign trade (imports and exports licenses), taxation (tax structures and administration, including customs), and entry and exit barriers for investment have been proven in many countries. Such effects are clearest when these measures are coupled with the development or strengthening of

³² See, e.g., World Development Report - From Plan to market 95-6 (World Bank 1996) (listing economic measures such as transparent privatization, liberalization, demonopolization of the economy, and deregulation as measures which, according to Bank experience, have produced the scope for corruption and are supposed to also have this effect, if applied, in transition economies).

institutions which supervise the proper implementation of remaining regulations and ensure their effectiveness. In the absence of strong and effective institutions, economic liberalization may become counter-productive. It may increase the chances for corruption and create a vacuum for organized crime to fill. Even privatization authorities and regulatory institutions can themselves be subject to corruption.

In addition to general economic reform measures, specific anti-corruption actions enhance the chances of success. These may include the imposition of user fees for government services (with a simultaneous increase in the salaries of public employees, practically replacing illicit bribes), or reducing the discretionary distribution of benefits (especially subsidized food and public housing allocations which can be delivered at market prices, with cash payments to the needy) as well as similar measures which, to the extent possible, replace administrative approvals with market mechanisms, thus obviating the need for influencing the officials in charge and reducing the scope for rent seeking. Governments must be careful however as all these measures may easily be exploited in the absence of strong supervisory institutions.

2. Legal and Judicial Reform

Clarifying and streamlining the necessary laws and eliminating the unnecessary ones, strengthening the law enforcement capacity in the country while

putting in place measures to ensure an efficient and just judicial process are not only general steps required for the creation of a sound investment climate;³³ they are also necessary for reducing the incidence of corruption.³⁴ Specific laws may also be issued to introduce a greater measure of transparency in government actions, to regulate procurement of goods and services for the government on a competitive basis and impose deterrent procedures on corrupting bidders, to create investigative, monitoring and evaluating authorities, to prohibit bribery of both local and foreign officials, and to impose severe punishment on both the giver and recipient of bribes, to end tax deductibility of bribes, to impose strict corporate auditing, accounting and disclosure rules, to forfeit corruptly gained assets and contracts, to protect witnesses and informers, and to reverse the burden of proof in cases of unjustified enrichment in order to facilitate the often elusive attempts to capture corrupt officials. Legislative action may also address political corruption by criminalizing bribery (and other advantages) of members of and candidates for law-making bodies and officials of public parties.

³³ On the role of legal and judicial reform for private sector development, see I. Shihata, *The World Bank in a Changing World*, Vol. II, 127-182 (1995), Chapter Three (Legal Framework for Development and the Role of the World Bank in Legal Technical Assistance) and Chapter Four (Judicial Reform in Developing Countries and the Role of the World Bank).

³⁴ See generally Rose-Ackerman, *Corruption*, *supra* note 5, Part II on bureaucratic corruption. See also *World Development Report - From Plan to Market 95* (World Bank 1996) (identifying uncertain rules and heavy regulation in many economy-related areas as causes of corruption and calling for legal order to reduce corruption).

Such legislative anti-corruption measures may not be effective, however, in the absence of honest and efficient investigative and judicial bodies. Increasing the remuneration and training of clerks, prosecutors and judges and enhancing their career development opportunities as well as protecting their independence contribute greatly to the fight against corruption. The establishment of an anti-corruption commission, an ombudsman's office and the like may also be helpful, although experience has been mixed in this respect. Corruption is rampant in some countries with several such offices, filled with low-paid and ill-trained staff at all levels. Worse still, these offices have been actively used in some instances by incumbent governments against their political enemies.

3. Administrative (Civil Service) Reform

As in the cases of economic and legal/judicial reforms, general administrative reform (especially in the revenue-collecting departments) can significantly reduce corruption.³⁵ Reform of the civil service may also include specific measures which directly address this phenomenon. Obviously, the issue here is not merely the reduction of the size of the civil service, necessary as this may be.

³⁵ See generally Rose-Ackerman, Corruption, *supra* note 5, Part II on bureaucratic corruption, and World Development Report - From Plan to Market 95-6 (World Bank 1996) (listing some administrative reform measures such as the strengthening of oversight and appeal mechanisms, as well as the increase in public officials salaries, etc. as efficient anti-corruption efforts). See also Corruption in Government 12-17 (United Nations 1990), TCD/Sem. 90/2, INT-89-R56 (Report of an Interregional Seminar held in the Hague, the Netherlands on December 11-15, 1989).

The required general reform includes as well all the measures needed to ensure efficiency and honesty of the civil service. Of particular relevance are:

- the restructuring of the civil service to make it responsive to actual needs;
- the streamlining of administrative rules and procedures, especially by eliminating meaningless approvals and programs riddled with corruption;
- the introduction of competition between government agencies and the private sector in the delivery of public services and the supply of goods;
- the professionalization of the service through adequate remuneration (especially for officials with discretionary powers over distribution of benefits), continuous training, skilled management, objective systems of recruitment and promotion based on qualification and performance and improved definition of tasks and work standards;
- the promotion of ethics in the civil service through the enactment and enforcement of clear rules governing conflicts of interest, elaboration on expected behavior, obligatory disclosure of assets and investments above a certain threshold (including those of dependents) and meaningful sanctions in cases of violation;
- paying special attention to the selection of managers, both from the professional and ethical viewpoints, and applying to them an effective system of incentives and sanctions;

- increasing the public's awareness of their rights to government services and the channels available to them for submission of complaints, while strengthening the capacity of these channels and access to administrative and judicial remedies;
- introducing an effective system of financial management, including serious and timely record keeping, auditing and supervision of performance, especially in the procurement of goods and services and the execution of public works;
- adoption of clear legislation and regulations on public procurement generally based on the principle of competitive bidding, and
- adequate regulation, staffing and equipment in the agencies in charge of combating tax evasion and money laundering, including rewards and punishments needed to ensure effective compliance and implementation.

Such general administrative reforms may also be complemented by specific anti-corruption techniques, such as creating several offices to provide the same function (e.g., to issue driving licenses or passports), in order to reduce the monopoly rents of a single outlet and allow the public to opt out of the corrupt ones. They may also include anti-corruption measures, such as anti-bribery laws which impose penalties representing a multiple of the marginal benefits of the pay-offs, not just the amounts paid or received, in addition to mandatory dismissal of corrupt officials, and the disqualification (from bidding for government contracts or services) of corrupt

firms or individuals and regulating the payment of commissions for public contracts with a view to limiting them to appropriate remuneration for legitimate services, if not eliminating them altogether.

4. Other Institutional Reforms , ,

The above reforms may not produce their desired effect in the absence of a system of government endowed with adequate checks and balances to prevent collusion between the separate branches of government and the emergence of *de facto* centers of power which act above the law. Depending on the circumstances of each country, the introduction of such a system may require a massive effort of political reform, along with broad access to information and a free press. This, of course, may not always be feasible and cannot at any rate be sustained if it is merely imposed from the outside. However, political reform may gradually develop from within the society, through the elimination of illiteracy, the strengthening of the education system, the development of civil society, the liberalization of economy, the building up of the citizens' confidence in their state's political and economic system, and the adoption of measures of legal and judicial reform to establish the rule of law, especially with emphasis on the due process of law.

Nothing in the above suggests that democratic governments are immune from corruption; it simply indicates that the more checks and balances exist within a

society, and the more strong institutions are in place to protect such checks and balances, in an overall environment of liberalization, the fewer opportunities there may be for corrupt practices which remain unchecked or unpunished. Electoral laws can also be used to curb political corruption. They should regulate political contributions and provide for their disclosure. Immunity of members of Parliament should not be invoked in cases of alleged bribes or extortion to them or by them.

5. Moral Reform

Underlying all reforms is the commitment of the reformers, the pressure from the civil society that sustains this commitment, and the ability of the leadership to influence the public. This usually requires high moral standards at the leadership level. Such standards normally reflect the common aspiration of the society and are often embedded in the teachings of its predominant religion and ethics. It is not uncommon, however, to note a wide gap between such teachings and peoples' day-to-day behavior. Rather than attempting to narrow this gap through a combination of reinterpreting the teachings and reforming the behavior, most societies are content to live with it and to see it widening further over time. The effect on the level of corruption is then inevitable.

If corruption becomes rampant, combating it would require a major change in moral behavior. The issue here is hardly the lack of an agreed set of moral

values, but rather the prevalent hypocrisy which confines these values to public postures, with little impact on daily behavior. While a new moral movement, with or without religious underpinnings, may emerge from time to time, it cannot be always relied upon as a practical remedy. The attitude of the elite in power can have demonstrable effects, however. The behavior of parents at home, teachers at school, and political leaders in and outside government inevitably influence the behavior of a new generation. An ideology of austerity may be useful in a poor society, but not if it is required only from the poor. Religious teachings may also have little effect if the public has little faith in the degree of their observance by those who are more privileged in the society or by the religious establishment itself.

6. International Measures

While domestic measures of reform such as those already mentioned may help in checking corruption, certain corrupt practices defy remedies by domestic measures alone. International collaboration is particularly needed with respect to activities which by their very nature are transboundary, such as corruption in international business transactions and money laundering (especially in connection with illicit narcotics trafficking). It is required in particular to enhance the capacity of states which need assistance in combating corruption and to strengthen mechanisms for exchange of information and for mutual assistance in the investigation.

It should be noted, however, that international measures addressing corruption are still in their infancy. Apart from the international measures for the criminalization of money laundering which started with the 1988 UN Convention Against Drug Trafficking,³⁶ other international measures, are the product of more recent years (with the exception of the abortive attempt of the UN Commission on Multilateral Corporations referred to later on). Mostly regional in character, these measures have, for the most part, taken the form of draft agreements or non-binding recommendations.

The one multilateral anti-corruption agreement which has already been signed (although it has yet to enter into force) is the 1996 Inter-American Convention Against Corruption prepared under the auspices of the Organization of American States (OAS). This regional convention (so far signed by all OAS members, with a belated signature by the US) is open for accession by non-OAS members. It requires

³⁶ Reference is to the UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances which was open for signature on December 20, 1988 and entered into force on November 11, 1990. This convention establishes that illicit trafficking in drugs and laundering of the proceeds from such trafficking shall be criminal offenses in the state parties. The Convention also requires parties to it to render mutual legal assistance with respect to the prosecution of the just mentioned offenses and particularly with respect to search and seizures. International measures against money laundering include, in addition to the above-mentioned UN Convention, the 1988 Statement on Prevention of Criminal Use of the Banking System for the Purposes of Money-Laundering issued by the Basle Committee on Banking Regulations and Supervisory Practices, the 1990 Council of Europe Convention of the Proceeds from Crime (in force), the 1991 EC Directive on Prevention of the Use of the Financial System for the Purpose of Money Laundering (in force), and the 1990 Forty Recommendations of the Financial Action Task Force (FATF) (created by the G-7 Summit in 1989) on Money Laundering. The Forty FATF Recommendations were revised in 1996.

the states parties to take action against defined corrupt practices both within their territories and, subject to their respective constitutions, those committed by nationals and residents abroad. As defined in the convention, the actions to be outlawed cover corruption both in its active (the offering or granting of any article of monetary value or other benefit to a government official in exchange for any act or omission in the performance of a public function) and passive forms (the solicitation or the acceptance by a government official of such article or benefit for the same purpose). It also covers the fraudulent use or concealment of property derived from the aforementioned acts, the participation, in any manner, in their commission or attempted commission, and other acts of corruption which the states parties agree to include under the Convention. Subject to the constitutional law of each member, the Convention equally covers the offense of "illicit enrichment," that is any unexplained significant increase (in relation to lawful earnings) in the assets of a government official. (The US delay in signing the Convention has been justified by the possible inconsistency of this latter requirement with the constitutional protection in the US against self-incrimination.) In addition to requiring that such acts of corruption be established as criminal offenses, and providing the jurisdictional basis for such state actions (including the possible extra-territorial application of bribery laws), the Convention also provides for mutual assistance among the agencies of the states parties in the investigation and prosecution of acts of corruption and in the tracing and

seizure of their proceeds. It prohibits states parties from invoking bank secrecy as a basis for refusal to provide such assistance.

At the OECD level, two recommendations to governments have been adopted. The 1994 Recommendation is directed against "bribery of foreign public officials in connection with international business transactions." Recommending the extra-territorial application of bribery law, the Recommendation suggests the criminalization of bribery and making its acts illegal in terms of civil, commercial and administrative laws and regulations, along with eliminating the indirect favoring of bribery in tax laws and introducing company and business accounting requirements and banking regulations to facilitate inspection and investigation as well as the denial of public subsidies, licenses, and other public advantages in cases of bribery. The 1994 Recommendation also provides for cross boundary cooperation and consultation among the relevant authorities, regular reviews, and international legal assistance. By contrast to this broad recommendation, the 1996 OECD Recommendation is confined to the prohibition of tax deductibility of bribes to foreign officials - a practice which seems to have been tolerated before outside the United States.

A number of European draft conventions are also worth mentioning. These include first a draft Protocol on Corruption to the EC Convention on the Protection of the Communities' Financial Interests which will be discussed this month (September,

1996). Due to the confidential nature of its contents at this stage, it cannot be commented upon here.

Other European initiatives include the two 1996 draft conventions which the Multidisciplinary Group on Corruption of the Council of Europe has still to finalize. The first of those is the draft Framework Convention on Corruption which focuses on the criminal law aspects of this phenomenon, requires the parties to outlaw corruption (and the laundering of its proceeds) “at home and abroad,” and prohibits the granting of tax deductions for bribes or other economic advantages linked to corruption “whether benefited at home or abroad.” It also requires parties to adopt “appropriate legislation” for the procurement of public goods and services and for the restructuring of administrative procedures as well as codes of conduct for elected representatives, freedom of the press, auditing of businesses and the establishment of appropriate civil law remedies for victims of corruption.

The second draft convention of the Council of Europe is the draft Convention on Corruption. Unlike the previous one, this draft convention provides a detailed definition of the forms of corruption covered by this term. Those include both active and passive bribery as well as the trading in influence over the decision-making of public officials and money laundering. It is not limited in scope to public officials. Also covered are private, including foreign, entities, and senior officials of

international organizations, elected representatives of international bodies and judges and officials of international courts. The latter draft convention also provides for cooperation and assistance between the parties in the investigation of corrupt acts and in the confiscation of their proceeds and the provision of additional remedies for their victims.

At a more universal level, the UN Commission on Transnational Corporations completed in 1978 a draft International Agreement on Illicit Payments which has since been abandoned, in spite of its apparent usefulness. Covering both active and passive corruption, this draft requires the criminalization of corruption in international commercial transactions and establishes the jurisdictional basis for the prosecution of this offense. It requires the parties to provide for the obligation of transnational corporations to keep accurate records of payments related to their international transactions. It also requires civil sanctions for corrupt practices and mutual assistance among the states parties to it.

Finally, at a less formal level, the International Chamber of Commerce issued in 1996 a revised version of its 1977 ICC Rules of Conduct as a set of legally non-binding rules of ethical business conduct. While these Rules appeal to public international organizations, such as the World Bank, to take measures to combat

corruption, they basically address the behavior of member corporations.³⁷ They prohibit corruption in a broad sense which includes extortion, bribery, kick-backs, payments to agents which represent more than the appropriate remuneration for legitimate services and contributions to political parties or committees or to individual politicians if undisclosed and made in violation of applicable law. The Rules also require proper financial recording and auditing by the enterprises and introduce control and review procedures within each enterprise to ensure compliance and sanctions against the responsible director or employee contravening the Rules. They also speak of the need for a code of conduct for each individual company (with examples provided) and of coordination between the ICC headquarters and its national committees in this field as well as for the promotion of the Rules themselves on the domestic and international levels.

IV. The World Bank's Efforts

1. The Bank's Growing Concern with Corruption Issues

The World Bank is required by its Articles of Agreement to ensure that the proceeds of its loans will be used only for the purposes for which they are granted and to disburse its loans only as expenditures on the projects it finances are actually

³⁷ See Heimann, *supra* note 20.

incurred.³⁸ It is also required by these Articles to finance such expenditures with due attention to considerations of “economy and efficiency,” and without regard to political or other non-economic influences or considerations.³⁹ The Articles of Agreement do not specifically include curbing corruption among the Bank’s purposes or functions. They generally prohibit the Bank from taking non-economic considerations into account in its decisions and from interfering in the political affairs of its members.⁴⁰ For this reason, the Bank has traditionally been active and explicit in ensuring that procurement under its own loans is done in a transparent manner and on a competitive basis but has avoided, until very recently, any full-fledged attempt to adopt an anti-corruption strategy. Since the early 1990s, the Bank, has however identified corruption as an issue to be taken into account in its work on governance and, in a few cases, began to raise it in the country dialogue. It has also sought to

³⁸ See Article III, Section 5 (c), 2nd sentence of the IBRD Articles of Agreement (providing, *inter alia*, that “in the case of loans made by the Bank, it shall open an account in the name of the borrower and the amount of the loan shall be credited to this account in the currency or currencies in which the loan is made. The borrower shall be permitted by the Bank to draw on this account only to meet expenses in connection with the project as they are actually incurred”). See also Article V, Section 1(h) of the IDA Articles of Agreement (providing that “[f]unds to be provided under any financing operation shall be made available to the recipient only to meet expenses in connection with the project as they are actually incurred”).

³⁹ See Article III, Section 5(b) of the IBRD Articles of Agreement (providing that “[t]he Bank shall make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency and without regard to political or other non-economic influences or considerations”). See also Article V, Section 1(g) of the IDA Articles of Agreement to the same effect.

⁴⁰ See Article IV, Section 10 of the IBRD Articles of Agreement (stating that “[t]he Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned”). See also Article V, Section 10 of the IDA Articles of Agreement to the same effect.

assist its borrowing countries in introducing economic, administrative, legal and judicial reforms through a series of structural and sectoral adjustment loans, technical assistance loans and grants and sectoral investment loans. While the Bank was not in this way directly involved in fighting corruption, it was aware that these reforms have a direct positive effect not only on the growth prospects of the borrowing countries but also on the level of corruption.

The Bank's explicit concern with corruption as a general development issue came with the assumption of James D. Wolfensohn of its Presidency in mid-1995. Soon thereafter, he highlighted the issue in his first speech before the Annual Meeting of the Board of Governors (in September 1995). He then asked me, as General Counsel, to review all proposals and consider initiatives for possible actions by the Bank. Detailed discussion of such proposals and initiatives at the senior management level led to specific action which has been approved by the President and, as needed, by the Board of Executive Directors. Such action covers a number of different fronts, all related to measures deemed to be within the Bank's competence which will be detailed below. In the meantime, a comprehensive strategy to address corruption, both as an issue of the Bank's own effectiveness and more generally as a development policy issue, is being prepared for consideration by the Bank's Board in the near future. The address of the Bank's President before the 1996 Annual Meeting of the Board of Governors next month will provide the occasion to outline the President's

thinking in what may prove to be one of the important changes in the Bank's approaches.

Before addressing in the remaining part of this lecture past and current actions of the Bank in combating corruption, it may be useful to explain the reasons which prompt it, at this particular stage, to take a leading role in this area.

The Bank's involvement in addressing corruption issues beyond the projects it finances has not been free from controversy. On the one hand, it can validly be argued that the Bank is not a world government for the borrowing countries; its mandate is defined by its Articles of Agreement. Being subject to a weighted voting system and limited in its operations to the borrowing countries, its role as a world reformer beyond its defined purposes would inevitably carry the marks of rule by the rich countries of the poorer ones. In any event, the Bank should only be concerned, under this argument, with the functions provided for in its Articles of Agreement, the main among which is to help finance specific projects for productive purposes.⁴¹ It should, in particular, avoid involvement in a subject matter which has obvious domestic political connotations and could otherwise entangle the Bank in complex

⁴¹ See Article III, Section 4(vii) of the IBRD Articles of Agreement which reads: "Loans made or guaranteed by the Bank shall, except under special circumstances, be for the purpose of specific projects of reconstruction or development." See also Article V, Section 1(b) of the IDA Articles of Agreement to the same effect.

domestic considerations which it is explicitly prohibited from taking into account under its Articles.

It should nonetheless be stated that as the world's major development finance institution and the coordinator of foreign aid to many of its members, the Bank cannot realistically ignore issues which significantly influence the effective flow and appropriate use of external resources in its borrowing countries. It has already been able to deal with a large number of governance and institutional issues which have direct relevance to its development mandate, without entanglement in partisan domestic politics. Its concern with public sector management in its borrowing countries has been an important factor in its operational and research work through the years. Any intervention by the Bank would, at any rate, take the form either of a financial instrument to which the country involved would be a contracting party, as a borrower or guarantor, or advice which must be related to the Bank's development mandate. In neither case can the Bank take a coercive stance or impose a particular direction on a borrowing member. It can only play a facilitating role, the effectiveness of which would depend largely on the borrower's full cooperation.

As a practical matter, the World Bank can hardly insulate itself from major issues of international development policy. Corruption has become such an issue. Its prevalence in a given country increasingly influences the flow of public and private

funds for investment in that country. The Bank's lending programs and in particular its adjustment lending take into account factors which determine the size and pace of such flows. From a legal viewpoint, what matters is that the Bank's involvement must always be consistent with its Articles of Agreement. The Bank can in my view take many actions to help the fight against corruption. It can conduct research on the causes and effects of this world-wide phenomenon. It can provide assistance, by mutual agreement, to enable its borrowing countries to curb corruption. It may take up the level of corruption as a subject of discussion in the dialogue with its borrowing members. And, if the level of corruption is high according to factual and objective analysis and the government is not taking serious measures to combat it, the Bank can take this as a factor in its strategy towards the country. The only legal barrier in this respect is that in doing so the Bank and its staff must be concerned only with the economic causes and effects and should refrain from intervening in the country's political affairs. While the task may be difficult in borderline cases, its limits have been prescribed in detail in legal opinions endorsed by the Bank's Board.⁴²

According to one such legal opinion ("Governance Issues and their Relevance to the Bank's Work" issued in December 1990), the concept of governance in the

⁴² See Issues of "Governance" in Borrowing Members - The Extent of Their Relevance Under the Bank's Articles of Agreement, Legal Memorandum of the General Counsel, dated December 21, 1990 (SecM91-131, February 5, 1991) and Prohibition of Political Activities in the Bank's Work, Legal Opinion of the General Counsel, dated July 11, 1995 (SecM95-707, July 12, 1995).

sense of the overall management of a country's resources cannot be irrelevant to an international financial institution which at present not only finances projects but also is deeply involved in the process of economic reform carried out by its borrowing members. Clearly, the concern here is not with the exercise of state powers in the broad sense but specifically with the appropriate management of the public sector and the creation of an enabling environment for the private sector. It is a concern for rules which are actually applied and institutions which ensure the appropriate application of these rules, to the extent that such rules and institutions are required for the economic development of the country and in particular for the sound management of its resources.⁴³

No doubt, the Bank has to address issues of corruption in this context with great caution, acting on the basis of established facts and only to the extent that the issues clearly affect the economic development of the country. It cannot, however, ignore such issues at a time when they have become a major concern, not only to the sources of international financial flows but also to business organizations and indeed to the governments and peoples of most of its member countries.

2. Ensuring a Corruption-Free Institution

⁴³ For details see I. Shihata, *The World Bank in a Changing World*, Vol. 1, 53-96 (1991).

For an institution like the World Bank to take a leading role in the international efforts to assist its members in curbing corruption, it must first introduce adequate safeguards against any corruption within its ranks. There is no evidence of any major instance of corruption in the more than 50 years of Bank's history; few incidents have been promptly dealt with, even harshly in some cases, according to the Bank's Administrative Tribunal.⁴⁴ The Bank's Staff Rules include detailed provisions on conflicts of interest and the expected behavior of staff in their dealings within and outside the Bank.⁴⁵ They require annual financial disclosures of all assets and financial transactions by senior staff⁴⁶ and disclosure by all staff of "any financial or business interest of the staff member or of a member of his immediate family that might unfavorably reflect on or cause embarrassment to the Bank."⁴⁷ An Outside Interests Committee, headed by a Deputy General Counsel, must approve any staff activity unrelated to the performance of Bank duties, other than a non-compensated position in a non-profit corporation or organization, to ensure that it is compatible

⁴⁴ So far two case before the Bank's Administrative Tribunal have involved fraud committed by Bank staff. In both cases the Bank had terminated the staff for defrauding the Bank by submitting exaggerated overtime claims. This sanction was found, however, to be disproportionate by the Administrative Tribunal. *See* W. Carew v. IBRD, Decision 142, WBAT Reports (1995); A. Planthara v. IBRD, Decision 143, WBAT Reports (1995).

⁴⁵ *See* Staff Rule 3.01, Paras. 1.01, 4.01-4.06, 5.01-5.03, 6.01-6.03, (setting forth the rules governing conflicts of interest including public and private activities of Bank Staff). *See also* Principle 3 of the Staff Manual summarizing the general obligations and general behavior of Bank staff.

⁴⁶ *See* Staff Rule 3.01, Paras. 8.01-8.02.

⁴⁷ *See* Staff Rule 3.01, Para. 8.01.

with Bank Group work requirements and the principles of staff employment.⁴⁸ In addition, a statement on staff ethics, first issued in 1994, is now to be distributed annually under the President's signature.⁴⁹ As part of the recently approved measures, the Staff Rules will be amended to make termination of employment mandatory in any case of corrupt or fraudulent practice resulting in a misuse of Bank funds or other public funds. They will also clarify the duty of staff to report incidents of corruption and strengthen the reporting procedures in such cases. Focal points have been designated to receive corruption-related complaints and to investigate them or advise on how best they should be investigated. Programs for increasing staff awareness about corrupt practices will be launched. Periodic audits of internal activities will also take place over and above the normal auditing work of the Internal Audit Department, to establish whether any questionable practice has taken place.

3. Curbing Corruption Under Bank-Financed Loans

While the Bank has long been known for its stringent measures to insulate the projects financed by it from any possible corruption, such measures have recently been enhanced in a number of areas, some of which have broader objectives:

- (i) At the early stages of project design, preparation and appraisal, the
Bank now places emphasis on the participation of affected people and

⁴⁸ See Staff Rule 3.01, Paras. 10.01-10.05.

⁴⁹ See The World Bank Group Code of Professional Ethics.

NGOs.⁵⁰ Such participation, while serving other purposes, indirectly improves the accountability of government agencies and allows the Bank to hear and verify possible complaints about corruption, such as the selection of the project location to accommodate some special interests. Also, during project appraisal, Bank staff are now required to place emphasis on confirming the adequacy of the project's accounting system and to make sure that loan agreements include adequate covenants on appropriate financial management.

(ii) During project implementation, the Bank now places a much greater emphasis on supervision, including the actual observance of auditing requirements. It reviews with borrowers the Bank's portfolio of on-going projects, both to identify problems and agree on solutions.⁵¹ Through such close supervision and review, questions of corruption, if they arise at all, have a much greater opportunity to be addressed. The Bank's more open disclosure policy adopted in 1993 also allows concerned NGOs and the public at large to play a more effective role in monitoring Bank-financed projects.⁵² The

⁵⁰ Pursuant to Operational Directive (OD) 14.70, NGOs may become involved at all stages of a Bank-financed project. Other Operational Directives such as OD 4.00 on Environmental Policies or OD 4.30 on Involuntary Resettlement ensure the participation of people affected by Bank projects.

⁵¹ See Operational Policy Statement (OP) 10.02 which is discussed *infra*.

⁵² See Bank Procedure (BP) 17.50 on Disclosure of Operational Information and the Bank's Operational Policy Statement on Disclosure of Information (OP 17.50).

establishment, also in 1993, of the Bank's Inspection Panel gives affected parties access to an independent mechanism to review alleged deviations by the Bank from its policies and procedures with respect to the design, appraisal or implementation of projects financed or to be financed by it.⁵³

(iii) In the preparation of the periodic Country Assistance Strategies for each borrowing member and more generally in the on-going dialogue between Bank staff and government officials, Bank senior staff are authorized to raise governance issues relevant to the Bank's mandate. Should an issue related to alleged corruption under Bank-financed projects arise, it would no doubt figure prominently in such discussions and might influence the Bank's position if they are not adequately dealt with by the government.

(iv) A new Operational Policy Statement and Procedure (OP/BP 10.02 - Financial Management) has recently been prepared. It requires the strengthening of accounting and auditing procedures for the borrowers and the project implementing agencies with respect to Bank-financed projects and tightens the rules regarding the borrowers' compliance with audit and other financial covenants in the loan agreements. This OP/BP includes specific

⁵³ See Resolution Establishing the World Bank Inspection Panel (Resolution No. 93-10; Resolution No. IDA93-6). See also I. Shihata, *The World Bank Inspection Panel* (1994).

procedures for the suspension of loan disbursement in cases of prolonged non-observance.

(v) Perhaps more importantly in the context of curbing corruption, the Bank's rules, applicable to the procurement of goods and services under its loans, which are incorporated in its loan agreements, have been further tightened by virtue of new rules and procedures approved by the Bank's Board on July 23, 1996. According to these new rules and procedures:

- a) The Bank can at any time cancel the financing of any contract under the loan, not only in cases of misprocurement as previously stated, but also whenever corrupt or fraudulent practices were engaged in by representatives of the borrower or a beneficiary of the loan during the procurement process or the execution of the contract, unless the borrower takes timely and appropriate action satisfactory to the Bank to remedy the situation. Both the General Conditions applicable to IBRD loans and IDA credits, and the Procurement Guidelines, have been amended to reflect this important change.
- b) Any supplier/contractor/ consultant financed by a Bank loan which is found by the Bank, after appropriate investigation with adequate safeguards, to have engaged in a corrupt or fraudulent practice, will be declared by decision of the Bank's President, upon the recommendation of

a high level committee, ineligible to bid for Bank-financed contracts, for a specific period of time or indefinitely, according to the gravity of the offense.

- c) The Bank will also reject a proposal for the award of a contract by the borrower if it determines that the bidder recommended for this purpose by the borrower has engaged in corrupt or fraudulent activities in competing for that contract.
- d) The Bank can now require its borrowers to include in the contracts financed by Bank loans a provision by virtue of which the Bank will have the right to inspect the accounts and records of the contractor/supplier/consultant concerned relating to the performance of the contract and to have them audited by auditors appointed by the Bank.
- e) Bidders for Bank-financed contracts are now required to disclose in their bids any commissions or other payments paid to local or foreign agents in the context of the procurement or execution of such contracts.

(vi) In addition to the above, recently approved measures include additional, previously unannounced, audits of Bank operations in a specific country by outside firms, and regular post-review of procurements on a country basis. Three of the first type of audits have already started in large borrowing countries.

4. Assisting Borrowing Members in Curbing Corruption

The main vehicle for assisting its members in their fight against corruption as a general phenomenon is the Bank's policy lending instruments and its technical assistance loans. Other measures have also been used by the Bank, however, to good effect.

(i) Policy Lending

Although adjustment lending was initiated in 1980 to assist countries in improving their economic performance, many reform measures introduced under structural and sectoral adjustment loans (and other "rehabilitation" and "recovery" loans) have indirectly and at times specifically helped in stemming corruption.⁵⁴ These have included, in addition to general measures of deregulation, liberalization and privatization which aim at replacing administrative dictates with market mechanisms, such specific measures as the following:

- a) The introduction of banking laws and regulations to ensure the health of the financial sector and also to strengthen controls over fraudulent and imprudent practices and money laundering;

⁵⁴ For details on the policy of adjustment lending as a response to macro-economic disturbances in the 1980s in most developing countries, see *The Social Impact of Adjustment Operations: An Overview* (World Bank Operations Evaluation Department, Report No. 14776, 1995) and *Structural and Sectoral Adjustment: World Bank Experience 1980-1992* (World Bank Operations Evaluation Department, Report No. 14691, 1995); see also *World Development Report - Poverty* 104-20 (World Bank 1990).

- b) The introduction of tax laws and regulations, not only to simplify tax structures and reduce tax rates but also to improve tax administration and collection;
- c) The introduction or amendment of procurement laws, regulations and documents as well as measures of financial management, not only for development projects but more generally of the government budget, accounting and auditing systems;
- d) Less specific measures of legal and judicial reform have also been introduced in the context of policy based lending, especially under sectoral adjustment loans in situations where agreement was reached with the borrower on the pressing need and the feasibility of short term actions;
- e) Specific civil service reform measures have often been agreed under adjustment loans, especially for downsizing and pay increases.

(ii) Technical Assistance and Sectoral Investment Loans

Both free standing loans and components of technical assistance and sectoral investment loans have covered Bank financing of legal and regulatory reform, civil service reform, judicial reform and public sector reform, all with potential direct or indirect effects on the opportunities for and level of

corruption.⁵⁵ While relatively large free standing loans have been made in recent years for legal and/or judicial reform in countries as diverse as Venezuela, Bolivia, China, Russia and Ecuador, public sector reform and civil service reform loans started earlier and have covered a large number of countries. The recently agreed measures by the Bank's top management to assist in combating corruption include the broadening of activities in these fields as may be needed in the circumstances of each country.

(iii) Bank Grants

Since the establishment by the Bank of its Institutional Development Fund (IDF) as a trust fund to provide grants to borrowers for capacity building purposes (other than project preparation, which may be financed by other types of Bank grants), a number of grants have been made for purposes such as the preparation of new legislation, public procurement and associated training, or the carrying out of studies which diagnose the problems of the civil service or the judiciary. Some of these studies paved the way for technical assistance loans for these sectors. Among the recently agreed measures, IDF grants will also be made for capacity building in accounting and auditing in borrowing countries. Other grants have already financed a

⁵⁵ For a general overview of legal technical assistance by the Bank, see the World Bank and Legal Technical Assistance (World Bank Policy Research Working Paper No. 1414, 1995).

number of surveys to assess the level of delivery of public services in some borrowing countries.

(iv) Seminars by the Economic Development Institute (EDI)

EDI has pioneered a number of "Integrity Workshops" for specific countries to increase awareness of the causes and economic effects of corruption. These seminars are planned to cover more countries in the future. EDI has also provided training for economic journalists. Recently agreed measures for the Bank to assist in combating corruption include new procurement seminars to be provided by EDI for the training of specialists in borrowing countries.

(v) Bank Research

Corruption has been researched on a few occasions by Bank staff as a separate topic but has been more regularly addressed under more general reports. Examples include the two Bank reports on governance issues published in 1992 and 1994, private sector assessment reports carried out for most borrowing countries, service delivery surveys (financed mostly by IDF grants), surveys of manufacturing enterprises in transition economies, a few Country Assistance Strategy (CAS) reports and the 1996 World Development Report (WDR) on Transition. The 1997 WDR, which will deal with "The

State in a Changing World," will treat the issue of corruption in a broader and more detailed manner. In depth analysis of the causes of corruption, the empirical evidence of its impact on development, and how best to address it in Bank's lending and non-lending operations, is now being considered as possible subjects to be specifically addressed by Bank research.

V. Conclusion

Although corruption can be seen in a much broader context, it has been addressed here mainly in terms of the use of public office or trust for private gain, the abuse of a public or private position in favor of the position-holder, his family, friends or bribers and the selective or arbitrary application of public rules to benefit the official in charge and those who pay him for the favor. Its causes and effects, both on the parties to a corrupt deal and on the society at large, have been discussed from different angles. In spite of direct material benefits to the corrupting and corrupt parties and possible facilitating effect on business transactions, the long term effects of corruption are found to be negative on the society, its government, law, ethics and economy. Businessmen may be content to live with it as long as it is fairly predictable, and the poor may accept it as a fact of life, but its devastating distributional effects are increasingly recognized on a world-wide scale.

In practically all societies, corruption has been recognized as a social malaise, if not a religious sin. However, its manifestations continue to exist in varying degrees in all societies. Measures to combat it have also had different degrees of success but have generally been more effective when they followed a comprehensive approach and combined the efforts of governments with those of business groups and non-governmental organizations.

International conditions seem to be more conducive now than any time in the past to address corruption as an issue of global concern. With the greater liberalization of trade and investment, the gradual globalization of the market place and overwhelming advances in technology, corruption is becoming not only a common domestic problem but an international problem as well. It is being recognized as a development issue in view of its possible impact on the cost of transactions, the volume of external flows, the stability and predictability of the investment environment, if not the rate of growth itself. Inevitably, it has become a concern for the world's premier development finance institution.

The World Bank has already played an extensive role in the fight against corruption, a role which goes beyond the confines of the activities of its staff and the projects it finances. As corruption becomes a major issue of development policy, with respect to aid, trade and investment, the Bank's role is bound to increase and

take on new dimensions. Chances of success in this complex area are more limited, but the expected impact on development may well be worth the effort.

SVEN SANDSTRÖM
Managing Director

June 28, 1996

To: All Vice Presidents

Addressing Corruption: An Action Program

Attached is a summary of a joint Transparency International/World Bank seminar on Strategies for Addressing Corruption, chaired by Mr. Wolfensohn.

Although the Bank's work -- including economic policy reform, institutional strengthening, and transparent procurement in Bank projects -- helps countries control corruption, we need to think through how we can develop a broader, more coherent Bank Group strategy -- and an action plan. As a first step towards this, I would like us to meet during the week of July 15, to discuss the issues involved and the next steps; I will let you know the time and place.

Mike Stevens, in the PSM Unit of the Poverty and Social Policy Department, will lead a small working group on this issue, and he will circulate a short issues paper in advance of our meeting. The working group will coordinate closely with Legal and Controller's, as well as with Operations, IFC and MIGA. Your support, obviously, is key. I hope we can move ahead with this quickly.



Attachment

cc: Mr. Wolfensohn
Messrs./Mmes. Iida, Lindbaek,
Einhorn, Frank, Kaji, Koch-Weser

Transparency International / World Bank Joint Seminar: Strategies for Addressing Corruption

A Summary of the Meeting on June 7, 1996

A seminar on Strategies for Addressing Corruption, chaired by Mr. Wolfensohn, took place on Friday, June 7, 1996. The Transparency International (TI) team, led by Peter Eigen (Chairman, TI) presented TI's approach to controlling corruption, and how the organization had evolved since its founding in 1993 to over 50 national chapters, with a small international secretariat in Berlin. The Bank presented its approach, based on economic policy reform, institutional reform, and procedures to limit corruption in Bank-financed projects. Also noted were EDI's ongoing integrity workshops with TI and the 1997 WDR on the Role of the State in a Changing World -- which will address corruption.

Mr. Wolfensohn emphasized that controlling corruption is a central issue of development. He underlined the need for the Bank to provide leadership in this area, and to be ready to assist country efforts to control corruption. He supported the thrust of what TI was doing, and foresaw growing cooperation with TI and other similar organizations.

Specific points to emerge from the discussion:

- 1) *The Bank Group should develop a three-year action program, which would include:*
 - a strong message about corruption in the President's 1996 Annual Meeting speech;
 - dissemination of the Bank's approach to corruption;
 - country level programs to fight corruption, in support of concerned governments (RVPs are identifying governments that would be interested);
 - sponsoring of conferences and seminars, e.g. on how corruption affects investment;
 - staff training; and
 - intensified efforts to control corruption in Bank-financed projects.
- 2) *MIGA and IFC should be part of the overall approach.*
- 3) *TI and other similar organizations could play a role in Bank Group activities, and TI was invited to send its proposals for future cooperation.*
- 4) *The Bank Group should play a leading role in the international arena as an advocate and activist in fighting corruption, taking a developmental approach.*
- 5) *Broad support and collaboration in this sensitive area is vital and a Board paper should be prepared, which would outline the Bank Group's proposed approach.*

OFFICE MEMORANDUM

DATE: July 31, 1996

TO: Vice Presidents

FROM: Jules W. Muis, CTRVP

EXTENSION: 81674

SUBJECT: "The C--- Word"

8/1
 1. ~~AMB~~ ①
 2. ~~EB~~
 Jane Anwar
 You have got yourself
 on this, right?
 M

As several of you know, last year I sent to the President's Office a paper entitled "The C--- Word," with a proposed set of actions for the Bank to take to minimize its exposure to corruption. Due to the sensitivity of the subject, the paper had a very limited distribution. Indeed, although a number of Bank staff and managers were interviewed as part of the preparation for the paper, most of them were not given a copy of the end result. The paper was discussed by Jim Wolfensohn and several of his senior managers last December. Subsequently, other proposals for how the Bank should deal with corruption were sent to the President's Office -- some from Ibrahim Shihata, some from Professor Susan Rose-Ackerman (who was a Research Fellow in DEC at the time), and some from the Business Round Table. These various proposals have led to a series of discussions in the President's Office, which resulted in the decision to form a Corruption Action Plan Task Force, to which you have nominated a member to represent your VPU.

The Task Force has been given a summary of the recommendations from these various sources. Now that the subject has been opened up for Bankwide debate via the newly formed Task Force, the distribution of "The C--- Word" can be broadened, though still on a limited basis. In consultation with Sven, our Vice MD, I am enclosing a copy of the paper to you as well as, separately, to the Task Force members. I ask that you and your Task Force representatives treat it with discretion.

Attachment

cc w/o attachment: Messrs./Mmes. Einhorn, Frank, Kaji, Koch-Weser, Sandström, Shihata, and Williams

THE C----- WORD*

THE WORLD BANK'S EXPOSURE
AND HOW TO ADDRESS IT



*Corruption - from the Latin *com rumpus*,
meaning "jointly broken," or alternatively,
"it takes two to tango"
(song title by Hoffman & Manning, 1952)

CTRVP
November 8, 1995

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FOREWORD

This paper expresses the views of CTRVP -- rather than a Bankwide consensus -- on the issue of corruption and its implications for the World Bank. CTRVP gratefully acknowledges the input and suggestions of staff from across the Bank, in particular: Nimrod Raphaeli, Raghavan Srinivasan (OPR); Michael Stevens (PSP); Graham Joscelyne, Robert Saunders (IAD); Robert Picciotto (OED); Louis Forget, Hans Gruss, Christian Walser (LEG); Katrina Sharkey (EDI); Randolph Andersen, Fayezul Choudhury, Michael Ruddy, George Russell (ACT); Babu John, V.S. Raghavan, Senga Sengamalay (LOA); Richard Lynn, Kabir Ahmed, Miguel Schloss (PBD); Karl Krueger, George West (CTRCS); Ladipo Adamolekun, Stephen Berkman, Colin Lyle, Katherine Marshall (AFR); Francis Colaco, Marianne Haug (EAP); Allan Legg (ECA); and James Wesberry (LAC).

I. PURPOSE AND SCOPE OF PAPER

1. The purpose of this paper is to stress the exposure of the World Bank (IBRD and IDA) to corruption, to take stock of how far the Bank has gone toward heeding its own rallying cry to establish accountability as a means of addressing it, to take stock of what other organizations have done or are undertaking, and to recommend further actions for the Bank to take to minimize its exposure, and in so doing, further optimize its development effectiveness. This paper will not attempt to shed new intellectual or ethical light on the issue of corruption, about which much has been written and more could be learned. Nor will it attempt to quantify the extent to which corruption has directly affected the Bank (i.e., has involved Bank loan funds and/or the Bank's budgetary resources), as this was beyond the terms of reference for this paper. While its recommendations focus mainly on the Bank (IBRD and IDA), they are equally relevant to the Bank Group as a whole (i.e., including IFC and MIGA).

2. For purposes of this paper, corruption is defined as the misuse of position for private gain; more specifically, the use of influence (whether by a politician, supplier or civil servant, or staff member or manager of the World Bank) on account of his or her position, to reap illicit, personal or corporate benefit -- either monetary or in-kind, and whether for himself or herself, or for an entity or person close to him or her. Corruption can take many forms, including bribery, fraud, extortion, embezzlement, falsification, and kickbacks. It typically involves two beneficiaries profiting at the expense of one or more third parties.

II. SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

3. Corruption compromises the ability of the Bank to carry out its fundamental mission of poverty alleviation and economic development. Corruption also puts the Bank's financial integrity at risk -- in terms of its own assets, those for which it has a fiduciary responsibility, and IBRD loans and IDA credits. And the real victims are the poor, for whom corruption inflates the future debt burden, by an amount far greater than bribes themselves. Hence, corruption jeopardizes the Bank's ability to carry out its mission of poverty alleviation and economic development. With its mission and effectiveness at stake, the Bank must confront the issue in a clear and consistent manner.

4. The Bank has already taken a number of actions to strengthen financial accountability -- in the Regions' project work; in policy setting units within the Bank (CTR, OPR, and MPS); and via EDI training seminars and grant allocations from the Bank's Special Programs in support of capacity building. But more remains to be done. To take the recommended actions, the Bank will need to overcome several major internal attitudinal barriers. These include: (a) the Bank's own inhibitions to discuss corruption, long a taboo subject; (b) a perceived incentive structure that, despite some improvements following the Portfolio Management Task Force Report, to some extent continues to emphasize lending volume (output) at the expense of quality and effectiveness (outcome); (c) a tendency to recognize corruption as merely an ethical or political issue, and not a serious economic development or financial control issue, for the Bank to address accordingly; (d) the legalistic position that to address corruption, unless specifically related to the use of Bank loan funds or at the request of the borrower, constitutes political activity -- prohibited by the Bank's Articles of Agreement; and (e) not giving resource priority to this strategy (including staff with necessary specialized expertise) in the face of declining or stagnant budgets. Unless management is prepared to confront and overcome these barriers, the Bank will remain *corruptus*, i.e., "jointly broken," and jeopardize its development effectiveness as well as its reputation for financial strength and integrity.

5. Corruption is increasingly a key issue in public debate. The time is ripe for the Bank to take a more coherent and proactive role in this debate. This paper recommends that the Bank take certain steps to address systemic accountability, accountability of suppliers -- and their governments -- under Bank projects, accountability of the Bank's borrowers, and accountability of Bank management and staff. These proposed actions (summarized in Table 1) are aimed at (i) galvanizing a concerted, visible, and coordinated effort at the highest levels of management and across the Bank, to address corruption issues affecting the Bank both as a lender and as an employer; (ii) going beyond past exhortations to specific actions; and (iii) linking the Bank's anti-corruption strategy to the Bankwide COSO initiative's emphasis on effectiveness and accountability for financial controls. Over the medium to long term, the cost of taking the proposed actions will be more than offset by more efficient project implementation and real, albeit not easily quantifiable, improvements in the Bank's effectiveness and development impact.

III. THE BANK'S EXPOSURE

A. The Risks

6. The Bank's financial integrity and its associated reputation as a sound financial institution are *sine qua non* to its effectiveness as a lender, and particularly as a lender to developing countries. The potential for corruption puts the Bank's financial integrity at risk on two fronts: (i) the Bank's own assets and those for which it has a fiduciary responsibility (i.e., trust funds); and (ii) IBRD loan and IDA credit funds. The statistical chance is always there that a major scandal could break and damage the Bank's reputation and therefore its effectiveness, at a time when it has come under close scrutiny by its members and severe criticism by some NGOs (albeit often for varying and sometimes self-serving reasons). The inevitable price the Bank and its ultimate clients -- the poor -- would pay in that case is paralysis of the Bank's resource mobilization potential.

B. The Victims

7. Corruption is of deeper concern to the Bank than in the context of its own financial integrity and capacity to raise funds in capital markets and in donor country capitals. Corruption is an impediment to economic development. It therefore goes to the heart of the Bank's *raison d'être*. The victims are very often the poor -- viz., diversion of increasingly scarce donor funds and the higher debt burden that results from procurement contracts inflated by an amount highly leveraged relative to the amount of associated bribes. Hence it mortgages future generations with the bills to pay for their forbears' ill-gotten, expensive lifestyle. Corruption damages a country's credibility, is an obstacle to transparency -- a prerequisite for competition -- and deters private investment critical to economic growth, even in high-growth developing countries. High transaction costs (financial and/or otherwise, e.g., delays) are often associated with corruption. Social costs can far outweigh the personal benefits, as in the case of violated environmental, public health, and safety standards. And corruption is exacerbating donor fatigue. Corruption therefore compromises the ability of the Bank to carry out its fundamental mission of poverty alleviation and economic development.

Table 1

RECOMMENDED NEXT STEPS

A. Systemic Accountability	B. Accountability of Suppliers And Their Governments	C. Accountability of the Bank's Borrowers	D. Accountability of Bank Staff
(i) Multi-Country Initiatives	(i) Donor Governments	(i) Immediate Actions	(i) Financial Management and Covenant Compliance
(a) Link a multilateral debt initiative (should one materialize) to a coherent and visible anti-corruption strategy of the Bank. (b) Increase Special Programs grant support for international NGOs and professional associations, to develop international standards and best practice guidance for accounting and auditing, and for establishing legal and regulatory frameworks and enforcement capacity.	(a) Together with the IMF and other multilateral development banks, work with the OECD and the European Community to pressure their member countries' repeal of tax deductibility of foreign bribes, and toward universal adoption by member governments of domestic anti-corruption laws. (b) Work with the WTO toward an international convention, making transnational corruption (including bribery) a crime and establishing an international grievance mechanism; limit bid eligibility to firms based in signatory countries.	(a) Require regional sign-off on the adequacy of the project accounting system in place, as a condition for effectiveness for every loan and credit; offset costs by relaxing requirements for project audits (e.g., require more limited reviews rather than full audits), which are of limited value in project management. (b) Include a mandatory review of financial accountability issues relevant to a given project at the key review stages (Initial Executive Project Summary, Final Executive Project Summary and Loan Committee), highlighting outstanding issues flagged in reports of the borrower's Auditor General; have IAD periodically audit these reviews for compliance and effectiveness. (c) Include in all Public Expenditure Reviews (PERs) not only an assessment of (i) the allocation of resources, but (ii) the government's institutional capacity to manage budgets and public expenditures, and (iii) the accounting framework within which government funds are accounted for and controlled; and recommendations on how to address weaknesses. (d) Make Board consideration of new Bank loans to a given borrower contingent on financial covenant compliance under all Bank loans under implementation in that country.	(a) Assemble Regional teams to do in-depth review (including some physical verification) of SOEs for a sample of problem projects, to assess nature and extent of misprocurement. (b) Establish a structured position of Regional Accounting and Auditing Adviser, in the front office of each Regional Vice President and with a dotted line reporting relationship with ACTCO, to serve as a focal point for addressing borrower accountability issues in the Region. (c) Establish a small team of financial, accounting, and procurement specialists in each Regional Technical Department to serve as consultants to task managers; the team would monitor project financial management at entry and thereafter, compliance with financial covenants and procurement guidelines; the team would have a dotted line reporting relationship to the proposed Regional Accounting and Auditing Adviser. (d) Institute more systematic independent <i>ex post</i> field SOE reviews (including some physical verification) on a sample basis, under the Bank's direction, whether at the Bank's expense or funded by the borrower; the Bank should contract for this work within a global framework vis-a-vis international accounting firms' worldwide headquarters.

Table 1
RECOMMENDED NEXT STEPS

A. Systemic Accountability	D. Accountability of Suppliers And Their Governments	C. Accountability of the Bank's Borrowers	B. Accountability of Bank Staff
(i) Multi-Country Initiatives (Cont'd)	(ii) Suppliers	(i) Immediate Actions (Cont'd)	(i) Financial Management and Covenant Compliance (Cont'd)
(c) With international NGOs and professional associations, cosponsor conferences, workshops, and EDI seminars for government officials on accounting, auditing, and legal framework and enforcement issues relevant to developing countries. (d) Undertake a major research initiative on corruption (e.g., a WDR) to improve understanding of its dynamics, the implications for economic development, and options for addressing it.	(a) Revise the Bank's procurement guidelines and bidding documents to include a no-bribery pledge, to be signed by a senior official of the bidding firm.	(e) Make it official Bank policy to suspend disbursements if an audit is overdue by more than 90 days. (f) Require that written terms of reference for all audit engagements in connection with Bank-financed projects be submitted to the Bank for no-objection review, prior to the audit engagement. (g) Revise Standard Bidding Documents to remove ambiguity regarding tolerance of bribery.	(e) Establish a cycle of internal audits of supervision reports to check for systematic independent SOE reviews as well as for project audit compliance. (f) Building on the work of the Portfolio Management Task Force, reorient the incentive system to reward outcome rather than output -- e.g., the flagging of accountability issues and enforcement of financial covenants, even if at the expense of commitments and/or disbursements; reflect this shift in Performance Management Process and management contracts.
			(ii) Procurement
			(a) Make random post reviews of procurement contracts the responsibility of field offices (overseen by proposed team in the Regional Technical Departments), and include review of this procedure in IAD field office audits. (b) Address clearly in the Staff Rules the obligations of Bank staff to report known or suspected violations of the Bank's procurement guidelines, and put in place a mechanism for handling these leads.

Table 1
RECOMMENDED NEXT STEPS

A. Systemic Accountability	D. Accountability of Suppliers And Their Governments	C. Accountability of the Bank's Borrowers	B. Accountability of Bank Staff
(ii) Country-Level Initiatives	(ii) Suppliers (Cont'd)	(ii) Longer Term Actions	(iii) Bank Financial Resources
(a) Collaborate with the IMF, other MDBs, and borrowers to include anti-corruption policies in economic and regulatory reform programs. (b) Finance initiatives at the country level -- through the Bank's lending program as well as its Institutional Development Fund -- for building capacity in accounting, auditing, and legal frameworks, based in part on Country Financial Accountability Assessments. (c) Through high level country visits by both the Bank's General Counsel and its Controller, work to raise borrowers' awareness of the importance of institutional development and accounting, auditing, and legal professionalism, to effective governance, poverty alleviation, and economic development. (d) In country dialogue, stress the importance of eliminating incentives that spawn corruption, and of promoting a transparent, competitive investment climate.		(a) Make proper financial management a development objective in its own right and as such, a priority for Bank financing; implement a more aggressive schedule of Country Financial Accountability Assessments (an assessment for each borrower country by the year 2000, and an update every five years), and feed results into CASS, discussions at Consultative Group meetings, and Lending Allocations Reviews. (b) Revise the grievance procedures for allegations of procurement malfeasance under Bank projects, to facilitate recourse to the Bank (e.g., via a hot line or continued use of the Inspection Panel), and clarify these procedures in the Bank's procurement guidelines and Instructions to Bidders. (c) Give prominence to corruption and its impact on economic performance, in the context of policy dialogue and private sector development and financial sector work; encourage borrowers to adopt anti-corruption legislation, put in place enforcement capacity, and promote a transparent, competitive investment climate. (d) Strengthen sanctions for borrowers that have willingly engaged in misprocurement, and/or have not enacted anti-corruption legislation; limit IBRD/IDA lending to countries that have enacted anti-corruption legislation or signed an international convention, on grounds of country performance.	(a) Consider adopting commercial bank practice of having staff members sign an annual "integrity letter" on a retrospective basis, in addition to the prospective statement signed upon appointment to the Bank. (b) Take steps to clarify in the Staff Rules and the Bank's Code of Professional Ethics, that Bank staff are obliged to report, <i>inter alia</i>, suspected or known fraud or corruption committed either by Bank staff related to the use of Bank or fiduciary resources, or by borrowers in connection with Bank loans or other services; and establish a mechanism for their doing so. (c) Establish a formal mechanism by which the Ethics Officer makes regular reports to IAD on lessons learned from breaches of Staff Rules and/or the Bank's Code of Professional Ethics, to assess whether preventative measures are needed.

C. The Cynics

8. That being said, why should the Bank bother to confront corruption? After all, some would argue, it is a fact of life, a concomitant of human nature which the Bank cannot purge. In some situations, it may even enhance efficiency and redistribute wealth more equitably. It is subject to different cultural interpretations (although, according to a scholarly treatment of the history of bribes, a form of it -- bribery -- is officially condemned in the laws of every country¹). As Robert E. Klitgaard writes,

“ ‘But who’s to say that a given act is really “corrupt”? Maybe it is corrupt in your culture but not in theirs. And might not corruption play a useful role in developing societies? Doesn’t it grease the wheels of commerce, build political coalitions, and help organizations overcome red tape? Besides, what can you or anyone else do about corruption? Like sin, it’s everywhere. So isn’t your topic fatally fraught with arbitrary value judgments, naivete, and futility?’ ”

“Each of these rhetorical questions has a point. Together, they have spawned the definitional debates, functionalist apologies, and moralist and antimoralist polemic that have dominated the literature on corruption. And yet if you are interested in what to do about corruption, the questions may strike you as tangential, even supercilious. It is as if you expressed an interest in reducing poverty and were told that ‘poverty’ is a relative term, that poverty has its social functions and perhaps its social utility, and that the poor shall always be with you.

“Like illness, corruption will always be with us. But as this sad fact does not keep us from attempting to reduce disease, neither should it paralyze efforts to reduce corruption. Corruption involves questions of degree. Countries and agencies have more and less corruption, and various kinds of illicit behavior are more and less harmful. We can do better in controlling corruption.”²

D. The Stakes

9. In short, because corruption compromises its ability to carry out its basic mission, the Bank cannot afford to take the passive position that it is a necessary evil. With poverty reduction, economic development, and the donor community’s confidence in aid effectiveness at stake, the Bank will be best served if it confronts the issue in a clear and consistent manner and takes advantage of its ability to lead by example and promote best practices, by setting and enforcing rigorous standards for its borrowers and their suppliers under Bank loans, and by taking a balanced view of the root causes of corruption -- including the complicity of developed countries that allow (even encourage) their firms to pay foreign bribes. In confronting the issue of corruption, the Bank should also set and enforce rigorous standards for its own management and staff, since minimizing risk to the Bank from corruption is ultimately their responsibility; in line

¹John T. Noonan, Jr. Bribes (New York: Macmillan, 1984), pg. 702.

²Robert E. Klitgaard, Controlling Corruption (Berkeley: University of California Press, 1988).

with the principles underlying the COSO initiative being started across the Bank in FY96,³ it is not limited to the purview of the Bank's Controller.

IV. THE BANK'S ACTIONS AND INACTIONS

A. Exhortation

10. Six years ago the World Bank exhorted the donor community -- itself included -- to address the issue of corruption:

"The widespread perception in many countries is that the appropriation of the machinery of government by the elite to serve their own interests is at the root of this crisis of governance. The willingness of the donor community to tolerate impropriety - by failing to insist on scrupulous conduct by their own suppliers, by not ensuring that funds are properly used, by overlooking inadequate accounting and auditing, and by tolerating generally lax procurement procedures - aggravates the malaise. Everyone avowedly deplores the situation and wishes it were otherwise. But it will not be so until accountability is instituted."⁴

B. Actions

11. The Bank has subsequently taken some actions to strengthen financial accountability on the part of borrowers and Bank staff, many of which are summarized below.

(i) Regions

12. The Regions have introduced operations specifically aimed at strengthening the borrower's national accounting and auditing capacity.⁵ The Regions are also introducing Country Financial Accountability Assessments in selected countries⁶ as recommended in the Financial Reporting and Auditing Task Force (FRAT) Report; they are including the issue of financial

³ "COSO" stands for the "Committee of Sponsoring Organizations of the Treadway Commission." This Committee developed criteria for assessing the adequacy of internal controls for assuring the integrity of financial reporting, efficiency, and effectiveness. The term "COSO" refers to these criteria.

⁴ Sub-Saharan Africa: from Crisis to Sustainable Growth (Washington, DC: The World Bank, 1989), pg. 192.

⁵ Such operations are under way in Tanzania, Zambia, Uganda, Madagascar, China, Indonesia, Pakistan, Mongolia, Nepal, Bolivia, El Salvador, Venezuela, Mexico and Egypt. Others are planned for Laos PDR, the Philippines, India, and a second operation in Indonesia.

⁶ Country Financial Accountability Assessments have been completed for Moldova, Kenya, Malawi, Senegal, Zimbabwe, South Africa, Morocco, Tunisia, and Iran; and are planned for *inter alia* Estonia, Latvia, Lithuania, Ukraine, and Peru.

accountability in Country Portfolio Performance Reviews (CPPRs) and at Consultative Group (CG) meetings; they are creating working groups to resolve auditing problems; and they are engaging local professional accountants at resident missions.

13. With the 1987 reorganization, the number of accounting and auditing specialists and financial analysts in the Regions dropped significantly. And those who remained have typically become task managers, no longer working in their specific area of expertise. To address this problem, the Regions together with the Accounting Department (ACT) are assessing the Regions' skills needs in accounting and auditing as against their current skills inventory, and will develop a remedial action plan, in collaboration with the Accounting, Auditing and Budgeting Staffing Group.

(ii) Africa Region

14. In response to a paper voluntarily written by one of its staff members,⁷ which describes various types of corruption associated with past Bank projects, the Africa Region has formed a task force to develop an action program for the Region, in the course of its supervision work, to identify and deal with corrupt practices. The action plan begins with a "SWAT Team" effort during October - December 1995, to review Statements of Expenditure (SOEs)⁸ for a sample of 50 problem projects. Depending on the outcome of this initiative, the task force will then consider specific remedial steps to improve borrower compliance with accounting and auditing covenants as well as with procurement guidelines. Further actions will include greater coverage of in-country financial management capacity in Country Assistance Strategies (CASs) and in other nonlending outputs, more emphasis on "quality at entry" in terms of project financial management, and more extensive training of staff as well as an assessment of the Region's staffing requirements in the area of financial management.

(iii) Controllers

15. Within CTR, ACT in 1993 established an advisory service to the Regions and their field offices on issues of borrower accountability; in the spring of 1995, issued to all task managers and many borrowers the Financial Accounting Reporting and Auditing Handbook (FARAH), which stresses the importance of quality of project accounts and internal controls at entry; is drafting an Operational Policy and Bank Procedure to replace Operational Directive 10.60 on Accounting, Financial Reporting and Auditing; is offering training to task managers on the Bank's requirements for project accounts, SOEs, Special Accounts, and audits; is revising the Guidelines for Bank Project Financial Reporting and Auditing; and is making the Bank's financial reporting of trust funds more transparent.

16. CTR's Loan Department (LOA) is rigorously exercising its fiduciary role in portfolio management, by closely monitoring the status of audit compliance in each country in collaboration with task managers, so as to avoid overdue situations; and is training local field staff as well as

⁷Stephen A. Berkman, "Corruption and Its Impact on Project Management," April 1995.

⁸When Bank-financed expenditure amounts are small and the associated documentation is voluminous, the Bank reimburses the borrower with loan funds, against a withdrawal application supported by an SOE prepared and certified by the implementing agency and acceptable to the Bank in form and content. Supporting documentation is retained by the borrower or project entity, and made available for inspection and verification by independent auditors and Bank supervision missions. Once the Bank and the borrower agree to the use of SOEs for specified categories or items of expenditure within defined dollar-equivalent limits, all withdrawal applications for such expenditures are to be submitted with SOEs.

staff of borrowers' project implementation units on procedures for withdrawal applications and SOEs, including documentation requirements. LOA is also -- in collaboration with the Internal Audit Department (IAD) and the Borrower Accountability Unit in ACT -- proactively following up on all reports of fraud in connection with Bank loan disbursements. In each known case of misuse of Bank loan funds disbursed in the past two to three years, the Bank has enforced its policy of full repayment of these misused funds. In several instances, these cases were detected and brought to the attention of the Bank by vigilant accountants in project implementation units.

(iv) COSO

17. More broadly, CTR is about to embark on a major effort to strengthen the Bank's internal controls, with the aim of independent attestation using a COSO framework⁹ in FY96; and has asked each Vice President and each Chief Administrative Officer or Program Coordinator to sign a letter of representation with respect to (i) the adequacy of internal controls in their VPU, and (ii) their knowledge (either actual or contingent) of fraud or corruption, whether committed by Bank staff or by borrowers in connection with Bank operations.

(v) Legal

18. At the request of the Board, the Senior Vice President and General Counsel of the Bank has issued legal opinions, statements, and memoranda¹⁰ to clarify the meaning of the prohibition of political activities in the Bank's work, as stated in the Bank's Articles of Agreement.¹¹ The most recent of these papers states:

"Upon the request of a borrowing member, the Bank may finance projects for purposes of ensuring predictability and stability of the business environment and efficiency of public administration, such as civil service reform, legal and regulatory reform and judicial reform. Through such reforms, the Bank should be able to assist its borrowing countries in their efforts to fight corruption and increase transparency and accountability in public functions [emphasis added]. These aspects of institutional development are directly relevant to the Bank's objective of facilitating investment for productive purposes. Experience has proven their great importance, especially for

⁹Attestation by the Bank's external auditor that the Bank's financial reporting meets the criteria set by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

¹⁰Prohibition of Political Activities in the Bank's Work (SecM95-707), July 12, 1995; Issues of "Governance" in Borrowing Members - The Extent of Their Relevance Under the Bank's Articles of Agreement (SecM91-431), April 12, 1991 and (SecM91-131), February 5, 1991; and Prohibition of Political Activities Under the IBRD Articles of Agreement and Its Relevance to the Work of the Executive Directors (SecM87-1409), December 23, 1987.

¹¹ Per Article IV, Section 10 of the IBRD Articles of Agreement: "The Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions, and these considerations shall be weighed impartially in order to achieve the purposes stated in Article I." The same language is in Article V, Section 6 of the IDA Articles of Agreement.

countries in transition from command to market economies and for private sector development generally.”¹²

(vi) Operations Policy

19. The Operations Policy Department (OPR) issued a discussion paper in 1991 entitled Managing Development: The Governance Dimension (SecM91-820), which examined the meaning of governance and its relevance to development, and another report in 1993, Governance: The World Bank's Experience (R93-203), which gave an overview of the Bank's activity in the area of governance. More recently, in January 1995 OPR revised the Bank's procurement guidelines to include language relating to corruption. As in the past, procurement contracts financed under Bank projects are to be reviewed by the Bank either prior to or following signature, depending on the dollar value. Contracts above a given threshold dollar amount (based on, *inter alia*, country performance, and specified in the loan or credit documents) are subject to prior review by the Bank, and if approval is given it is done on a “no objection” basis. Contracts below that threshold are subject to post review by the Bank. The new language regarding corruption in the Bank's procurement guidelines is as follows:

“[I]f a borrower has awarded a contract after obtaining the Bank's ‘no objection,’ the Bank will declare misprocurement only if the ‘no objection’ was issued on the basis of incomplete, inaccurate or misleading information furnished by the borrower, or if it is established, by a decision of a court of law, that the contract was awarded on the basis of corrupt practices.”¹³

20. In addition, OPR has introduced a provision in the Bank's “Instructions to Bidders” issued in those countries which have instituted a legal requirement that bidders sign a “no bribery pledge.” This new provision calls for bidders, as a condition for eligibility to bid for Bank-financed procurement, to disclose commissions and gratuities paid to local persons or risk disqualification. At OPR's instigation, Country Procurement Assessment Reviews (CPARs) were introduced in 1992 and are to be conducted for every country every four years. As part of these CPARs, the Regions are working with borrowers to align local bidding procedures with the international competitive bidding procedures set out in the Bank's procurement guidelines, in terms of efficiency and transparency.

(vii) Development Training

21. The Economic Development Institute (EDI) conducted a workshop in November 1994 on “Enhancing Transparency and Accountability: Issues and Options,” which focused on the economic and social costs of corruption, strategies for combating it, case studies for pursuing anti-corruption programs in Uganda and the Ukraine, and the potential role of EDI and the Bank as a whole in promoting transparency and accountability. Bank and IMF staff accounted for 28 of the 43 participants, six participants were from the two case study countries, and the remaining nine were academics, consultants, or NGO representatives. EDI has also offered a workshop to train developing country journalists, with the goal of promoting transparency and information flow, both of which contribute to an enabling environment for private sector development.

¹²Prohibition of Political Activities in the Bank's Work (SecM95-707), July 12, 1995, pg. 25.

¹³Appendix 4, para. 3 of the Bank's procurement guidelines. Standard Bidding Documents (SDBs), mandatory and issued by the Bank, already include provisions regarding undue influence, bribes, etc. See Instruction 28.2 of SDB for Goods; and Instructions 26 and Conditions of Contract 74.1 of SDB for Works.

(viii) Bank Grants

22. The Bank has supported the strengthening of borrowers' accountability through two of its grant programs -- the Institutional Development Fund (IDF) and the Special Grants Program (SGP). Since its inception in FY93, the IDF has been used to fund 24 initiatives, for a total Bank contribution of \$6.6 million, spanning 20 countries, to strengthen the accounting and auditing standards, Auditor General function, procurement procedures, and/or judiciary system of the recipient governments. The SGP is funding the development of an international accounting standard for agriculture by the International Accounting Standards Committee (IASC), and is supporting an initiative by the International Organization of Supreme Audit Institutions (INTOSAI) to strengthen SAIs in developing countries through training and information exchange on a regional basis. SGP funding for these two initiatives is expected to total about \$1.4 million.

(ix) Human Resource Policies

23. In terms of managers' and staff accountability for abiding by the Bank's own procedures (including the handling of budgetary and trust fund resources), MPS ensures that as a condition of appointment, every new staff member and consultant sign a letter stating that he or she has reviewed and understands the Staff Rule pertaining to "Outside Activities and Interests" as well as the paragraph dealing with the "General Obligations of Staff Members" in the "Principles of Staff Employment." In addition, the Bank's President distributed to all staff on September 20, 1994 a copy of the Bank's Code of Professional Ethics, and beginning in FY93 ACT has required task managers to sign an annual letter of representation regarding use and financial reporting of Bank-executed trust fund resources.

C. Inactions

24. While the above initiatives are worthwhile, they are not sufficient. There continues to be a shortage of operational staff skilled in accounting and auditing, and management does not adequately stress their importance in conveying incentives and motivating staff. The consequences are many, and serious: (i) 37% and 7% of audit reports due in FY95 and FY94, respectively, are currently overdue; (ii) of the FY94 audit reports received, more than 500 (or about 15%) were qualified and in connection with nearly 300, Bank staff reported the possibility of serious accountability issues; (iii) Bank projects are designed without due prior consideration of borrowers' financial management capacity; (iv) the Bank does not adequately consider reports of the Auditors General in its borrower countries when planning a given country's lending program; (v) there is inadequate independent *ex post* review of SOEs; and (vi) there is inadequate attention to performing post reviews of bidding documents for procurement.

25. In addition, the Bank has been reluctant to discuss the issue of corruption openly. Consequently the Bank has not exerted pressure on donor countries to eliminate the tax deductibility of foreign bribes, enjoyed by their corporations doing business abroad. And there is ambiguity surrounding Bank staff's responsibilities for reporting fraud and corruption. Hence the Bank cannot afford to be complacent on the basis of past or ongoing efforts. More remains to be done.

V. ATTITUDINAL BARRIERS

A. Inhibitions

26. There are several major internal attitudinal barriers the Bank must overcome, if it is to give corruption the attention it deserves. One is the Bank's own inhibitions about discussing the issue of corruption openly. These inhibitions stem from uncertainty about what constitutes crossing the line from agnosticism to infringement of political sovereignty; reluctance to rock the boat by confronting client counterparts; and an incentive system that rewards task managers up through Regional Vice Presidents for making loans and disbursing them, in spite of assertions by Bank presidents that the Bank must place quality and effectiveness above lending volume targets in measuring its own performance, and in spite of some progress in this area following the Portfolio Management Task Force Report. Management -- from the country department director level up to senior management -- should therefore resist pressure to lend, which can be exerted by developed as well as developing country member governments. And it must give the right signals to staff to ensure that effectiveness is rewarded. This calls for some fresh thinking in setting performance criteria for operational staff and management (see para. 65 below).

B. Skills Gaps

27. As noted in para. 13 above, the current dearth of qualified accountants and auditors among operational staff in the Bank poses a major constraint to effective monitoring of project financial management and borrower compliance with financial covenants under Bank loans. CTR has flagged this issue before, notably in its FRAT Report. But little action has been taken, ostensibly due to the difficulties with recruiting new staff while cutting budgets, as well as the Bank's disinclination to redeploy resources.

C. Prohibitions

28. The Bank's traditional, somewhat legalistic position vis-a-vis corruption has been a barrier to meaningful action, on the grounds that for the Bank to address corruption in its borrower countries constitutes political activity, unless specifically related to the use of Bank loan funds or at the request of the borrower, and the Bank's Articles prohibit political activities in its work. Bank management should revisit the cost of this position. It should reassess whether this is the proper stance for the Bank to take toward such an impediment to development, and whether there is room to manoeuvre into a more substantive, proactive position -- and one that acknowledges that politics cannot be completely isolated from economics (hence the academic field of "political economy"). In the interim, the Bank is encouraged to work with borrower governments to "fight corruption and increase transparency and accountability in public functions."¹⁴ The Bank must therefore continue to use the tools already at its disposal -- e.g., policy advice, sector work, CASs, country performance ratings in the annual Lending Allocations Review. In the end, the Bank's actions must be driven by corruption's economic impact. Hence, the Bank must be vigilant to ensure that its initiatives to address corruption can be justified on economic grounds -- and clearly they can.

¹⁴Prohibition of Political Activities in the Bank's Work (SecM95-707), July 12, 1995, pg. 25.

VI. NON-BANK INITIATIVES

29. The Bank is not alone in giving increasing priority to accountability as a means of fighting corruption. Some of the efforts by others in this area are described below.

30. Summit of the Americas. Heads of state discussed the issue of corruption at the Summit of the Americas in Miami in December 1994, and included in the resulting Declaration of Principles a section entitled "Combating Corruption," which states *inter alia* that governments will "give priority to strengthening government regulations and procurement, tax collection, the administration of justice and the electoral and legislative processes, utilizing the support of the IDB [the Inter-American Development Bank] and other international financial institutions where appropriate."

31. Inter-American Development Bank. The IDB recently established a State and Civil Society Unit which with the Inter-American Bar Foundation (IABF) is co-sponsoring a regional information exchange on public contracting and procurement, with the aim of establishing national chapters of the IABF to promote anti-corruption legislation and its enforcement. The IDB's State and Civil Society Unit is also planning to conduct a workshop with Latin American NGOs in early 1996, in collaboration with Transparency International (see para. 37 below).

32. USAID. USAID has sponsored two inter-American teleconferences on "The Problems of Fraud and Corruption in Government," the first in 1989 and the second in 1992, with participation by several heads of state, other government officials, the private sector, academics, journalists, professional associations, consultants, and a World Bank representative.

33. United Nations. The UN's Department of Technical Cooperation for Development co-sponsored, together with the Crime Prevention and Criminal Justice Branch of the UN's Vienna office and the Ministry of Foreign Affairs and Ministry of Justice of The Netherlands, an inter-regional workshop at The Hague in 1989 on the problem of corruption in government. Participants included representatives from developing countries in Africa, Asia, the Middle East, Latin America and the Caribbean, as well as from developed countries and NGOs.

34. OECD. The OECD passed a resolution in June 1994 that its member governments would review their respective anti-corruption legislation and toughen their sanctions against foreign bribery (including the elimination of tax deductions for illicit foreign payments). The OECD also held a symposium in March 1995 (attended by two Bank representatives, one of whom was a discussant) on "Corruption and Good Governance." Two outcomes of the symposium were the establishment of a network of international organizations concerned with corruption and of an OECD task force to coordinate OECD efforts on the issue.

35. USAID, the Inter-American Accountancy Association, and the Office of the Auditor General of Nicaragua co-sponsored an inter-American regional seminar in Managua in April 1995 on corruption in Latin America. The discussions focused on the causes of corruption and what reforms governments should implement to address them.

36. NGOs and Professional Associations. There are numerous international and national NGOs and professional associations undertaking institution building initiatives and/or information campaigns to address corruption: the National Republican Institute, the Center for International Private Enterprise, the World Press Institute, the Freedom Forum, the International Consortium on Governmental Financial Management, the Africa Leadership Forum, the Latin American Institute Against Corruption, the Institute of Public Administration, the Inter-American Accountancy

Association, the International Federation of Accountants, INTOSAI, the International Development Law Institute, and Transparency International (TI), to name a few.

37. Transparency International. TI is working to establish national chapters in as many developed as well as developing countries as possible, always at the invitation of the government. The purpose of a national chapter is for TI to work jointly with the government of the country to develop strategies for combating corruption, specifically foreign bribery payments. Recently TI issued its first "Corruption Index," based on seven surveys by risk analysts and business organizations, which ranked 41 countries from least to most corrupt. Established in 1992 by two former Bank staff (Peter Eigen and Frank Vogl), TI has garnered funding from a broad spectrum of bilateral and multilateral aid agencies, private sector firms in developed countries, and the Government of Ecuador. TI sought SGP funding from the Bank in 1994 but was declined, on the grounds that to be effective, its activities would need to be adversarial vis-a-vis the government of a given country -- rendering them political in nature and therefore ineligible for Bank support. It is now seeking to open a dialogue with the Bank to explore opportunities for collaboration, including funding from the SGP. TI's track record thus far should dispel the notion that it is a "watchdog" organization dedicated to exposing specific instances of corruption, and instead should demonstrate that it works in countries at the invitation of -- and in partnership with -- the government concerned.

VII. MINIMIZING THE BANK'S EXPOSURE

A. The Time is Ripe

38. There is clearly growing concern about corruption. Long relegated to neutral jargon reflecting the macroeconomist's view that money is fungible (e.g., euphemisms such as "commissions," "rent-seeking," "facilitation payments"), corruption is now increasingly and openly recognized as an obstacle to economic development. The proliferation of multi-party elections in developing countries and in countries in economic transition has led to public debate on a number of key issues, not openly discussed previously, including corruption. This was reflected at the July 1995 meeting of the Development Committee Task Force on the Role of the Multilateral Development Banks (MDBs), at which "there was a strong consensus that the MDBs should not invest in countries where corruption and waste were rampant...."¹⁵ and in the World Bank President's October 1995 Annual Meetings speech, in which he specifically called for the elimination of corruption. A conclusion of this paper is that the time is ripe for the Bank to take a more coherent, orchestrated, proactive, and visible role in this debate -- at the country, regional, and global level. It is too critical an issue to the Bank's basic mission of poverty alleviation and economic development, to ignore it or to delegate it completely to others. Indeed, ignoring the problem renders the Bank complicit through its inaction. As the derivation of the word instructs, all parties to corruption (direct or indirect) are *com rumpus*, i.e., "jointly broken." To take no further action beyond what the Bank has already done or is currently doing would jeopardize the Bank's reputation for financial integrity and in particular, its development effectiveness. The Bank is in a unique position to address corruption in a meaningful way. But to that end, the Bank must be willing to lose (at least temporarily) some of its lending volume. Moreover, the Bank has a fiduciary responsibility to lead by example. In many developing countries, the Bank's procurement guidelines raise the overall standard for transparency in international competitive

¹⁵Record of Discussion, Development Committee Task Force on the Role of the Multilateral Development Banks, Third Meeting, London, July 10-11, 1995 (SecM95-866), para. 4.

bidding procedures. Similarly, the Bank needs to articulate its own anti-corruption strategy and policies, and enforce them. The demonstration effect could be powerful.

39. The Bank should consider a series of next steps, some to prevent and some to redress corruption, and organized around four aspects of accountability: (i) systemic accountability; (ii) accountability of suppliers, and their governments, under Bank projects; (iii) accountability of the Bank's borrowers; and (iv) accountability of Bank management and staff for monitoring the quality of project financial management at entry and thereafter, compliance with financial covenants and Bank procurement guidelines, and for use of the Bank's financial resources. Many of the recommendations below -- to be prioritized after due consultation with other VPUs -- are not new; they have been discussed and endorsed by management, but most remain unimplemented. Unlike past reports and action plans, the recommendations here are aimed at (i) galvanizing a concerted, visible and coordinated effort, at the highest levels of management and across the Bank, to address corruption issues affecting the Bank both as a lender and as an employer; (ii) going beyond mere exhortations to enforce the Bank's own policies and procedures more systematically, to a monitorable action plan with the active engagement, commitment and budgetary priority of management; and (iii) linking the Bank's anti-corruption strategy to the Bankwide COSO initiative's emphasis on effectiveness and accountability for financial controls. And while this paper focuses on IBRD and IDA, management should consider the following recommendations in the context of articulating a Bank Group strategy and action plan (i.e., to include IFC and MIGA as well), since corruption is a threat to the mission and effectiveness of the Bank Group as a whole.

B. Systemic Accountability

40. Corruption is a way of transacting business that can permeate the commercial, social, and political fabric of a society. It is unrealistic to expect that Bank projects could be immunized by foolproof Bank procedures and controls from the surrounding economic environment. Furthermore, no country is spared from corruption. It is not a problem unique to developing countries, as evidenced by recent events in Korea, Germany, the United Kingdom, Italy, Japan, and the United States, to name a few. Nor is corruption perpetrated only by the recipients of illicit payments. The party willing to pay a bribe is equally complicit or very often, even the driver. Therefore, while the Bank should take immediate actions to strengthen its efforts to ensure the financial integrity of projects undertaken with proceeds from IBRD loans and IDA credits (discussed in paras. 59-67 below), the Bank must also take a more inter-disciplinary, holistic, and necessarily longer term, approach to the issue of corruption. A multi-country as well as a country-specific approach is needed.

(i) Multi-Country Initiatives

41. Linkage. The recently leaked draft discussion paper on a possible multilateral debt relief initiative has triggered several negative reactions in the press, on the grounds that such a scheme would essentially constitute a "gift" to corrupt Third World leaders and would condone their form of governance. Of course, rejecting such a plan does not compel repayment of the outstanding debt by those who have siphoned off funds for private gain; the debt burden still falls on the poor. More to the point, when made by a developed country that officially condones the payment of bribes to foreign officials by domestic firms bidding on donor-financed projects, this argument is hypocritical. Management should consider linking a multilateral debt relief initiative (should one materialize) to the articulation and implementation of a coherent anti-corruption strategy on the part of the Bank. Because corruption is prevalent in many borrower countries that would not be

eligible for debt relief, such linkage would need to be made carefully, with the Bank pursuing debt relief and an anti-corruption strategy as parallel, complementary endeavors.

42. Collaboration. By their nature, multi-country activities are generally not feasible through the Bank's lending program. But there are alternatives. The Bank should step up its efforts to support the development of international accounting standards, and best practice guidance for accounting and auditing, and for establishing legal and regulatory frameworks (particularly for banking and commerce) as well as enforcement capacity. It can do this via increased grant support from the Special Grants Program (SGP) for international NGOs and professional associations. (See para. 36 above for a list of potential recipients.) In addition to grant support, the Bank should engage in collaborative efforts with some of these organizations, such as cosponsored conferences and workshops. Building on its work to date in the area of transparency and accountability, EDI should host a series of seminars on these issues, specifically targeted at government officials from borrower countries (rather than Bank/IMF staff and academics, as in the past). These seminars should be led, at least in part, by non-Bank experts (again, ref. para. 36 for a list of possible sources). EDI should also give priority to procurement training courses for borrowers. The Vice President and Controller should actively liaise with international professional associations and multilateral and bilateral donors to harmonize standards for financial accountability -- which currently differ and hence stretch developing countries' limited capacity in this area even further.

43. Awareness Raising. The Bank must be willing to play a lead role in the international debate on the economic consequences of corruption. Although a good deal of work has already been done on the economic aspects of corruption and how to combat it, notably by Robert E. Klitgaard, the Bank should undertake a major research initiative such as a World Development Report (WDR) on this issue. A major research paper on corruption published by the Bank would raise awareness and put the issue squarely on the development agenda, where it belongs from both the donors' and borrowers' standpoint. To take advantage of the existing expertise outside the Bank, research efforts should include the involvement of others such as Professor Klitgaard, Professor Susan Rose-Ackerman (a Yale law professor currently on a Visiting Research Fellowship at the Bank), and TI. The Bank's 1983 WDR dealt with "Management in Development," and included an informative chapter on "Reorienting Government" with a box on corruption. But the subject is so crucial to the development process, it should constitute a freestanding WDR theme in itself.

44. The purpose of such an endeavor would be to improve understanding of the dynamics of corruption; its implications for private sector development, public sector management, and macro policy dialogue and reform; and options for addressing it. Research would focus on the economic determinants of corruption (e.g., a civil service that is politically based, poorly paid, and inadequately skilled), the impact of decentralization, deterrents (e.g., deregulation), and the economic implications. Regional variations and comparative implications would be examined for developed, developing, and transitioning countries, in terms of distribution of illicit payments (e.g., domestic consumption versus capital flight and consumption of luxury imports), transaction costs (i.e., the extent to which some bribes are efficiency enhancing, while others are efficiency inhibiting), the incidence of petty versus grand corruption, and the impact on poverty alleviation and on private sector development and the attraction of private investment (foreign and domestic). The research would include an assessment of the divergent yet parallel interests of both developed and developing countries in wrestling with how to combat fraud, bribery, and corruption. The study would also include an assessment of the impact of (i) the United States Foreign Corrupt Practices Act and the anti-bribery laws of Peru, Singapore, and Ecuador, their enforceability, and the consequences of compliance as well as noncompliance; and (ii) the *de facto* "pro-corruption" laws of developed countries, allowing tax deductibility of bribes paid abroad. A comparative analysis of domestic versus transnational bribery would also be made.

(ii) Country-Level Initiatives

45. Bank action to address the issue of corruption systemically at the country level is also needed. To complement the multi-country initiatives described above, the Bank should collaborate with the IMF, other multilateral development banks, and borrowers to include the enactment and enforcement of anti-corruption policies in economic and regulatory reform programs, and give priority in development strategies to building local capacity in accounting and auditing, and legal and regulatory frameworks and enforcement, based in part on Country Financial Accountability Assessments. Capacity building should be approached in several ways: (i) more technical assistance loans (freestanding or components) to address weaknesses in these areas; (ii) capacity building components in financial sector and private sector development loans to help establish an effective Auditor General's Office (i.e., competent, independent, and adequately funded and staffed), and adequate pay scales and training for civil servants working in governments' accounting, auditing, and legal agencies or ministries (e.g., the Auditor General's Office, the Attorney General's Office); (iii) more Institutional Development Fund (IDF) grants for building national capacity in these areas; and (iv) high level country visits by the Bank's Senior Vice President and General Counsel and Vice President and Controller, respectively, to raise borrowers' awareness of the importance of institutional development and professionalism in these areas to effective governance, poverty alleviation and economic development.

46. It is equally if not more important to address corruption by working to eliminate the incentives that spawn it: burdensome and excessive regulations, licensing, significant authority vested in bureaucrats, multiple layers of approval required for transactions with government, monopolies, monopsonies, and lack of public awareness of the costs of corruption. The Bank must continue to work with its borrowers to design public and private sector reforms aimed at eliminating these incentives, and at promoting a transparent, competitive investment climate.

C. Accountability of Suppliers and their Governments

(i) Pro-Corruption Laws

47. Some choose to portray the context for corruption as one in which an official of the procuring government demands a bribery payment, as a requirement for awarding the bid to a given firm. But very often the tables are turned, and it is the other partner asking to "dance the tango." That is, a representative of the bidding firm (whether an employee or a contracted third party) initiates the corrupt transaction, by offering a bribe to a government official. And these firms are encouraged to do so under their governments' policy (common in many European countries) of allowing corporate tax deductions for the payment of foreign bribes -- in contrast to the payment of domestic bribes, which is considered a criminal offense. These tax deductions are at the expense of taxpayers in their home countries, and inflate multi-fold the debt burden of the poor in the world's developing countries.

(ii) Anti-Corruption Laws

48. To address this complicity of a number of donor countries, the Bank together with the IMF and other multilateral development banks should work with the OECD and the European Community, to put pressure on their respective member countries to adopt anti-corruption laws (e.g., the equivalent of the U.S. Foreign Corrupt Practices Act). At a minimum, the Bank should seek repeal of the tax deductibility, on the books in many donor countries, of foreign bribes. Such laws could be designed to go into effect only after a significant number of major countries has enacted them, in order to avoid undue advantage to those not enacting such laws.

Such an initiative is crucial to the success of any effort on the part of the Bank to address corruption. Without tackling this side of the equation, the impact of the Bank's related initiatives will be greatly diminished. The Bank's President should therefore take the lead in engaging the donor countries -- specifically his counterparts, their Finance Ministers -- to confront this issue openly and frankly, and its implications for development and for the cost effectiveness of the MDBs they help to support.

49. The Bank could also push for universal adoption of an international convention negotiated by the World Trade Organization (WTO) that would make transnational corruption (bribery in particular¹⁶) a crime. The treaty could include an international grievance mechanism, similar to that in the GATT Agreement for Government Procurement. Drafts of such a treaty are already under consideration by several regional organizations (the Council of Europe and the Organization of American States), but it would clearly have the greatest impact if it were signed more broadly and included the G-7 countries as signatories, as they account for such a large share of transnational bidding. Once this treaty was in effect, the Bank could take the further step of limiting bid eligibility for procurement under Bank projects to firms based in countries that have signed the treaty. The Bank should also ask the UN Commission for International Trade Law (UNCITRAL) to draft a model Foreign Corrupt Practices Act (taking account of lessons learned through the United States' experience with such a law¹⁷) for national governments to enact.

(iii) Technicality and Integrity

50. Some, TI in particular, have called for the Bank to adopt a "no bribery pledge" as a requirement for suppliers' eligibility to bid on Bank projects. This was rejected by OPR and LEG on the grounds that it violated the Bank's current procurement guidelines regarding qualification, which state that a bidder may be disqualified (pre or post bid) only on "technical" grounds (i.e., the bidder does not have the "capability and resources ... to perform the particular contract satisfactorily"), and they felt that this aspect of the guidelines should not be changed. OPR and LEG also concluded that a pledge on the part of bidding firms would be ineffective without the force of law behind it in their home countries. And because the payment of foreign bribes is allowed under the tax laws of many member countries to enhance their firms' competitiveness abroad, the Bank's Board would not likely approve a "no bribery pledge" requirement by the Bank for bidders on Bank projects. OPR and LEG therefore concluded that it was preferable for borrower governments to adopt a law banning corruption (or bribery more specifically), as has been done in Peru, Singapore, and Ecuador. It is more enforceable than a voluntary pledge, and has the support of (at least some members of) the borrower government. And as noted in para. 19 above, the Bank's Instructions to Bidders have been adapted to situations where such a law exists.

51. But the Bank should avoid legalistic escapism. Disqualification on "integrity" grounds is just as valid, as doing so on "technical" grounds. Therefore the Bank's procurement guidelines and bidding documents should include a no-bribery pledge, to be signed by a senior official of the bidding firm. Such a signature is not meaningless without the force of law behind it in the firm's home country. (If it were, letters of representation to external auditors would be meaningless.) In summary, the Bank should tackle the issue from both sides -- i.e., the legalistic approach with donor governments and the integrity approach with bidding firms. And if successful with the

¹⁶Bribery would need to be broadly defined, in order to encompass less obvious bribes, such as inflated bids, contributions to officials' favorite charities, etc.

¹⁷See a 1995 study entitled "The United States Foreign Corrupt Practices Act: The Effectiveness of a Unilateral Act," by Jill D. Rhodes, consultant to the Bank's OPR Department.

former on a global basis, the latter may no longer be necessary. Until then, both are needed, as complementary initiatives to address the accountability of suppliers and their governments.

D. Accountability of the Bank's Borrowers

(i) Immediate Actions

52. The borrower is responsible for ensuring sound project financial management at entry and financial covenant compliance, but these are often lacking. There are several corrective actions the Bank should take, some of which could be taken immediately:

(a) Make proper project financial management a precondition for loan effectiveness by requiring, for every loan and credit, regional sign-off prior to project implementation on the adequacy of the project accounting system in place; offset some if not all of the associated costs by relaxing requirements for project audits (e.g., require more limited reviews rather than full audits), which even if submitted on time, are completed well after the period covered and are therefore of limited value in terms of project management.

(b) Include a mandatory review of financial accountability issues relevant to a given project at the key review stages (Initial Executive Project Summary, Final Executive Project Summary, and Loan Committee), highlighting outstanding issues flagged in reports of the borrower's Auditor General; have the Internal Audit Department (IAD) conduct a compliance and effectiveness audit of these reviews on a periodic basis.

(c) Include in all Public Expenditure Reviews not only an assessment of (i) the allocation of resources, but (ii) the government's institutional capacity to manage budgets and public expenditures, (iii) the accounting framework within which government funds are accounted for and controlled; and recommendations on how to address weaknesses.

(d) Make Board consideration of new Bank loans to a given borrower contingent on financial covenant compliance under all Bank loans under implementation in that country.

(e) As is done with overdue payments, make it official Bank policy to suspend disbursements if an audit (or more limited review, per (a) above) is overdue by a given number of days (e.g., 90 days -- a slightly more relaxed timeframe than the 60-day policy in the event of an overdue payment).

(f) Require that written terms of reference for all audit engagements in connection with Bank-financed projects be submitted to the Bank for no-objection review, prior to the audit engagement (as is already done with engineering consulting assignments).

53. The Bank's current Instructions to Bidders for projects in countries with an anti-bribery law say that violation of that law "may" result in disqualification. Similarly, the Bank's Standard Bidding Documents (SBDs) state that any attempt by a bidder to influence the bid processing, evaluation and award "may" result in bid rejection. The word "may" leaves open the possibility that bribery could be tolerated. This gives a bad signal and could also serve as a loophole. OPR should revise this wording, by changing "may" to "will," to eliminate the ambiguity.

(ii) Longer Term Actions

54. Accountability Performance. The Bank should make proper financial management a development objective in its own right and as such, a priority for Bank financing. A more aggressive schedule for conducting Country Financial Accountability Assessments should be implemented, with such an assessment to have been carried out for each borrower country by the year 2000 and updated every five years.¹⁸ The purpose of these reviews should be not only to identify possible areas for institution and capacity building, but also to serve as direct input to the Country Assistance Strategies, discussions at Consultative Group meetings, and the annual Lending Allocations Review. With respect to the latter, DEC should consider explicitly integrating the results of these assessments into its country performance ratings for IDA borrowers.

55. Bidding Grievances. The Bank's procurement guidelines say that "if a Borrower has awarded a contract after obtaining the Bank's approval on a 'no objection' basis [i.e., the Bank has conducted a prior review], the Bank will declare misprocurement only if the 'no objection' was issued on the basis of incomplete, inaccurate or misleading information furnished by the Borrower...." Elsewhere in the guidelines, it states that the current process for determining whether this was the case in a given situation is for the complaining bidder to submit its complaint in writing to the Bank, and the Bank then takes responsibility for resolving the matter. However, if a complaint is made regarding the award of a contract subject to post (as opposed to prior) review by the Bank, the Bank turns over the matter to the borrower government for response and any appropriate action, which will then be reviewed by the Bank's task manager during the next supervision mission (perhaps as much as three to four months later). While about one-third of the dollar value of Bank-financed procurement contracts are subject to post review, in terms of numbers of contracts more than 80% are subject to post review. Therefore, with the vast majority of contracts subject to post review by the Bank, for most contracts resolution of a complaint can result in delays, and is the responsibility of the party against whom it has been made, namely, the borrower government -- with the likely effect of either discouraging complaints from being filed in the first place, or unofficial blacklisting of the complaining firm by the borrower government.

56. The Bank should therefore consider revising its grievance procedures for would-be suppliers alleging procurement malfeasance under Bank projects, and it should consolidate a description of those procedures (for prior and post review contracts, prior and subsequent to contract award) in a freestanding section in the Bank's procurement guidelines. OPR should lead this effort, in cooperation with LEG, CTR, IAD, and the Regions. One option for revising the grievance procedures would be to facilitate recourse to the Bank (e.g., via a hot line, with the Bank then turning over the matter to one or more independent firms contracted by the Bank, or continued use of the Inspection Panel). Whatever mechanism is selected, it will be important to ensure adequate capacity for handling complaints objectively but expeditiously, so as not to cause undue project delays. In addition, the grievance mechanism for suppliers should be described in the Bank's Instructions to Bidders.

57. Policy Dialogue. In the context of policy dialogue (including Policy Framework Paper discussions), and private sector development and financial sector work, the Regions should explicitly discuss corruption, anti-corruption enforcement capacity, and linkage of these issues to the country's economic performance; and encourage borrowers to adopt an anti-corruption law and to put in place the capacity to enforce it. At the same time, as stressed in para. 46 above, the Bank must continue, in its policy dialogue with client countries, to press for the elimination of the

¹⁸ Due to competing priorities Country Financial Accountability Assessments (recommended in the FRAT Report) have had a slow start, relative to Country Procurement Assessment Reviews which are required for each country every four years.

incentives that spawn corruption, and for the promotion of a transparent and competitive investment climate.

58. Teeth. Suppliers can be "blacklisted" by the Bank for misprocurement. But borrowers are held to a lower standard; funds used for misprocurement are to be repaid in full, and the amount of an investment loan is reduced by the amount of funds used for misprocurement. Management should therefore establish stronger sanctions -- with penalty clauses beyond the amount misappropriated -- for borrowers that have willfully engaged in misprocurement. And the Bank could also consider discontinuing or severely curtailing its lending to borrowing countries not enacting anti-corruption legislation or not signing an international convention, on the grounds that official condonation of corrupt practices is a major impediment to country performance.

E. Accountability of Bank Staff

(i) Financial Management and Covenant Compliance

59. Drudgery. While the borrower is responsible for *ensuring* sound project financial management at entry (crucial to sound project management) and financial covenant compliance thereafter, Bank staff are responsible for *monitoring* them. The record of borrowers' performance in these two aspects of project implementation is weak, in part due to weak institutional capacity in a number of borrower governments. But a second major factor is inadequate monitoring by the Bank. Task managers are usually not qualified in this area (they are more likely to be macroeconomists than financial analysts or accountants); they have little time for such responsibilities during supervision missions; the current incentive structure promulgated by management puts task managers under some pressure to disburse and does not motivate them to delegate these monitoring responsibilities to others (e.g., consultants, Technical Department staff). Independent *ex post* field review of SOEs (e.g., by local accounting firms) was recommended by the Portfolio Management Task Force, but has not generally been implemented, as Country Departments generally focus far more on substantive project implementation issues rather than the relative drudgery of accounting systems and process compliance -- even though poor financial management and breach of compliance at the project level are often a sign of more systemic accountability weaknesses.

60. Diagnosis. To address these problems, the Bank should take several actions. First, the Regions should follow the Africa Region's lead, and assemble a Regional team to perform more in-depth review (including some physical verification, not just cursory document reviews) of SOEs, for a sample of problem projects identified in collaboration with LOA. The findings should shed some light on the nature and extent of faulty SOEs. This diagnostic approach would form the basis for a Regional strategy to strengthen the Bank's monitoring of borrower accountability. But this is only a start; the Regions should apply more scrutiny to the procurement process (see paras. 66-67 below). And in aggregate, the Regional findings -- together with input from the Bank's procurement and disbursement specialists as well as supervision task managers -- could contribute to some quantification of misprocurement under Bank-financed projects.

61. Focal Point. While all of the Regions already have on staff at least one accounting and auditing expert -- and these staff meet monthly with ACTCO management -- this expertise is fragmented and has no functional leadership from the Regional Vice President's office. This expertise currently resides in a Technical Department division in four Regions and in a Country Department Director's front office in two others. To provide Regional leadership and a focal point at the Regional Management Team (RMT) level, there should be a structured position of Regional Accounting and Auditing Adviser, housed in the front office of each Regional Vice President. This

Regional Accounting and Auditing Adviser would oversee the Region's efforts to monitor the quality of project financial management at entry and financial covenant compliance thereafter, work with task managers and ACTCO to identify and address borrower accountability issues in the Region (including independent SOE verification), assess the Region's staff skills in accounting and auditing (currently there are about 100 formally qualified accountants in the Bank, of whom two-thirds are in the Regions), make recommendations -- to be discussed by the Controller with the Regional Vice Presidents and MPS -- for filling skills gaps through training and recruitment, and provide the impetus and intellectual leadership for a more aggressive timetable for Country Financial Accountability Assessments. Like the Regional Procurement Adviser, the Regional Accounting and Auditing Adviser would report to either the Senior Operations Adviser or the Regional Vice President, and would have a dotted line reporting relationship with ACTCO.

62. Accountability and Compliance Specialists. As noted above, just as task managers are not currently motivated to give priority to carrying out all of their monitoring responsibilities themselves, similarly they are not motivated to oversee delegation of them to others. As evidenced by the Bank's experience in acting on the recommendations of the Portfolio Management Task Force Report to establish more of an "implementation" culture in the Bank, it is a very difficult and slow process to change internal incentives. This is not to say that no effort should be made to move away from undue emphasis on commitment and disbursement volume; indeed, incentives should be changed to promote quality at entry and development effectiveness (see para. 65 below). But the current reality is overloaded task managers, who perceive the accountability and compliance aspects of their monitoring responsibilities as drudgery in relation to the more creative work of project design and the technical challenges of project implementation. To address this problem, the Regions should consider forming a team of financial, accounting, and procurement specialists in each Regional Technical Department, who would serve as consultants to task managers. Task managers would delegate to this team responsibility for monitoring project financial management at entry (a team member would participate in each appraisal mission, for this specific purpose) and thereafter compliance with financial covenants and procurement guidelines. Each member of this team would be responsible for monitoring financial management and compliance for a given portfolio of projects. They would have a dotted line reporting relationship to the Regional Accounting and Auditing Adviser.

63. SOE Reviews. The Regions should institute systematic independent *ex post* field review and verification of SOEs, on a routine and random sample basis. To help ensure an arm's length relationship with the borrower, this independent verification should be under the Bank's direction, whether at the Bank's expense or funded by the borrower via Bank loans or counterpart funds. The Bank should take advantage of its own reputation and procurement clout, by engaging large international accounting firms to undertake independent SOE review and verification work, within a contract framework negotiated with these firms' worldwide headquarters (rather than on an *ad hoc* and local basis, as is currently done). This should lead to lower costs and enhanced quality of such certifications.

64. Internal Audits. IAD should randomly select a fixed, preannounced number of divisions per Region per year, in which to audit supervision reports for a two-month period, to determine whether task managers are in fact having investment loan SOEs (which are accounting for an increasing share of IBRD/IDA disbursements) independently reviewed (including some physical verification) systematically on a random sample basis. The same internal audit practice of random sampling should be instituted for project audit compliance.

65. Incentives. Building on the work of the Portfolio Management Task Force, CTR should work with the Regions, Central Vice Presidencies, and MPS to change the incentives, such that both managers and staff are motivated to report and address corruption, rather than ignore it (which can lead *inter alia* to low morale), even if it is at the expense of commitments and/or disbursements.

The incentive system (in particular, the performance rating system) should be changed to reward outcome rather than output -- e.g., establishing quality at entry in project financial management, flagging accountability issues and taking corrective measures to enforce financial covenants, as opposed to rewarding favorable portfolio ratings. Performance Management Process (PMP) forms should be amended accordingly; for example, competencies should explicitly and positively value (i) the identification of breaches of Bank policies and guidelines in Bank projects, and (ii) implementation of appropriate sanctions and/or corrective measures. Management contracts should not just relate dollar inputs to outputs measured in terms of the number of loans, reports, and Country Assistance Strategies (CASs); rather, they should also include benchmarks for the unit's ability to monitor project financial management and financial covenant compliance, and to ensure systematic independent review of investment loan SOEs. In other words, there should be explicit linkage of a unit's self-assessment under COSO to the performance evaluation process.

(ii) Procurement

66. Post Reviews. Under current procedures, task managers are responsible for random post reviews of procurement contracts with a dollar value below a threshold specified in the loan or credit agreement. These contracts totaled \$6 billion in FY94, and represented 36% of the total dollar value of Bank project procurement contracts, but a disproportionate 82% of the total number of such contracts. Many of these contracts are for local procurement, with documentation in local languages or dialects, and provide a tremendous opportunity for misuse of funds. As with reviewing SOEs, it is unrealistic to expect task managers to give review of these numerous contracts high priority. CTR therefore supports OPR's proposal to EXC that post reviews be conducted on a systematic, sampling basis by Bank field offices, with the necessary local staff or consultants and supervisory resources totaling \$2-3 million per year. The Regions would be responsible for ensuring that this work was done, and task managers could delegate this responsibility to the accountability and compliance specialists in each Technical Department, proposed in para. 62 above. To ensure greater independence, post reviews should be at the Bank's expense, and not paid for by the borrower. IAD should include review of this procedure in its field office audits.

67. Whistle Blowing. While the Bank's Code of Professional Ethics calls for Bank staff to "report to supervisors any departure by other staff members from ...[the Bank Group's] policies, rules, or procedures," there is currently no policy regarding how staff are to handle reports or suspicions of violation of the Bank's procurement guidelines on the part of borrowers and/or suppliers. This is an important issue, particularly given the role that task managers play, either in directly selecting consulting and accounting firms or in influencing their selection by the borrower. CTR and OPR should establish Bank staff's obligations in this regard, determine what mechanisms would need to be in place in order to follow up appropriately on such leads, and with input from MPS and LEG, address these issues clearly in the Staff Rules. Relevant language should also be included in the "integrity letter" (see paras. 68-69).

(iii) Bank Financial Resources

68. Integrity Letters. In addition to being responsible for monitoring project financial management and borrower compliance with financial covenants, Bank staff are accountable for their use of the Bank's own financial resources. (They are also accountable for resources entrusted to the Bank, for which a trust fund letter of representation was already introduced.) To reinforce the importance of one's accountability, management might consider adopting a practice in the commercial banking industry, of having every staff member sign an "integrity letter" not only

prospectively upon appointment, as is currently done,¹⁹ but retrospectively on an annual basis. The text of the "integrity letter" upon appointment would be amended to include a pledge to abide by certain standards (not merely to have reviewed and understood them, which is the current wording). Furthermore, the substantive text of both letters would be integral or annexed to the letters themselves, and not merely referenced therein; and the addressee would be the President of the Bank rather than the Manager of the Staff and Consultants Appointment Unit in MPS.

69. The annual "integrity letter," which would cover the prior year, would state that the staff member is not aware of (i) any unreported matters potentially embarrassing to the Bank; (ii) any instances of fraud or corruption committed either by Bank staff related to the use of Bank or fiduciary resources, or by borrowers in the context of the Bank's lending program or other services; or (iii) any breaches of professional confidence by Bank staff (including leaking of confidential papers) -- apart from any exceptions to be noted at the end of the letter by the signing staff member. There will, of course, be gray areas (e.g., suspected, rather than known, fraud or corruption). In that event, the relevant Staff Rule (see para. 67 above) should require the staff member to consult with the Ethics Officer or IAD. And the annual "integrity letter" would include a statement that in matters of uncertainty or doubt, such consultations have taken place. As part of this initiative, the text of Staff Principle 3 ("General Obligations of Staff Members") and Staff Rule 3.01 ("Outside Activities and Interests") should be amended to address specifically the issue of Bank staff's independence, *inter alia* from firms (in particular, consulting and accounting firms) engaged by the Bank and/or by the borrower. The agreed final text for both "integrity letters" would need to be cleared by MPS, the Ethics Officer, CTR, IAD, OPR and LEG.

70. Whistle Blowing. Management should also consider revising the Code of Professional Ethics, so that it not only obliges staff to report to supervisors any departure by other staff members from the Bank's policies, rules, or procedures but, more specifically, any departure by other staff members from "due regard to the appropriate use of World Bank Group resources." Management should consider establishing a "hot line," either to IAD or the Ethics Officer, for reports of suspected or known misuse by staff of the Bank's financial resources (budget or trust funds), including for the selection of consultants in line with the Bank's guidelines.

71. Preventative Post Mortem. The Ethics Officer should make reports to the Auditor General on the underlying causes and circumstances (motives and opportunities) which led to each case of a breach of the Bank's Staff Rules and/or the Bank's Code of Professional Ethics, so that IAD may assess whether preventative measures are needed. Currently, there is no such formal mechanism in place to link the efforts of the Ethics Officer with those of IAD. As fraud is not only an ethical problem but also a financial control problem, IAD will continue to involve CTR as appropriate in matters under review by the Ethics Officer.

¹⁹The current procedure is for each staff member and long-term consultant, upon becoming an employee of the Bank, to sign the following statement, addressed to the Manager of the Staff and Consultants Unit in MPS: "I have reviewed and understand the World Bank's Staff Principle 3, 'General obligations of Staff Members,' and Staff Rule 3.01, 'Outside Activities and Interests.'"

VIII. COSTS AND BENEFITS

72. Perhaps the most tangible obstacle to addressing corruption is the budgetary cost of implementing the recommendations put forward in this paper. If Bank management agrees in principle with the approach proposed, PBD will work with the Bank's VPUs to develop a costed "business plan." Most elements of the proposed approach are not expensive, although the costs might be higher at the early stages of implementation. And over the medium to long term, these costs will be more than offset by (i) more efficient project implementation, and (ii) real, albeit not easily quantifiable, improvements in the Bank's effectiveness and development impact.

The Corruption Eruption

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Why, in the 1990s, has corruption suddenly become such a political lightning rod? From India to Italy, from Japan to Brazil—why have societies which have traditionally tolerated corruption at the highest levels in government and the private sector suddenly lost their patience, their citizens willing to take to the streets to topple high officials accused of wrongdoing?

In the last few years, at least six heads of state, more than fifty cabinet ministers, scores of congressmen, and hundreds of businessmen throughout the world have lost their jobs, their liberty, and even their lives on account of allegations of corruption.¹ Indeed, suicides among powerful government officials and businessmen accused of corruption have become quite common. This veritable eruption of corruption scandals has affected every region of the world, regardless of cultural background or gross national product.

Even nations that pride themselves on their established democratic systems and rule of law have not been immune. In France, one ex-minister and a prominent senator have been jailed, a former treasury minister committed suicide after having been accused of improprieties, another minister was forced from office, and at least five additional ministers are under investigation on account of allegations of corruption. In Spain, popular support for the government of Felipe Gonzalez has been substantially eroded by repeated accusations

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of corruption. In 1994, two British ministers resigned over a corruption scandal.² In the same year, Willy Claes, NATO's secretary general, became entangled in a scandal related to kickbacks that took place when he was the economic minister of Belgium. In Switzerland, a cabinet member was forced to resign after her husband was accused of using her position to advance his business interests.³ In the United States, in 1994 alone, both a cabinet member and the powerful chairman of the House Ways and Means Committee were accused of unethical behavior—and subsequently lost their jobs—while a senior White House aide, who was also a close associate of President Clinton, committed suicide. In addition, a senior official at the Justice Department resigned, and pleaded guilty to wrongdoings in his previous activities as a lawyer in the private sector. In the 1994 presidential summit in Naples, the financial affairs of President Clinton and former prime ministers Hosokawa and Berlusconi received as much media attention as the deliberations of the heads of state. Even quiet Norway was dragged into the fray, as the director of the Oslo Stock Exchange was dismissed from his position and, some days later, found dead.

Countries with a long tacit acknowledgment of corruption have also been affected by the wave—what was once the norm has now become a cause for scandals. In Brazil and Venezuela, democratically elected presidents were

Is not the daily disclosure of corruption a sign that democracy and markets are working?

impeached following accusations of corruption. In India, former prime minister V.P. Singh quit the ruling party and resigned from office, claiming that widespread corruption made governing impossible. Three ministers in the cabinet of P.V. Narashima Rao—Singh's successor—were accused of being involved in corruption scandals, and subsequently resigned after the ruling party suffered important losses in state elections; in those elections, in a break from the past, corruption became a central concern of the voters.⁴ Japanese Prime Minister Morihiro Hosokawa resigned in April 1994, following charges that he had mismanaged funds and decimated his political support base.⁵ In a four year period in Argentina, twenty ministers and senior presidential aides were forced to resign.⁶ In Italy, where corrupt activities have long been the hallmark of the elite, twenty prominent politicians and businessmen have committed suicide over allegations of corruption. Prime Minister Berlusconi was toppled by a no-confidence vote after having been targeted by the famous Milan magistrates who, however, found themselves investigated shortly thereafter by the Ministry of Justice for their own alleged improprieties.⁷

To some, this barrage of scandals is an unmistakable sign that corruption has reached unprecedented levels. It seems that the erosion of moral values and the excessive, almost anarchic, freedoms that accompany the present spread of democracy and capitalism are reinforcing each other, creating the conditions for corruption to soar. Yet, is not the daily disclosure of corruption a sign that democracy and markets are working? Indeed, more democratic regimes and freer markets are making government decisions more transparent,

increasing the accountability of public officials, and reducing the impunity that has often accompanied the corruption of those in high places.

It is a paradox that corruption is perceived to be erupting just as new global, political, and economic circumstances are creating unprecedented conditions for the *decline* of corruption. Any discussion of corruption is constrained by the impossibility of arriving at reliable data with which to measure corruption's occurrence. Because corruption is, by design, covert, there is no real way of quantifying it; thus, there is no real way of knowing whether it is increasing or decreasing. However, there is no question that within the past five or ten years, the public's *perception* of corruption has greatly increased because of the great increase in publicity. This eruption of awareness stems from the increasing openness that accompanies democratic transition, and from changes in the nature of corruption, which, in many cases, make violations more visible. While constant media coverage on pervasive corruption may convey a sense of gloom over the current state of ethical behavior in the world, a deeper analysis of underlying trends shows that, instead, this is a time to be optimistic about the possibility of reducing corruption.

In addition to strong moral values, the best antidotes against corruption are an independent parliament and judiciary, a vigorous political opposition to the party in power, and a free and independent media. Moreover, the elimination of economic policies relying too heavily on the discretion of government officials to allocate resources and guide economic activities helps minimize the opportunities for corruption.

In recent years, the world has made unprecedented progress on these two fronts. According to Freedom House, an organization that tracks different measures of civil and political liberties, 114 countries had a political system classified as a democracy in 1994. This is the largest number in history—more than double the total of the early 1970s. The World Bank has the same opinion about the spread of free markets. The economic reforms that have swept the world during the last decade have created the freest economic landscape in recent memory. Democratization, decentralization, marketization, financial integration, and the globalization of business, the media, and even politics have surged with unprecedented force. Admittedly, some of these trends also create new forms of corruption and facilitate some of the old corrupt practices. However, in the long run the new global conditions will hinder, more than help, corruption.

Corruption has always existed, and will probably never be completely eradicated. But, if current global trends continue, it is possible to envision a world in which the scope for corruption is shrunk to its historical minimum. It will not be easy, and it will not occur spontaneously. Leaders in government, business, and the media will have to seize this emerging historical opportunity, and act together.

The effectiveness of such actions requires clear ideas about the nature of corruption and the way in which current international trends in politics, economics, and business are offering grounds for optimism in the fight against corruption.

Corruption's Multiple Meanings: A Conceptual Framework

Corruption, like cancer, has many manifestations. In the same way that different types of cancer require different treatments, fighting corruption requires different initiatives, tools, and institutions. For example, the money-laundering associated with the drug trade is a different phenomenon than the corruption that often distorts a government's procurement of large public works. Using the same approach and institutions to deal with both cases is surely less effective than targeting each with strategies that incorporate its relevant characteristics.

Nonetheless, corruption's multiple manifestations do share many commonalities. In principle, a conflict of interest underlies all acts of corruption. This conflict can often be open and brutal, such as when a government official extorts a payment in exchange for allowing imports to go through customs. Usually, however, the process is more subtle—perhaps a vendor's gift to the wife of a corporation's procurement manager, exchanged for his tolerance of higher prices. In fact, corruption can only exist when someone—the agent—is given authority to allocate the resources of others—the principals. All salaried managers in a private corporation act as the agents of the shareholders, who are the principals; all government officials are agents for their citizens. From this perspective, the potential for corruption exists every time a principal-agent relationship is present.

Every time an agent buys or sells on behalf of the principals, he can, in exchange for personal gain, conduct the transaction at prices above fair market value when buying, or under market value when selling. Moreover, in the case of governments, in addition to the buying and selling of properties on behalf of the community, officials can also sell their decisions for personal gain. From zoning rights that benefit a specific land developer, to health regulations that benefit specific pharmaceutical companies, government intervention offers a wide array of possibilities for the personal sale of public decisions. These decisions can be sold wholesale, as when government policies are distorted to benefit a specific interest group which has bribed policymakers. However, they can also be sold retail, as is the case when public employees personally collect a payment for the granting of a permit or a license. From this perspective, corruption in the public sector can only exist when the government buys goods and services, privatizes public assets, and regulates the activities of individuals and corporations.

The variety of corruption can lead to a complex system of classification, but for our purposes, we will focus on three specific categories, which together capture most of the instances of corruption more frequently denounced by the media and prosecuted by the courts: 1) competitive corporate corruption, 2) corruption instigated by organized crime, and 3) political corruption.

Competitive corporate corruption includes all the illegal activities that companies undertake to remain competitive. This is a form of institutional corporate corruption distinct from the individual corruption that occurs in corpora-

tions when employees benefit personally from their actions against the interest of the corporation. Competitive corporate corruption instead seeks to further the interests of the corporation. In some countries, it is impossible to win a bid for large public works projects without paying off government officials. In other countries, extensive government regulations make corporate survival overly dependent on the goodwill of public bureaucrats. Corporations challenged by competitors that are actively greasing the hands of eager government officials often find that they cannot compete unless they also relax their ethical standards. In some industries, these practices are widely accepted as part of the cost of doing business; some companies regretfully follow the practice, others do so enthusiastically, while still others rigorously and vehemently reject participating in corrupt practices, allowing competitors to take away their business. Often this ethical fortitude is supported by technological, financial, or other competitive advantages which make it affordable. Unfortunately, not all companies have the resources or the alternatives needed to withstand the consequences of losing business to rivals willing to break legal or ethical standards.

The point, however, is that the core business of companies involved in competitive corporate corruption is legal; they do not depend on systematically breaking the law to be profitable. Companies involved in *organized crime*, on the other hand, are purposefully created to break the law. While a legitimate private corporation may engage reluctantly in corrupt practices, occasionally, as a consequence of the competitive behavior of its rivals, or of the extortion of government officials, organized crime exists to break the law deliberately and constantly. As the profits of organized crime—especially the profits of narcotics trafficking—have soared, the natural path for these companies has been to diversify by investing in legitimate businesses whose survival and prosperity does not require illegal activities. Yet, because immoral and unethical acts are the basic business of these groups, they do not hesitate to—and actively seek to—corrupt government officials. Thus, the same group that keeps a Mexican drug enforcement official on its payroll will bribe a New York City official in order to keep its garbage-collecting cover operation in business. As organized crime groups increasingly operate across borders, they are becoming a critical element in international affairs.

Both categories are closely intertwined with *political corruption*, whose manifestations range from government officials stealing outright from the national treasury, to the illegal financing of political parties. The recent upheavals involving corruption in Italy and France, for example, can be traced to this category. In many countries, political parties customarily rely on the illegal payments of both private and state-owned corporations, which finance their activities and the posh lifestyles of the political elite. There is, of course, much overlap between the aforementioned three categories, as one form of corruption frequently spawns another.

There is little doubt that, in the last decade or so, some forms of corruption have greatly increased in scope and importance, and that such increases are related to changes in technology, as well as to changes in international politics and economics. Money laundering has been facilitated by the unprecedented

It is no coincidence that corruption has acquired its current political prominence just as democratic ideals are making their greatest progress.

level of international financial integration. The demand for illegal political financing has been boosted, as the spread of democracy has made elections more frequent, and the intense use of expensive media strategies has increased the cost of political campaigns. However, democracy and a free media are also increasing government accountability and lowering the impunity of corrupt politicians and businessmen. In addition, market reforms are decreasing the instances in which the profits

of private firms depend on the signature of a government bureaucrat.

Beyond the Velvet Revolution

It is no coincidence that corruption has acquired its current political prominence just as democratic ideals are making their greatest progress. The type of political system is a determining factor in the behavior of civil servants and the transparency of business activities, especially those of large corporations.

In one of the best analyses of corruption, Robert Klitgaard argued that the level of corruption depends on three variables: the monopoly (M) on the supply of a given good or service, the discretion (D) enjoyed by the suppliers, and their accountability (A) to others that have the authority to reduce M or D, that is, the agents' monopolistic control of the supply or their discretion in administering their monopoly power. Klitgaard then suggested that the level of corruption (C) could be expressed as:

$$C = M + D - A$$

The more concentrated the supply of a good or service, the higher the discretionary power of those that control the supply; the lower their accountability to other authorities, the higher the corruption level will be.⁸

This equation would then predict that corruption is more probable in government agencies that have a monopoly on the supply of a specific good, service, or decision, than in a private corporation that sells goods and services in a highly contested market. Corruption will also be directly proportional to the degree of discretion accorded to those in charge of making the decision. A government agency that has to use some market-based benchmark to make its economic decisions has a narrower scope for corruption than one that relies only on the judgment of its officials. While competitive bidding among different suppliers does not necessarily eliminate the possibility for the distortionary effect of corruption on price and quality, it certainly limits its scope. In contrast, in a contract unilaterally awarded to a specific vendor in accord only with the judgment of the agents in charge, the room for corruption is obviously much larger.

In all cases, however, accountability has a significant inhibitory effect on corruption. From internal auditing processes to large scale congressional investigations, from organizational reporting procedures to media scrutiny, a

wide array of mechanisms can be used to boost accountability and limit corruption.

Democracy and Corruption

A corollary of Klitgaard's equation is that the deepening of democratization should have corruption-curbing effects. Why, then, is there the perception that corruption is mounting, if democratic regimes are displacing authoritarian governments which are presumably more corrupt? Democracy provides opportunities for corruption which are necessarily more visible than those present under authoritarian rule. In a dictatorship, corruption can be more institutionalized, controlled, and predictable. A well-organized dictatorship allows for "one-stop shopping," where the right amount of money, given to the appropriate official, will take care of all of one's bribe-paying needs. The various bribe-takers, each of which has a monopoly on the service offered, work together to insure that the system continues to function, and the money continues to flow. This collusion can help insure that bribes stay both "reasonable" and out of the public view.⁹ Democracy, on the other hand, is all about competition. If a government employee maintains his monopoly on a government service (such as, for instance, the one rubber stamp required to process a certain form), but is no longer in cooperation with his fellow bribe-takers, the bribe amount demanded can skyrocket, the employee caring little if he stifles demand for the various services, as long as he can continue to increase the amount of the graft. This sort of competition is inhibited in societies that are small, homogeneous, or controlled by a police state. However, when a society becomes more open, without eliminating the monopoly, the bribery problem becomes acute.

Elections, another crucial element of democracy, can affect corruption by increasing the need of politicians for two scarce resources: money and public affection. According to Transparency International—an international pressure group formed to fight corruption—the increased need for contributions has caused political parties to seek the support of business interests, increasing the potential for corrupt relations between the two.¹⁰ This problem has recently become overt in France, where the national employers' federation, the *Patronat*, has urged a suspension of all corporate campaign contributions.¹¹ The problem has been blamed on French laws concerning campaign funding; these laws have undergone various changes in the past several years. As the old laws made legal fundraising difficult, a culture of corrupt campaigning developed; the laws remain ambiguous, furthering the problem. In Italy, the same problem was at the core of the scandals that have led to a fundamental restructuring of the country's political structure.

The increased competition for public affection engendered by elections encourages the revelation of corrupt acts. In a non-competitive system, the wolves travel in a pack, colluding and protecting each other. Only the insiders have the necessary evidence to convict the perpetrator. When a system is democratized, the wolves turn upon each other, offering up their knowledge in hopes of dashing their opponents and gaining a reputation as a reformer. The

danger here is evident: the anti-corruption crusade can easily be turned into a populist tool. While the accusations may be true, it does not necessarily follow that the accuser stands on higher moral ground. Brazilian President Fernando Collor de Mello won his presidency on an anti-corruption crusade, billing himself as a *cacador de marajás* ("hunter of overpaid bureaucrats"), only to be impeached two years later under accusations of corruption.¹² Ironically, many of the congressmen who actively sought President Collor's removal were later themselves accused of having embezzled huge amounts of funds through their influence in the Congressional Budget Appropriations Committee. For the non-insider, it is frequently difficult to know whom to believe. As power shifts from discredited politicians and bureaucrats accused of corruption, to journalists specializing in exposing graft in government, the latter soon become tempted to use their new-found power for their own personal gain. In Venezuela, the journalists who gained significant public acclaim through their aggressive denunciations of government officials were later found to have been paid by businessmen seeking to exert as corrupt an influence as that of the public bureaucrats exposed by the journalists themselves.

Democratization is frequently accompanied by the deliberate weakening of central state authority. In societies in transition from dictatorship, this is due to the bitter memory of abuses committed by states with absolute central authority. In other cases, decentralization is fed by the growing perception of corruption at the national level. The US, with its Congressional check-kiting and Savings and Loan scandals, is a good example. However, if corruption is already present, decentralization can frequently exacerbate an existing problem, giving local bureaucrats free reign to create new regulations that charge transaction fees. Moreover, as power devolves to regional authorities, operating nearer to the people, abuses of power also devolve downwards, becoming more evident to the people.

In addition, the dismantling of national institutions can lead to a regulatory and security vacuum which allows corruption to flourish. This is not to say that these old institutions should remain untouched—public agencies in developing nations are frequently bloated with non-productive personnel, and hobbled by unclear mandates. The devolution of power away from the center makes their effective reformation even more problematic.

As the ideological battlefield of the Cold War is vacated and the tenets of democracy take hold, government effectiveness is questioned both by citizens at home and by governments abroad. Corruption is becoming much more of a factor in political life in general, and in voter preferences in specific. The success of the democratization movement can be affected by the perceived level of government corruption. Just as citizens worldwide are discovering their ability to participate in and affect politics, they are also discovering how collusive and dirty politics can be. This tension threatens to drive a wedge between citizens and their governments. A poll of Brazilians conducted in 1993 showed a weakening commitment to democracy as the best system of government for Brazil, with "corruption/weak government" most often cited as a problem of democratic government.¹³ Democracy requires some minimal amount of trust

accorded to the government. While a lack of trust is evident even in nations with established democracies, for nations without a history of positive state-civil interaction, it is a critical hurdle which must be overcome.

The New Economic Order

In the last decade, not only has the political environment changed, but economic policy frameworks have been drastically altered, as government intervention and centralized planning have been increasingly displaced by market-oriented policies. These reforms are as good for the anti-corruption campaign as they are for macroeconomic stability. The less that economic decisions are made inside the state apparatus, the narrower the scope for corruption. State-owned industries, which have long enjoyed an unwarranted popularity in developing nations, generally provide fertile ground for bribe extortion or the utilization of company resources for the private use of their managers. It is now a well-established fact that while state-owned enterprises may, in principle, be owned by society at large, in practice, their "ownership" resides with the coterie of politicians, top managers, and union leaders that control the company's decisions. In state-owned enterprises, the benefits of ownership often accrue to an even smaller elite than that found in many privately owned companies.

Privatization eliminates the years of hidden, day-to-day corruption prevalent in state-owned companies. However, because privatization of a national firm is such a high-profile and high-profit event, it easily leads to corruption of a different sort. In one notable instance, when the Spanish airline Iberia acquired the Argentine national airline, Aerolineas Argentinas, it listed \$80 million in expenses as "costs associated with the sale."¹⁴ The Argentine privatization system came under so much criticism that it had to be entirely revised with help from the World Bank in 1991. Suspicion has now fallen upon the Eastern European privatization process. In Russia, where the process of *privatizatsia* ("privatization") has been nicknamed *prikhvatizatsia* ("grabitization"),¹⁵ one study estimates that 61 percent of Russia's new rich are former Soviet managers who took advantage of privatization to make the industries their own.¹⁶

The process through which a state-owned firm is sold can, of course, be plagued by corruption. However, once the corporation is in private hands, the scope for corruption narrows. While there is no reason to assume that corruption will not also be found in a private corporation—especially those in which principals have inadequate control or information about their agents—it is safe to expect that market discipline will limit its extent, both in magnitude and in time.

In publicly listed companies, for example, investors demand greater transparency in corporate finances, with regular reports on expenditures. The common man provides an incentive for publicly-owned companies to keep their hands clean; when executives of French corporations Sant-Gobain and Alcatel were placed under investigation last fall, company stock fell immediately in

reaction to their foreseeable instability.¹⁷

While economic reforms decrease the opportunity for corruption, they also decrease public tolerance for corruption. As developing nations put a long-overdue end to decades of economic populism, and industrialized nations feel the pinch of economic slowdown, fiscal belts everywhere are being tightened. These changes do not go unnoticed by the population at large, which casts an ever-more-watchful eye on public accounts, as their own pet benefits and entitlements are slashed. The end result is closer monitoring of government officials, and greater public indignation over corruption. As one commentator, writing about the Japanese Recruit scandal of 1989, remarked, "public opinion only becomes critical when politicians are seen to be too greedy and start welshing on their obligation to deliver the appropriate share from Tokyo's bottomless pork barrel."¹⁸ The reform process breaks the existing social contract wherein everyone got their cut: labor through higher wages and protected jobs, consumers through lower prices, and politicians through whatever they could skim off the public coffers.

The Globalization of Business and Corruption

Increased international trade and transnational business operations, stimulated by economic liberalization and marketization, have introduced new elements into what were once closed economies, causing old practices to be questioned. As competition among developing nations for international investment increases, companies have more options. In this context, corruption, or the lack thereof, has become one of the relevant factors in deciding where to invest. Macy's recently announced its withdrawal from the clothing industry in Myanmar, stating that it was "impossible to make money there," because corruption "makes normal operations impossible."¹⁹ US businesses are forbidden by the 1977 Foreign Corrupt Practices Act from paying bribes in order to gain contracts.²⁰ As a result, US companies often feel they are at a disadvantage in a world where many of their international rivals do pay bribes and, in some cases, even declare payoffs a tax deduction. However, the ability to bribe is, at best, a costly advantage—last year, the French armament industry spent approximately 60 billion Belgian francs bribing foreign officials for contracts.²¹ Businesses operating in China spend between 3 percent and 5 percent of their operating costs on "gifts" to officials; all this is frequently spent without any guarantee that results will be forthcoming. Moreover, a company which pays the big money quickly acquires a reputation as an easy mark, and, in this day of global gossip, this unwanted reputation frequently precedes its entry into new markets.

Corruption can be just as frustrating for the government concerned as it is for the corporation. For developing nations, the inefficiency and waste associated with corruption is often crippling. In Kenya last year, three banks failed as a result of corrupt practices involving campaign funds. In Ecuador, the cost to the state annually is estimated at \$775 million, 9.5 percent of the GDP. It is estimated that bribes and blackmail add a 50 percent surtax onto Russian consumer goods. Even China, with its reputation as an economic powerhouse, has

lost an estimated \$50 billion due to the deliberate undervaluing of state assets by public employees. Moreover, countries desirous of foreign aid have a vested interest in proving themselves not to be corrupt "rat holes" which swallow up foreign aid, as Senator Helms has accused them of being.

The difficulties experienced by developing nations trying to reform themselves are often compounded by the outdated perceptions of foreign businessmen. Many companies operating in poor countries assume that corruption is pervasive, and that payoffs are an inevitable fact of doing business there. In a survey of American business leaders, more than half of the respondents affirmed that they would, under certain circumstances, bribe a foreign official in order to gain a desired contract—an act which is illegal under US law.²² Their justifications were based on the ideas that business abroad could not be conducted without such bribes, that cultural differences made American business ethics inapplicable, and that such payments might not be illegal under foreign law. This attitude is itself a self-fulfilling prophecy, creating a vicious cycle of corruption in which foreigners continue to bribe because they think they have to, and officials continue to extort because they know they can. The incongruence of the resources involved—where the annual revenue of a large multinational can easily outweigh the GDP of a small developing nation—makes fighting corruption a daunting task for a government greatly in need of the jobs and goods provided by foreign firms.

However, small countries are beginning to make known their frustration with corrupt practices, acting independently to eliminate opportunities for the unethical. Last year, the Malaysian government declared several British firms found guilty of bribing officials ineligible to bid for government contracts.²³ Ecuador requires any company, foreign or domestic, which bids on government contracts to sign an agreement that it will not bribe officials, and to disclose all payments made to "consultants" or middlemen of any kind. By instituting open-bidding systems and mandating transparency in payments, a reforming government can make life much harder for the parasites in its own bureaucracy. A clear and transparent legal code is also necessary, as it prohibits bureaucrats from inventing their own regulations, thereby creating additional opportunities for graft, and allows the public to know when transgressions have been committed. Governments can remove some of the incentive to demand bribes by making sure that salaries are commensurate with responsibilities.

However, given the lack of international agreements concerning corruption, it is frequently difficult to enforce regulatory violations across borders. Governments are, in general, loathe to prosecute bribery when it is performed in another country, or by a foreign national. Legal jurisdiction in these cases—which are now among the most significant of bribery cases—is unclear, as laws differ among countries. International cooperation is needed to develop common standards of behavior and establish acceptable means of penalizing offenders. Unilateral action, such as the United States Foreign Corrupt Practices Act, can only go so far. The US example has failed to catch on; so far, only Sweden has instituted a similarly restrictive law.²⁴ As is the case with trade

liberalization, nations are understandably reluctant to act independently, since no one wants to feel that their companies are alone in operating at a disadvantage. Such a problem can best be solved by bilateral or multilateral agreements. In recognition of this fact, the OECD met in June 1994 to ratify the Recommendation on Bribery in International Business Transactions, the first multinational agreement to attack bribery in international trade.²⁵ A follow-up symposium was held in March 1995. Among the OECD's recommendations for its twenty-five member countries are: 1) to cease considering bribes as legitimate, deductible business expenses; 2) to extend national criminal law to acts committed by citizens in foreign countries where such acts are also illegal; 2) to treat payments made to foreign officials in the same way that payments to national officials are treated, at the request of the country involved; and 3) to extradite offenders to be prosecuted in the country involved.²⁶ The recommendations will be reviewed within three years and mandatory sanctions for noncompliance are being considered. The trend is catching on in the Western hemisphere as well; corruption was a major agenda item at the Summit of the Americas held last December in Miami.

The push is not limited to political leaders. Business leaders are also working on the problem. The World Economic Forum made corruption a major agenda item at its annual meeting last January, bringing together CEOs, politicians, social scientists, and law enforcement officials to discuss the topic. Out of the talks was born the Davos Group—named for the city in Switzerland where the meeting was held—which is working on an agenda to catalyze the adoption of international standards for business ethics and regulation.

The globalization of legitimate business practices, which has made it easier to transfer money between nations, has inadvertently aided the growth of international criminal groups. Organized crime has become truly global, and it has become apparent that it cannot be attacked from one country alone, as evidenced by the recent opening of a FBI branch office in Moscow. As authoritarian states disappear and market economies flourish, crime groups are making strongholds out of weak states, such as Russia, which still lack the framework and institutions for a market economy to function. The 26.5 percent surge in investment by the Cosa Nostra in the Italian manufacturing sector is attributed to their ties with the Russian mafia; the Italians export goods to the Russians, who enforce their distribution monopoly with an iron fist.²⁷ The vast sums of money controlled by these groups far outweigh the annual GDP of most countries, thus making it nearly impossible for nations acting individually to make much of an impact. Changes in the international finance system have made it increasingly more difficult to trace the source of this money. Every day, trillions of dollars are transferred electronically.²⁸ British intelligence estimates that around \$500 billion may have been laundered through international finance channels last year.²⁹ A Financial Action Task Force, established in 1987 by the Group of Seven most industrialized nations and the European Community, issued forty recommendations, including making money-laundering a criminal offense, requiring banks to disclose more information, and extending some current regulations to cover firms other than banks; however,

few member countries actually passed these directives into law.³⁰ Even this, though, would be less than adequate. If regulations are not truly international, dirty money will simply shift to safer havens, as it previously did when Switzerland tightened its regulations and money flowed into Luxembourg and the Netherlands Antilles.

A Shrinking World

Just as money flows across borders, political trends now spread from one nation to another. It is commonly suggested that the French magistrates have been inspired in their vigorous investigations by Italian magistrates. An American commentator, discussing the success of the magistrates in Southern Europe, concludes his commentary by noting "America does not have national magistrates, and our corruption takes a different form. But the mood is right for people with serious law enforcement backgrounds to have a serious national impact."³¹ Allusions to the Italian magistrates frequently appear in Latin American newspapers as well. The hope exists that this marks the beginning of a trend towards imitation and transnational encouragement.

This global exchange is made possible by the increasingly international character of the mass media. Within the last few years, news has spread more quickly and farther than ever before. This is, in part, due to political changes, where increasingly open societies have led to a more numerous and independent press corps, and in part to technical advancements connected with the advent of satellite broadcasts and of CNN. The character of political journalism has also changed over the last two decades. Adam Gopnik has written that the journalistic profession has changed from an "access" culture into an "aggression" culture. Formerly, "in exchange for access, the reporter would show discretion."³² If a reporter broke this gentlemen's code and published the seamier side of political life, he could suffer professional death. In the United States, this system ended with the Nixon era. In many other countries, however, the access system, which in a police state carried a penalty much greater than professional ostracism, has only recently ended. The burgeoning press of a newly opened society creates a stiff competition among journalists, accentuated worldwide by the growing importance of television news. Aggressive, investigative reporting, especially when it involves a scandal, sells papers and keeps independent newspapers solvent. Corruption has thus become the bread and butter of some journalists; Gopnik writes, "the reporter used to gain status by dining with his subjects, now he gains status by dining on them." It should also be remembered that journalistic power, like any other power, can be bought and sold. However, the new culture of aggression means that no one, be they politician, journalist or businessman, can be assured secrecy of action.

A Time for Action

Changes in the political, economic and social standards of the world have opened

a window of opportunity in the fight against corruption. However, while this time of upheaval provides unprecedented opportunities for corruption-fighting initiatives, it also provides an opening for the dishonest.

Money is pouring in and out of countries at a rate never before seen, while the globalization of business and communications systems has created a complex web of global interactions, making it increasingly difficult to discover, or even define, the criminal. Corruption has always existed, yet the problem is often dismissed as either an idiosyncratic inconvenience or an unavoidable cultural imperative. However, the stakes involved are growing, as is the scope of those affected. Now is not only an opportune moment to act, but, in fact, a critical moment. Vito Tanzi has posited that corruption stems from the failure to recognize the need for "arms-length" distance in government decision-making. This tendency is strongest in societies where communities are small and interactive, relationships are highly personal, and where the need to accumulate "social capital" is great.³³ The process of globalization destroys old-world patrimonialism, undermining the importance of social capital. Globalization,

The smoke-filled rooms and family politics of yesteryear are largely going the way of the dinosaur.

along with the economic pressure caused by years of governmental waste and the political pressure exerted by an increasingly informed populace, has made the old system of doing business simply untenable in today's world, leading to an eruption in the seams of

political life. The smoke-filled rooms and family politics of yesteryear are largely going the way of the dinosaur. The current challenge is to ensure that this old-style corruption is not replaced with a new-style corruption of international intimidation. Instead of denouncing corruption or moralizing about its ills, the time has come to address the issue head-on, creating incentives for businesses and government officials to stay clean, and the regulatory and penal frameworks to punish them when they do not.

It is important to strengthen the forces and trends that have lowered the tolerance for corruption, and to continue to heighten the consciousness of how these things pollute and endanger everyone's environment. Businesses, despite having a vested interest in cleaner politics, cannot act on their own. Politicians must cooperate internationally to generate frameworks that create behavioral inducements and disincentives. That will not happen until the politicians get strong signals from the political marketplace of voters. The solution is thus very dependent on the media and on public opinion. Corruption flourishes under public apathy. Happily, democracy and the free market are just the thing to reduce apathy by giving citizens a stake in how things are run. Perhaps the steady stream of discouraging stories is a consequence of a global renewal of political ethics. With the necessary pressure and encouragement, the recent eruption in the global perception of corruption could turn out to be the catharsis world politics needed. ❸

Endnotes

¹ This includes Brazilian President Collor de Mello (impeached in 1992), Venezuelan president Perez (impeached in 1993), Japanese premiers Takeshita (1989) and Hosokawa (1994), Irish Prime Minister Haughey (1992), Pakistani Prime Minister Bhutto (dismissed in 1990, but later re-elected), and Italian Prime Minister Berlusconi (1995).

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⁸ Robert E. Klitgaard, *Controlling Corruption* (Berkeley: University of California Press, 1987).

⁹ For a discussion on the idea of cooperative monopolies in bribe-taking as opposed to competitive monopolies, see Andrei Shleifer and Robert W. Vishny "Corruption," *Quarterly Journal of Economics* 108, no. 3 (August 1993).

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- 22 Justin C. Longnecker, Joseph A. McKinney, and Carlos W. Moore, "The Ethical Issue of International Bribery: A Study of Attitudes Among US Business Professionals," *Journal of Business Ethics* 7 (1988).
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