Helping Countries Combat
Corruption

The Role of the World Bank

Poverty Reduction and Economic Management
THE WORLD BANK

SEPTEMBER 1997

The report grew out of the work of an internal task force, the Corruption Action Plan Working Group, which was set up in 1996. The group was coordinated by Mike Stevens and included Ladipo Adamolekun, Peter Calderon, Michael Cohen, Alejandro Escobar, Gunnar Eskeland, Louis Forget, Anthony Gaeta, Cheryl Gray, Daniela Gressani, Rohil Hafeez, Ernesto Henriod, Petter Langseth, Kathryn Larrecq, Karin Millett, John Nellis, Klaus Rohland, Malcolm Rowat, Alfonso Sanchez, Sabine Schlemmer-Schulte, Paul Siegelbaum, Raghavan Srinivasan, Frederick Stapenhurst, Stephen Weissman, Jim Wesberry, and Myla Williams, with additional support from Peter Eigen and Jeremy Pope of Transparency International. The report also draws on *World Development Report1997: The State in a Changing World*.

The Bank's expanding agenda for addressing corruption issues has been developed under the overall direction of Sven Sandstrom. This report was produced by the Poverty Reduction and Economic Management (PREM) Network of the Bank under the guidance of Masood Ahmed and Cheryl Gray. Further information about the Bank's work in this area can be obtained by contacting the staff of this network.

CONTENTS

FOREWORD

Global concerns about corruption have intensified in recent years. There is increasing evidence that corruption undermines development. It also hampers the effectiveness with which domestic savings and external aid are used in many developing countries, and this in turn threatens to undermine grassroots support for foreign assistance. Corruption is of growing concern to donors, nongovernmental organizations, and governments and citizens in developing and industrial countries alike. Fortunately, the opportunities to address corruption are also greater than they have ever been. New global standards of behavior are emerging, driven partly by changing attitudes toward transnational bribery in industrial countries and partly by heightened awareness in developing countries of the costs of corruption. Developments in information technology in both developing and industrial countries have also played a role.

The success of national anticorruption efforts depends primarily on the resolve with which they are pursued and on the economic policies and institutions that underpin them. External agencies can also play an important supportive role. With its cross-country expertise and broad development mandate, the Bank can help countries design anticorruption strategies and can also be an active participant in international efforts to deal with the issue. At the Annual Meetings of the World Bank and the International Monetary Fund in October 1996, I offered the World Bank's assistance to member governments implementing national programs to discourage corrupt practices and I pledged the Bank's support for similar efforts at the international level.

The Bank has long been concerned with controlling fraud and corruption in its projects, and its procurement and disbursement procedures have been progressively refined to minimize the risks for both lenders and borrowers. More broadly, 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 *World Development Report 1997: The State in a Changing World*. 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 nonviable and costly public investment projects. The Bank has curtailed lending, sometimes drastically, where poor governance, including systemic corruption, has affected Bank projects. And the structural adjustment programs it has supported in many countries, as well as improving economic performance, have reduced economic rents that are the source of much corruption.

However, until now the Bank has not had a systematic framework for addressing corruption as a development issue in the assistance it provides to countries and in its operational work more generally. This report provides such a framework. It identifies ways in which the Bank might help countries implement national anticorruption measures, suggests how the Bank should mainstream consideration of the issue in its work, discusses how the Bank can contribute to international efforts to control corruption, and examines the control of fraud and corruption within Bank-financed projects.

The international community simply must deal with the cancer of corruption, because it is a major barrier to sustainable and equitable development. This report clearly signals that the World Bank Group stands ready to do all that we can to help our member countries and partners to increase their efforts in the fight against corruption. The time for action is now.

James D. Wolfensohn
President

CHAPTER 1

Key Messages

The purpose of this report is to provide a framework within which the World Bank can approach corruption. Such a framework is needed to guide Bank activities at four levels:

- Preventing fraud and corruption within Bank-financed projects.
- Helping countries that request Bank support in their efforts to reduce corruption.
- Taking corruption more explicitly into account in country assistance strategies, country lending considerations, the policy dialogue, analytical work, and the choice and design of projects.
- Adding voice and support to international efforts to reduce corruption.

The first level has long been a concern of the Bank. Procurement and loan disbursement policies have been progressively refined to ensure the efficient use of Bank resources. Further initiatives are under way to streamline procurement and disbursement and to promote borrower accountability. The second level is partly familiar territory, partly new. While the Bank has helped countries reform economic policies and strengthen public institutions for many years, its involvement in explicit anticorruption strategies is novel. In the past year a small but growing number of countries have approached the Bank for assistance, adding to the larger number of countries in which the Bank is already supporting policy and institutional reform that, among other things, contributes to the fight against corruption. The third level is more difficult terrain, but unavoidable if the Bank is to confront corruption squarely as a development issue and provide relevant policy advice to borrowers. The fourth level is a new area for the Bank, but one in which a strong lead has been given by the Bank's president, and in which prospects for collective action are good.

Each level is linked with the others. Preventing fraud and corruption in Bank-financed projects should be done in ways that build the capacity of national procurement and financial management systems. If the Bank is to help countries design and implement anticorruption strategies, it needs to integrate an awareness of corruption risks and costs into the economic and social analysis it undertakes. And since corruption is a global problem, the Bank's efforts to help individual developing countries deal with this issue will be enhanced by more active participation in international efforts.

Corruption should be explicitly taken into account in country risk analysis, lending decisions, and portfolio supervision if it affects project or country performance and the government's commitment to deal with it is in question. Lending and, with due respect to legal obligations, disbursement decisions will be guided by:

- Whether Bank projects are likely to be affected by corruption during design or implementation, or thereafter.
- The extent to which the achievement of development objectives is compromised by corruption.
- The willingness of the government to act to control corruption if it threatens the effectiveness of Bank projects and/or economic and social development.

The scope and nature of the Bank's response will be tailored to the type and extent of corruption being addressed. In all cases, the Bank's activities will be defined by its Articles of Agreement and focus on the economic issues within its mandate. The Bank recognizes that corruption is a complex and sensitive topic and that staff will need careful guidance on how to approach it in the country dialogue, in the lending program, and in economic and sector work.

The Bank's approach grows from an understanding that:

- Corruption is a global problem (chapter 2). Corruption exists in all countries to varying degrees. It is systemic in many of the countries that borrow from the Bank and in some industrial countries. And corruption has significant transnational dimensions that the Bank must consider. Current efforts by OECD countries to criminalize foreign bribery and end its tax deductibility are strongly welcomed.

- 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 trust in government and diminishes the effectiveness of public policy.

- Corruption puts political support for aid programs at risk. Corruption undermines the effectiveness of aid and threatens to erode political support for it. The Bank's ability to continue to support the development efforts of poor countries depends critically on maintaining confidence that aid works.

- A window of opportunity has opened to address corruption in a more comprehensive way (chapter 2). Bank staff, other donors, and many borrowers strongly support such efforts.

- 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 within its Articles of Agreement to help countries fight corruption. However, the Bank must focus on the economic concerns within its mandate and must refrain from interfering in countries' political affairs.

- Tackling corruption is neither easy nor quick (chapter 3). Corruption is a symptom of deeper-seated factors. The causes 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 some developing countries. Corruption often has a political dimension and reflects the way power is exercised in a country. And it is constantly changing its form in response to changes in the global economy and technical innovation. Like others working in this area, Bank staff must address the issue with humility, realizing that we have much to learn. Approaches that work in one setting can have unintended consequences in another, and the Bank must constantly evaluate the effectiveness of its efforts.

- Political will is essential (chapter 3). The sustained reduction of systemic corruption requires committed leadership and support from citizens and civil society. External actors like the World Bank can help, but aid conditionality cannot substitute if political will is missing.

- The Bank should address corruption more explicitly than in the past, but in ways that reflect its mandate and its comparative advantage (chapter 3). In the past the Bank was often reluctant to confront corruption openly because of the issue's political sensitivity and the lack of demand from borrowers for assistance in this area. As an institution that believes in the power of public policy to achieve development goals, the Bank needs to more readily acknowledge the effect corruption has on the programs of its borrowers and be ready to help where it can be effective.

Despite the complexity and sensitivity of corruption, there are measures the Bank can take to help countries tackle the problem:

- **The Bank can help countries design and implement anticorruption strategies (chapters 5 and 6).** With its considerable experience in helping countries reform economic policies and strengthen institutions, the Bank is well placed to support national anticorruption efforts. For governments intent on reform, a central part of controlling corruption is getting the basics of public policy and management right.

- **The Bank can pay more attention to corruption when designing and assessing economic reforms (chapter 5).** Although most of the Bank's economic policy recommendations clearly reduce opportunities for corruption, there are some areas—including tax reform, expenditure reductions, infrastructure privatization, and environmental regulation—in which close attention should be paid to the capacity of governments to implement policy reform. If such capacity is lacking, policy change may increase the risk of corruption. The answer is not to forgo reform, but to consider and help strengthen institutional capacity in tandem with policy design.

- **The Bank can put additional emphasis on strengthening public sector management and governance (chapter 6).** Although many of the Bank's activities help 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 policymaking. Fighting corruption also requires strengthening the rule of law through clear legislation, effective enforcement capacity, alert statutory oversight agencies, an independent judiciary, and an engaged civil society.

To play a more active role in these areas, the Bank needs to place a concern for corruption in the mainstream of its operational work and research. It needs to:

- **Ensure that the projects it supports and its operational procedures set an example of best practice, while taking into account their effect on borrowing countries (chapter 4).** 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 that depend on aid to finance their development projects, the lending operations and policies of the Bank and other donors deeply affect overall public management. The Bank's procurement and disbursement should progressively place more emphasis on borrower accountability, thereby contributing to stronger government financial management systems.

- Raise the impact of corruption in its dialogue with borrowers (chapter 7). Where corruption is widespread and affects a country's development objectives and Bank-financed projects, the Bank needs to raise the issue with borrowers and seek ways to help governments and civil society address it.

- Address corruption and its economic effects more explicitly in country assistance strategies and the design of projects (chapter 7). The country strategy should consider how the Bank might help a country address corruption when it is a problem. Design of projects should take account of corruption risks.

- Build knowledge (chapter 7), by dedicating more resources to understanding the dynamics of corruption and how some countries have reduced it, disseminating such knowledge, and applying such learning actively in its work.

- Fill critical skill gaps (chapter 7)—particularly in financial management, procurement, and public sector management.

- Continue to build working relationships with partners (chapter 7), 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). Doing so will help focus the Bank's efforts where it has a comparative advantage.

- Become an active partner in multilateral efforts to control corruption and reduce transnational bribery (chapter 8). One important example is the current initiative, led by the OECD, to coordinate the criminalization of transnational bribery and the elimination of its tax deductibility in member states.

CHAPTER 2

Corruption and Economic Development

Corruption is a complex phenomenon. Its roots lie deep in bureaucratic and political institutions, and its effect on development varies with country conditions. But while costs may vary and systemic corruption may coexist 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 policies in areas in which government intervention is clearly needed—whether environmental regulation, health and safety regulation, social safety nets, macroeconomic stabilization, or contract enforcement. This chapter looks at the complex nature of corruption, its causes, and its effects on development.

How do we define corruption?

The term *corruption* covers a broad range of human actions. To understand its effect 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. In considering its strategy the Bank sought a usable definition of corruption and then developed 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*.[1] Public office is abused for private gain when an official accepts, solicits, or extorts a bribe. It is also abused when private agents actively offer bribes to circumvent public policies and processes for competitive advantage and profit. Public office can also be abused for personal benefit even if no bribery occurs, through patronage and nepotism, the theft of state assets, or the diversion of state revenues. This definition is both simple and sufficiently broad to cover most of the corruption that the Bank encounters, and it is widely used in the literature. Bribery occurs in the private sector, but bribery in the public sector, offered or extracted, should be the Bank's main concern, since the Bank lends primarily to governments and supports government policies, programs, and projects.

Bribery. Bribes are one of the main tools of corruption. They can be used by private parties to "buy" many things provided by central or local governments, or officials may seek bribes in supplying those things.

- *Government contracts.* Bribes can influence the government's choice of firms to supply goods, services, and works, as well as the terms of their contracts. Firms may bribe to win a contract or to ensure that contractual breaches are tolerated.

- *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 the 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 issuance of a license that conveys 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 from 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 construction permits. Bribes can also 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.

The government benefits purchased with bribes vary by type and size. Contracts and other benefits can be enormous (grand or wholesale corruption) or very small (petty or retail corruption), and the impact of misinterpretation of laws can be dramatic or minor. Grand corruption is often associated with international business transactions and usually involves politicians as well as bureaucrats. The bribery transaction may take place entirely outside the country. Petty corruption may be pervasive throughout the public sector if firms and individuals regularly experience it when they seek a license or a service from government. The bribes may be retained by individual recipients or pooled in an elaborate sharing arrangement. The sums involved in grand corruption may make newspaper headlines around the world, but the aggregate costs of petty corruption, in terms of both money and economic distortions, may be as great if not greater.

Theft. Theft of state assets by officials charged with their 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 economies. At the other end of the scale is petty theft of items such as office equipment and stationery, vehicles, and fuel. The perpetrators of petty theft are usually middle- and lower-level officials, compensating, in some cases, for inadequate salaries. Asset control systems are typically weak or nonexistent, as is the institutional capacity to identify and punish wrongdoers.

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, a pattern well documented in the reports of audit authorities. In such cases financial control systems typically have broken down or are neglected by managers.

Political and 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 regulations, and conflict of interest rules for parliamentarians. These types of laws and regulations lie beyond the mandate and expertise of the Bank but nevertheless are part of what a country needs to control corruption.[2] At another level corruption may be intrinsic to the way power is exercised and may be impossible to reduce through lawmaking alone. In the extreme case state institutions may be infiltrated by criminal elements and turned into instruments of individual enrichment.

Isolated and systemic corruption. 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 noncorrupt behavior is the norm, and institutions in both the public and private sectors support integrity in public life. Such institutions, both formal and informal, are sufficiently strong to return the system to a noncorrupt equilibrium. In contrast, corruption is systemic (pervasive or entrenched) where bribery, on a 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 the government. Another kind of equilibrium prevails, a systemic corruption "trap" in which the incentives are strong for firms, individuals, and officials to comply with and not fight the system. 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. Antibribery laws notwithstanding, there are many countries in which 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 certain agencies—such as customs or tax authorities, public works or other ministries, or particular levels of government.[3]

Corruption in the private sector. Fraud and bribery can and do take place in the private sector, often with costly results. Unregulated financial systems permeated with fraud can undermine savings and deter foreign investment. They also make a country vulnerable to financial crises and macroeconomic instability. Entire banks or savings and loan institutions may be taken over by criminals for the purpose of wholesale fraud. Popular support for privatization or the deepening of financial markets can be eroded if poor regulation leads to small shareholders or savers withdrawing when confronted by insider dealings and the enrichment of managers. And a strong corporate focus on profitability may not prevent individual employees soliciting bribes from suppliers. Furthermore, when corruption is systemic in the public sector, firms that do business with government agencies can seldom escape participating in bribery.

While noting the existence of fraud and corruption in the private sector and the importance of controlling it, this report is concerned with corruption in the public sector. Public sector corruption is arguably a more serious problem in developing countries, and controlling it may be a prerequisite for controlling private sector corruption.[4] Still, Bank activities can also promote the control of bribery and fraud in 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. In the long run, controlling corruption in the private sector may require improvements in business culture and ethics.

What are the causes of corruption?

The causes of corruption are always contextual, rooted in a country's policies, bureaucratic traditions, political development, and social history. Still, corruption tends to flourish when institutions are weak and government policies generate economic rents. Some characteristics of developing and transition settings make corruption particularly difficult to control. The normal motivation of public sector employees to work productively may be undermined by many factors, including low and declining civil service salaries and promotion unconnected to performance. Dysfunctional government budgets, inadequate supplies and equipment, delays in the release of budget funds (including pay), and a loss of organizational purpose also may demoralize staff. The motivation to remain honest may be further weakened if senior officials and political leaders use public office for private gain or if those who resist corruption lack protection. 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.

The dynamics of corruption in the public sector can be depicted in a simple model. 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.[5] Monopoly rents can be 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 economies, exacerbated by poorly defined, ever-changing, and inadequately disseminated rules and regulations. Finally, accountability is typically weak in these settings. The ethical values of a well-performing bureaucracy may have been eroded or never established. 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 anticorruption bodies may have been turned into partisan instruments whose real purpose is not to detect fraud and corruption but to harass political opponents.

A defining characteristic of the environment in which corruption occurs is a divergence between the formal and the informal rules governing behavior in the public sector. The Bank is unaware of any country that does not have 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 the expected behavior of public officials, conflicts of interest, the acceptance of gifts, and the duty to report fraud. Government agencies—police and army, tax and customs departments, local governments, and public enterprises—may have their own regulations and codes of behavior. Organic laws, often embedded in constitutions, cover 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 adapted from countries with a similar legal tradition, and some are additions to existing laws (for example, providing for special anticorruption commissions and other watchdog bodies).

Where corruption is systemic, the formal rules remain in place, but they are superseded by informal rules.[6] 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 changed. 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 sources of informality, first by understanding why the informal rules are at odds with the formal rules and then by tackling the causes of divergence. In some countries the primary reason for divergence may be political, a manifestation of the way power is exercised and retained. This limits what the Bank can do to help outside the framework of its projects. In other countries the reason may be weak public management systems and inappropriate policies, which the Bank can help improve.

What do economics and political science tell us?

While it would be easy to say that all corruption is bad, the Bank must base its approach on evidence and analysis of corruption's effects on development. The political sensitivity surrounding issues of governance underscores the need for such a foundation. In preparing this report, the Bank examined the conclusions drawn by economic researchers working on the topic, the perspectives of disciplines other than economics, and the evidence from the Bank's operational work.

Economic research. The body of research addressing the economic effects of corruption has grown significantly in recent years. The research is both macroeconomic and microeconomic, theoretical and empirical. Its conclusions depend in part on what the researcher views as the bottom line: short-term economic efficiency in private markets, long-term dynamic efficiency and economic growth, equity and fairness, or political legitimacy.

One strand of literature explores, primarily from a theoretical perspective, the likely economic effects of different forms of corruption.[7] Some writings of this group argue that corruption can be efficiency enhancing. First, the argument is made, corruption may not distort the short-run efficiency of an economy if it merely entails a transfer of economic rents from a private party to a government official. Thus a bribe to an official who is allocating, say, foreign exchange or credit in short supply can be seen as a market payment for ensuring that resources go to the party most likely to use them efficiently (the one who can pay the highest bribe). The problem with this line of reasoning is that it fails to take into account any objective other than short-term efficiency. In the long run, expectations of bribery may distort the number and types of contracts put up for bid, the method used to award contracts, and the speed or efficiency with which public officials do their work in the absence of bribes. It may also delay macroeconomic policy reform. In addition, the gains from such bribery may be inequitably distributed (accessible only to certain firms and public officials).

Second, bribes can theoretically increase economic efficiency if they allow firms to avoid overly restrictive regulations or confiscatory tax rates. That is, bribes lower the costs of bad regulations to firms that bribe. There may be some validity to this argument, particularly in the short run. Yet such bribery defuses pressure for broader reform and invites firms to evade good regulations as well as bad. Furthermore, the costs of such a system may fall disproportionately on smaller firms.[8] A policy framework based on many legal restrictions and widespread bribery to avoid them is like a highly regressive system of taxes on the private sector, and few would argue for such a system in developing countries. And in some transition economies such restrictions have proliferated in an uncontrolled way with the express purpose of extracting rents. This causes a shift of economic activity to the informal sector.

To summarize, models purporting to show that corruption can have positive economic effects are usually looking only at static effects in the short run. In the long 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.

Another strand of literature examines the links between investment, economic growth and the quality of government institutions.[9] It finds that weak public institutions, as evidenced by unreliable contract enforcement, unclear property rights, unpredictable policies, inefficient public administration, corruption, and other indicators, significantly reduce private investment and lead to slower growth. While useful in highlighting the broad economic effects of institutional deficiency, much of the literature has been unable to separate the effect of corruption from other dimensions of government quality.[10]

Finally, there is the uneven performance of countries to contend with. While few would disagree that corruption has undermined development in Africa and has slowed the emergence of well functioning market economies in the former Soviet Union, the coexistence 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.[11] Second, 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 in parts of the former Soviet Union).[12] Third, if political systems are well established and the rules of the game are known to all, the transactions costs of rent seeking may be less costly than in less stable, less certain environments. Fourth, corruption may be imposing environmental and social costs that are not captured in national accounts data. We do not know these costs, and country experience differs widely even within Asia. Nobody, however, argues that corruption is *good* for development, and recent research suggests that corruption may be restraining growth even in Asia.[13] What is clear is that the nature and dynamics of corruption vary greatly among countries, making it a diverse and complex phenomenon to address.

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. Corruption may be a manifestation of the way political power is contested and exercised. To the leadership the creation and allocation of state rents serves political purposes: rewarding supporters, buying off opponents, ensuring the backing of key groups, managing ethnic diversity, or simply accumulating resources to fight elections. To obtain these resources, leaders may forge alliances with business groups or create and distribute rents through the bureaucratic apparatus. The resulting policies may favor or discourage capital accumulation and economic growth, depending on the nature of the alliances struck.[14] Politicians in such countries may be aware of the distortionary consequences of such rents but view them as a necessary tool of political management. If this is the case, the pattern of corruption will change only if the power structure changes, which may result from a popular outcry against corruption.

Political scientists also take a historical perspective. Over time most industrial countries have developed merit-based bureaucratic values, institutionalized competitive politics, established transparent government processes, and fostered an active media and an informed civil society. These mechanisms constrain political and bureaucratic corruption, making it the exception rather than the norm. The transition may be spurred by an enlightened ruler or, more likely, by the growing power of new political groups with an interest in better-performing government. In developing countries, in contrast, government institutions are weaker, civil society is less engaged, and political and bureaucratic processes are less accountable and transparent. An effective state apparatus and capacity for law enforcement may be virtually nonexistent. In such settings, sustained progress in building an honest and effective state apparatus requires addressing the mix of factors in the state and in society that give rise to both corruption and weak social and economic performance. This is an exceedingly complex and long-term effort.[15]

Public management. The public management view of corruption is 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. Thus it weakens the ethical fabric of the civil 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 industrial countries and has been transferred to developing countries, includes systems that protect public organizations from corruption and promote accountability. These systems, including a meritocratic civil service and watchdogs such as supreme audit institutions, ombudsmen, and public service commissions, should not be neglected. Some OECD countries seeking to improve government performance through New Public Management reforms are developing "risk management" perspectives on corruption. But 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 in which 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 objectives (such as poverty reduction and environmental protection) that are at the core of sustainable economic and social development.

What is the Bank's experience?

Most of the economic and sector work undertaken by the Bank does not directly address corruption. However, a small but growing number of public expenditure reviews have drawn attention to the problem, and survey data gathered in the course of private sector assessments are beginning to illuminate the costs of bribery to entrepreneurs. Based on the economic and sector work that does address the topic, informal country knowledge within the institution, and examples from the Bank's vast store of country reports in which 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.

- *Macroeconomic stability* may be undermined by loss of government revenue and excessive spending. This can happen through corruption in tax and customs departments, through debt incurred when the scrutiny of finance ministries and central banks is bypassed, through contracts that are awarded to high-cost bidders or without competitive tendering, 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. It may also be threatened by fraud in financial institutions, leading to loss of confidence by savers, investors, and foreign exchange markets. In transition economies and in many developing countries 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.[16] The costs of macroeconomic instability are borne by all elements in society but especially by the poor.
- *Foreign direct investment* may still flow to countries in which corruption is systemic but only if bribery is affordable and the results are predictable. Even so, corruption can have a negative effect on foreign investment. Where corruption is large and systemic, investment may be concentrated in extractive industries in which operations can be enclaved, or in light manufacturing or trading operations that 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.[17] If the costs become too high or unpredictable, foreign firms will disengage unless global marketing or sourcing considerations require them to maintain a presence in that country. High levels of corruption add to the risk of a country being marginalized in the international economy.
- *Small entrepreneurs* may be affected in many developing and transition economies. Evidence from private sector assessments suggests that corruption increases the costs of doing business, that small firms bear a disproportionately large share of these costs, and that bribes can prevent firms from growing.[18]
- *The environment* may be endangered. Many countries have enacted laws to protect the environment and have created special agencies to enforce these laws,

but there is often a disconnect between policy and its implementation. Complying with environmental regulations imposes on firms costs that can be avoided by bribery. There are huge rents to be earned from activities such as logging in tropical rain forests, where permits can be obtained corruptly or where inspectors can be bribed. 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.

• The *poor* suffer. While poverty assessments have focused more on measuring poverty than explaining it,[19] anecdotal and survey evidence reveal the cost of petty corruption to the poor. When access to public goods and services requires a bribe, the poor may be excluded. Given their lack of political influence, the poor may even be asked to pay more than people with higher incomes.[20] Furthermore, when corruption results in shoddy public services, the poor lack the resources to pursue "exit" options such as private schooling, health care, or power generation.

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 effects 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 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. . .*[21]

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

Notes

1. The literature contains many definitions of corruption, as writers either seek a comprehensive term or focus on a single aspect. In the words of the Bank's General Counsel, Ibrahim Shihata,

> Corruption occurs when a function, whether official or private, requires the allocation of benefits or the provision of a good or service. . . . 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 a special gain or treatment not available to others 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, 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.

Most definitions relate corruption to the behavior of a public official, who may be the object or the subject of corruption. Thus corruption is "an illegal payment to a public agent to obtain a benefit that may or may not be deserved in the absence of payoffs" (Rose-Ackerman) or "the sale by government officials of government property for personal gain" (Shleifer and Vishny, "Corruption," *Quarterly Journal of Economics*, 1993, 108). The benefit need not be financial or immediate, the public official may be appointed or elected, and the bribe may be offered or extorted. For the OECD Working Group, the focus is on bribery: "the promise or giving of any undue payment or other advantages whether directly or through intermediaries to, or for the benefit of, a public official to influence the official to act or refrain from acting in the performance of his or her official duties in order to obtain or retain business." The Bank's Procurement Guidelines take a functional perspective, defining a corrupt practice as "the offering, giving, receiving, or soliciting of anything of value to influence the action of a public official in the procurement process or in contract execution."

Most definitions imply two willing actors (while fraud requires only one), usually but not always including a public official. Thus, "corrupt practices mean the bribery of public officials or other persons to gain improper commercial advantage" (EBRD). However, "no precise definition can be found which applies to all forms, types and degrees of corruption, or which would be acceptable universally as covering all acts which are considered in every jurisdiction as contributing to corruption" (Council of Europe). The definition adopted by the Bank is not original. It was chosen because it is concise and broad enough to include most forms. Like most other definitions, it places the public sector at the center of the phenomenon.

2. Participants in the "integrity workshops" facilitated by the Economic Development Institute, Transparency International (TI), and others may discuss such matters as part of the "integrity infrastructure" required to control corruption. "Integrity infrastructure" is a term coined by TI 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 in integrity 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 farther. This pattern of an initially rising but then falling cost can lead to multiple equi-

libria. One equilibrium is a society relatively free from corruption; the other is one in which corruption is widespread and systemic. Moving from widespread corruption to a society relatively free from corruption is much harder than merely reducing corruption at the margin within either case. Within systemically corrupt systems, decentralized forms appear to be economically more costly than centralized forms.

4. Recent survey work by Daniel Kaufmann ("Listening to Stakeholders' Views about Corruption in Their Countries," Harvard Institute for International Development, January 1997) suggests that opinion leaders in developing countries see corruption in the public sector as by far the greatest problem. The Bank's private sector assessments reveal the burden of public sector corruption on the private sector in many countries. This contrasts with a commonly held view in industrial countries that corruption within the private sector is the greater problem.

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

6. See C. Gray, "Legal Process and Economic Development: A Case Study of Indonesia," *World Development* 19: 7, 1991.

7. Susan Rose-Ackerman provides an excellent overview of this literature in "When is Corruption Harmful?" a background paper for *World Development Report 1997*, August 1996. See also 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.

8. For examples of this regressive impact, see Susan Rose-Ackerman and Andrew Stone, "The Costs of Corruption for Private Business: Evidence from World Bank Surveys," May 1996.

9. See 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*, 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; Shang-Jin Wei, "How Taxing Is Corruption on International Investors?" National Bureau of Economic Research Working Paper 6030, 1997.

10. This is changing, however, with the spread of survey data (such as Transparency International's Corruption Perception Index) that enable cross-country comparisons and analyses of corruption and economic performance to be made. Care must be taken in using these measures. The Transparency International Corruption Perception Index is a measure of what businessmen perceive to be a country's level of corruption. It is not an objective measure.

11. The importance of predictability is stressed in World Bank, *World Development Report 1997: The State in a Changing World*, New York: Oxford University Press, 1997.

12. See A. Shleifer and R. Vishny, "Corruption," *Quarterly Journal of Economics*, 1993, 108, 599–617.

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

14. See Mushtaq Khan, "Corruption in South Asia: Patterns of Development and Change," School of Oriental and African Studies, University of London.

15. See Michael Johnston, "What Can Be Done about Entrenched Corruption?" Paper presented at the Annual World Bank Conference on Development Economics, Washington, D.C., April 30–May 1, 1997.

16. See, for example, Hernando de Soto's description of the informal sector in Peru in *The Other Path*, New York: Harper & Row, 1989.

17. See Shang-Jin Wei, "How Taxing Is Corruption on International Investors?" National Bureau of Economic Research Working Paper 6030, 1997.

18. 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*, P. Cornelius and P. Lenain, eds., Washington, D.C.: IMF, January 1997; Daniel Kaufmann and A. Kaliberda, "Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies: A Framework of Analysis and Evidence," in *Economic Transition in the Newly Independent States*, B. Kaminski, ed., Armonk, N.Y.: M.E. Sharpe, 1996.

19. This is now changing, with participatory poverty assessments that seek to directly tap the experiences of the poor.

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

21. World Bank, *World Development Report 1997: The State in a Changing World*, New York: Oxford University Press, 1997.

CHAPTER 3

A Bank Strategy for Tackling Corruption

Given the mounting evidence of the costs of corruption and the need for more coordinated approaches at both country and international levels, the Bank requires a broad framework to address the issue. This chapter outlines the emerging strategy for the Bank, which has four channels:

- Preventing fraud and corruption within Bank-financed projects.
- Helping countries that request Bank support in their efforts to reduce corruption.
- Taking corruption more explicitly into account in country assistance strategies, country lending considerations, the policy dialogue, analytical work, and the choice and design of projects.
- Adding voice and support to international efforts to reduce corruption.

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 those countries move from systemic corruption to an environment of well-performing government that minimizes corruption's negative effect on development.

The Bank's legal mandate

Although corruption is a politically sensitive issue in many countries, the Articles of Agreement authorize the Bank to address corruption, within certain limits. In a recent paper on the subject, the General Counsel 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.[22]

According to one such legal opinion, 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.[23] *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.*[24]

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 finan-

cial flows but also to business organizations and indeed to the governments and peoples of most of its member countries.[25]

Thus corruption can be addressed by Bank staff as an economic concern within the framework already approved by the Board for governance issues. This framework provides scope for the Bank to help countries by advising on economic policy reform and strengthening institutional capacity. However, the Bank's mandate does not extend to the political aspects of controlling 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, as a lender to governments, can directly support civil society's efforts to control corruption. So while the Bank's mandate provides scope for the institution to help countries control corruption, it shapes the way in which the Bank may respond.

The Bank's fiduciary responsibility

The Bank has long recognized its fiduciary responsibility to ensure that fraud and corruption are minimized in the projects it finances. This is enshrined in the Bank's Articles, and was emphasized again by President James D. Wolfensohn in his speech at the Annual Meetings in October 1996. Procurement, disbursement, financial reporting, supervision, and auditing procedures have evolved to ensure that this responsibility is met, as discussed in chapter 4. The Bank's procurement guidelines were further amended in 1996 to make explicit what the Bank would do if it determined that fraud and corruption had occurred within a Bank-financed project.

The emphasis on controlling fraud and corruption within Bank-financed projects will continue to be a central part of the Bank's strategy. However, the strategy needs to reconcile a tension that all external aid agencies confront to some extent. In the short run, fraud and corruption within an aid-funded project can be controlled by tightening project management systems. In the long run, sustained reduction will come about only if government (or agency) control systems are strengthened.[26] A strategy for protecting Bank-financed projects from fraud and corruption needs to address this tension and try to ensure that whatever means are used, borrower accountability is enhanced.

Helping countries combat corruption

Experience with economic reform suggests that progress cannot be achieved merely through conditionality imposed by external actors like the Bank. Reform programs must be driven from within, and this is no less true for anticorruption ones. Furthermore, tackling corruption requires the engagement of those outside government—parliamentarians, civil society, households, the private sector, and the media. As a provider of development finance and policy advice to governments, the Bank is an important ally in the fight against corruption.

The main thrust of the Bank's support for countries' anticorruption efforts will be in helping to design and implement government programs. In some cases the Bank may be asked to help with specific anticorruption efforts, in areas within its mandate and expertise. It will respond to such requests in partnership with other international institutions and bilateral aid donors as appropriate. In other cases, the Bank may provide assistance in economic policy reform and institutional strengthening that, while aimed primarily at improving government performance, also helps reduce corruption. In addition, the Bank, and in particular the Economic Development Institute, can support government efforts by facilitating workshops for parliamentarians or journalists on these issues. These areas of assistance are discussed in detail in chapters 5 and 6.

As a practical matter, the Bank's advice to a particular country will depend on that country's circumstances. In some countries, economic policy reform will be the priority. In others the immediate need may be targeted interventions in tax or customs agencies, or procurement reform. Circumstances will also determine whether the strategy should be comprehensive or 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. Opportunities for in-depth reform may exist at the local level or in particular agencies or departments even if those opportunities 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 even when 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, that can lay the foundation for more substantial action later.

Developing countries range from those in which dynamic forces are 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 helping to modernize the state, working in much the same way they did in industrial countries a century ago. In Latin America, the civil society is engaged, and policymakers 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 policymakers recognize the challenges and opportunities of the global economy and the need for a change in the role of the state. The Bank's role in such circumstances is to be ready to help governments improve performance by providing policy advice and assisting with institutional strengthening while at the same time ensuring that Bank-financed projects are free of corruption.

Poorer countries, particularly some in Africa, cannot wait for historical processes, particularly if the preconditions for change are absent. Africa's modern private sector remains small and operates by informal rules in its relations with government. In some of these 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, similar forces exist in some transition economies, where the institutions of a command economy are no longer relevant and there is a vacuum in government capacity. Efforts to combat systemic corruption and build strong institutions in such countries need to be more deliberate, focusing not just on building the various components of the "integrity system" but also on economic policy reform and on how policy reform and institution building can reinforce one another. 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.

Contributing to international efforts

Finally, a central part of the Bank's strategy involves lending its voice and support to international efforts to control corruption. Corruption has important international dimensions, as many bribes flow across international boundaries. Governments in both capital-exporting and capital-importing countries have a responsibility to promote ethical and law-abiding behavior by companies and individuals within their jurisdictions. International initiatives to control corruption are growing, as outlined in chapter 8, and the Bank can play an active role.

Notes

22. 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," December 21, 1990 (SecM91–131, February 5, 1991); "Prohibition of Political Activities in the Bank's Work, Legal Opinion of the General Counsel," July 11, 1995 (SecM95-707, July 12, 1995).

23. "Issues of Governance in Borrowing Members" (Sec M91–131, February 5, 1991).

24. For details, see Ibrahim Shihata, "The World Bank in a Changing World," 1991, 1, 53–96.

25. See Ibrahim Shihata, "Corruption—A General Review with an Emphasis on the Role of the World Bank." Paper based on a keynote address delivered at the International Symposium on International Crime, Jesus College, Cambridge, England, September 9, 1996.

26. For example, a bilateral donor may ensure the proper use of aid funds by procuring goods directly and delivering them "in kind" to project beneficiaries. While this may ensure bribe-free procurement, it does nothing for (and may undermine) borrower accountability.

Controlling Corruption in Bank-Financed Projects

The Bank has a responsibility under its Articles to ensure that the funds it lends to borrowers are used for their intended purposes and with due attention to economy and efficiency. The Bank is also interested in the development effectiveness of its projects and sees loans as a vehicle for the transmission of best practice in project management to borrower governments. Central to the management of Bank-assisted projects are the Bank's procurement and loan disbursement procedures.[27]

Procurement

In public procurement, bribery and extortion are consensual crimes with the public at large as victim. Both givers and takers of bribes have every reason to keep quiet. Companies that have paid bribes, but not enough to win the contract, seldom call foul. Firms that have not bribed are often reluctant to lodge formal complaints even if they believe the successful bidder unfairly won. Bank procurement rules, based on open, competitive tendering with predisclosed evaluation and selection criteria, and Bank supervision are, overall, powerful deterrents to bribery. But fraud and corruption may still occur if Bank guidelines are not followed during bidding or contract execution. If the Bank is to have the moral standing to advise countries on the control of corruption, it must be seen to have effective processes to ensure that its own loans are, to the maximum extent possible, free of corruption.

Recent initiatives to strengthen the procurement process under Bank-financed projects include:

• Modifying the Procurement and Consultant Guidelines in August 1996 and January 1997, respectively, with a new section headed "Fraud and Corruption," setting forth how the Bank will disbar from future Bank-financed projects indefinitely or for a stated period a bidder it determines has engaged in fraud or corruption. The Bank may declare misprocurement and cancel the disbursement of funds if a public servant is found to be involved in a corrupt practice and the government does not take corrective action. The Standard Bidding Documents also now require information on commissions to agents and establish the right of the Bank to inspect the supplier/contractor's books.

• Introducing a provision in the Procurement and Consultant Guidelines to permit, at the request of a borrower, the inclusion in the bid form of an undertaking to observe the laws of the country on fraud and corruption in bidding and execution of the contract (in effect, a "no bribery pledge").

• Introducing more transparency in the selection of consultants by requiring public advertisement of larger assignments, disclosure of shortlisted firms and their technical scores, and public opening of financial proposals.

• Launching in-depth surprise procurement audits of selected projects in some countries to identify weaknesses in the procurement supervision system.

The Bank's Strategic Compact recognizes the importance of controlling fraud and corruption in the projects the Bank finances. The Compact includes additional funds to improve procurement, disbursement and audit capabilities. With respect to procurement the Compact provides resources for:

• Increasing the number of skilled procurement staff to better support task managers throughout the project cycle.

• Increasing the frequency of country procurement assessments to help borrower governments improve public procurement institutions and systems and thus build local capacity.

• Intensifying ex post reviews by external auditors, for procurements not covered by the Bank's prior review process, to ensure greater borrower accountability. Implementation of the above measures has begun and will be spread over three years.

The Cost Effectiveness study initiated by the President is examining measures to improve the efficiency of business processes including procurement supervision, and its recommendations are awaited. The decentralization of the Bank's business, another important component of the Strategic Compact, warrants a review of the feasibility and merits of delegation of procurement assistance and supervision functions to field offices. The outcome of these reviews will be presented in a procurement supervision strategy paper for discussion with the Board later this year. The paper will incorporate lessons from recent independent Country Procurement Audits. The paper will also examine the need for additional measures to strengthen the Bank's procurement supervision.

Codes, pacts, and pledges

Corporate codes of conduct. Some have proposed that bidders under aid-financed contracts should be screened according to whether they have established corporate codes and compliance procedures that discourage bribery. If this were adopted, a "white-list" of firms eligible to bid under donor aid contracts would be developed. The Bank should support the principle of adopting corporate codes eschewing bribery, although it would be impractical to make corporate codes a condition for participation in Bank-financed international competitive bidding contracts at this stage for the following reasons:

- Making corporate codes an eligibility requirement would restrict competition until codes become common for both large and small firms in all countries in which firms bid for Bank-financed contracts. Bank policy is to broaden, not restrict, competition for Bank-financed procurement.
- Corporate codes may not spread until countries criminalize foreign bribery. Only the United States has done this effectively, and few firms outside the United States have adopted corporate codes that address bribery (though the International Chamber of Commerce [ICC] is now urging all its national committees to encourage firms to adopt such codes).[28]
- Neither the Bank nor the borrower would have the resources to verify the adequacy of compliance procedures, a problem likely to persist until global standards and certification processes are developed.

When foreign bribery is more widely criminalized, corporate codes become common, and certification standards are established, corporate codes might be considered as a requirement in Bank-financed international competitive bidding contracts. In the meantime the Bank can encourage bidders to submit information on corporate codes and compliance procedures on a voluntary basis. The Bank will also follow international developments in this area closely.

No bribery pledges. The objective of a "no bribery pledge" is to discourage bribes, primarily in international bidding, by committing firms to bid on a bribe-free basis, secure in the knowledge that competitors are similarly binding themselves. The most basic form of the no bribery pledge is a letter from the chief executive of each bidding company promising that the firm will obey the laws of the country and not bribe to obtain the contract. Furnishing such a pledge would be a condition of bidding. Typically, this would be matched by a public announcement by the head of government that officials would neither accept nor solicit bribes. More elaborate versions of the no bribery pledge extend the pledge to contract implementation and to subsidiaries and subcontractors. They propose the submission of codes of conduct and a certification at the completion of the contract that bribes have not been paid at anytime. The no bribery pledge could be part of a broader "integrity pact" entered into voluntarily by government and bidders, featuring efforts to address capacity constraints in government and enlist the support of civil society in monitoring compliance.[29]

Advocates of the idea argue that a no bribery pledge can be a powerful signal that the rules of the game have changed. Furthermore, a pledge not to bribe offers a solution to the collective action dilemma that many firms that bribe in foreign markets face—they would rather not bribe but cannot be sure their competitors will abstain as well. Bidders may therefore welcome the chance to reduce the cost of bidding, and a no bribery pledge might increase competition and lower prices. Countries with weak procurement capacity that find it difficult to effectively police the bidding process may welcome the approach.[30] There is a risk, however, that aggressive firms may sign and bribe anyway.

To enable the Bank to respond to borrowers that request such a clause in Bank-financed projects, the Bank has amended its Procurement Guidelines so that, at the request of a borrower, an undertaking to observe the country's laws on bribery may be inserted into the bid form as part of a national anticorruption program. The key to the effectiveness of a no bribery pledge is credibility. This means it must be accompanied by supporting reforms which improve bidding and contract execution processes. Ideally, such reforms should emerge from a dialogue with the private sector in which constraints to efficient bidding for public sector contracts and their execution are discussed and remedies agreed on.

Loan disbursement

The Bank's loan disbursement procedures affect the control of corruption in Bank-financed projects. When the Bank lent heavily for large infrastructure projects, the proceeds of loans were often disbursed directly to contractors, on presentation by government of payment documentation. Now, with a different mix of projects and in an effort to develop borrowers' institutional capacity, increase project effectiveness, and reduce the Bank's costs, disbursements are increasingly made into special accounts established by the borrower, Around $8 billion out of $16 billion investment lending is routinely disbursed through special accounts. This includes about $4 billion of some $9 billion annually, or approximately one-half of total disbursements, which are made against statements of expenditure. The latter summarize how money has been used for agreed categories of project expenditure.[31]

The extent to which the Bank can check statements of expenditure is constrained by several factors. At headquarters it is often difficult to match items claimed for reimbursement with line items in the project accounts and to determine whether the items are eligible for Bank financing. Moreover, Bank staff conducting supervision missions carry out only limited on-site reviews of documentation due to claims on their time for resolving other project management and implementation problems.

In the long run more emphasis should be placed on borrower capacity building, by strengthening financial management and better integrating physical implementation with financial indicators and loan disbursement. The Loan Department has been developing a new approach to disbursement, the Loan Administration Change Initiative (LACI), which emphasizes the importance of borrower financial management and accounting systems to manage and monitor Bank projects effectively. Instead of being disbursed against individual expenditure transactions or statements of expenditure, the proposal is to disburse loans in quarterly payments against supporting documentation and other information derived from borrower financial management systems and reported quarterly in an integrated Project Financial Management Report, to include a project progress report, financial statements, and a procurement management report. This would strengthen the linkage between financial information and the physical progress of a project. LACI would be a graduated approach, with new projects following the LACI process and projects in the existing portfolio being converted to the new process when the Bank determined that acceptable project financial management systems were in place and reporting formats were agreed to. An integral feature would be the development of performance measurement systems. This approach would require the participation of a financial management specialist on each project task team. LACI is currently at the pilot stage. If it meets its objectives after a thorough assessment of the pilot results, the Bank will progressively adopt LACI as the basis for loan disbursement in countries that meet the required standards. Improved financial management approaches will, in any case, be implemented, regardless of whether there is a direct link with disbursement requests, as envisaged under LACI.

Notes

27. The stocks of IBRD and IDA projects currently disbursing are $88.4 billion and $42.5 billion, respectively, against an annual flow of new loan approvals of $14.5 billion and $6.9 billion, respectively, in FY96. This stock of projects collectively generates about 40,000 individual procurement contracts annually, of which 10,000 (60 percent of value) are conducted under international competitive bidding rules, and 20,000 (30 percent of value) are conducted under local bidding rules. About 10,000 contracts undergo prior review by Bank staff (60 percent of value). The remainder are subject to what is termed "post-audit" selective checking after the event to verify that procurement followed the procedures specified in the loan documents.

28. The International Chamber of Commerce (ICC) encourages its members to adopt a voluntary code of conduct to combat extortion and bribery in international trade.

29. The introduction of a no bribery pledge is being discussed by the Global Coalition for Africa with a number of African governments.

30. Another approach is to contract out the procurement process to international procurement agents. Alternatively, specialist firms may be used to provide benchmark prices against which to compare the prices obtained from government bidding. Both approaches have been applied at various times in Latin America and elsewhere.

31. In FY93 total disbursements were $18 billion, of which $7.8 billion was made against statements of expenditure. In FY96 total disbursements were $19.1 billion, of which $9.4 billion were made against statements of expenditure.

CHAPTER 5

Helping Countries Reform Economic and Sector Policies

Economic policy reform should be a main pillar of an anticorruption strategy in many countries. Deregulation and the expansion of markets are powerful tools for controlling corruption, and the Bank will continue to encourage governments to pursue these goals wherever feasible. Where governments must continue to play an active role in the economy, policymakers should carefully consider the demands a new policy might place on institutional capacity.

Deregulation and the expansion of markets

Markets generally discipline participants more effectively than the public sector can, and their power to do so is closely linked to sound economic policy. 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. There is a strong correlation between policy distortions and corruption.[32]

Some policy reforms can have quick results, particularly some macroeconomic reforms and deregulation, which do 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. The state's role in supporting rather than supplanting markets is now widely accepted around the world.

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.
- Cutting 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.
- Abolishing monopoly export marketing boards.

Policy reform has helped reduce opportunities for corruption in many countries. In cases where countries have carried out economic reform programs and corruption persists, part of the answer lies 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. The Bank stands ready to work with governments on macroeconomic and sector policies that not only improve performance but also help to reduce opportunities for corruption.

Policy advice when government continues to play a role

In some areas, advice on policy reform may need to pay more attention to anticorruption goals. Typically, these are areas in which the government must continue to be involved because of market failure but in which 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. In each of these areas the issue is not that the policies are necessarily misguided but that institutional capacity is crucial to a successful outcome and that policies must be designed in the light of a realistic assessment of this capacity.

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, however, the complex negotiations required for privatization—usually in a situation of shifting policies and regulations—create temptation and opportunity. Weak institutions are unlikely to resist temptation. If corruption 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.

The dangers are particularly acute in infrastructure privatization, in which, in most cases, the stakes are large, the negotiations before the sale are 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.

Governments embarking on privatization of state enterprises need to reinforce institutional capacity so that clear rules can 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.[33]

Environmental regulation. The environment is a sector in which governments have tended not to be involved enough in the past and are now seeking greater involvement through 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 crucial but is easily overlooked.

Some countries are testing new and innovative ways to use market mechanisms for environmental control. These include, for example, auctions of tradable permits to pollute and negotiated contracts with industry groups on acceptable pollution levels in a particular watershed basin. In each case the level of acceptable pollution is set by the government but how that level is reached is ultimately decided by the market or the private sector. The Bank can help strengthen governments' capacity to design and implement such decentralized, market-based approaches to pollution control.

Tax reform. In most cases tax reforms that eliminate multiple rates and exemptions and limit the discretionary powers of tax officials help reduce corruption and enhance economic efficiency. However, tax rates that exceed what taxpayers view as legitimate or what tax offices can administer encourage the informalization of the economy and induce tax evasion and the corruption of tax officials.[34] High tax rates coupled with weak collection arrangements simply inflate the gains from corruption without increasing the risk of detection. Where this is the case, efforts should be made to design tax structures and rates that better match institutional capacity and to strengthen that capacity over time (and adjust policy accordingly).

Public expenditure reduction. Corruption may also increase when governments are under pressure to reduce the public wage bill's share in the budget but find it politically difficult to do so. In such circumstances a mandated reduction in the wage bill translates into yet lower real pay for government employees. Pay cuts 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 its capacity to control fraud, and even the honest can be driven to absenteeism and moonlighting activities that may 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.

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 (see chapter 6). The Bank's ability to help with this, as with other policy areas discussed above, will continue to increase as it learns more about the important links between policy design and institutional capacity.

Notes

32. See Figure 2-2 in *World Development Report 1997: The State in a Changing World,* New York: Oxford University Press, 1997.

33. Daniel Kaufmann and Paul Siegelbaum, "Privatization and Corruption in Transition Economies," *Journal of International Affairs,* 1997. 50(2), 419–58.

34. For example, in a number of transition economies in which government revenue accounts for less than 10 percent of GDP, value-added tax rates are 20 percent or higher. Rates this high are not widely enforceable in such an environment and create incentives for bribery.

CHAPTER 6

Helping Countries Strengthen Institutions

Building strong institutions is a central challenge of development and is key to controlling corruption. Well-functioning public management systems, accountable organizations, a strong legal framework, an independent judiciary, and a vigilant civil society protect a country against corruption. Institutional strengthening is thus expected to form a key part of country anticorruption strategies.

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

- Building traditional systems of well-performing government: a professional civil service, sound financial management, disciplined policymaking, and a balance of responsibilities among central, state, and local governments.
- Strengthening the legal framework, including the judicial system.
- Increasing transparency and introducing other measures that strengthen the role of civil society in demanding better 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 helping countries build well-performing public institutions, and it has increasingly recognized the important role played by civil society. But institution building is hard work. Continued efforts are needed both within and outside the Bank to understand how successful institutional reforms are designed and implemented.

Public management reform

Civil service reform. One of a country's most important institutions is a professional and well-motivated civil service, with selection and promotion based on merit rather than 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, and internal and external audit departments. However, the Bank's experience in assisting with civil service reform in more than sixty countries has shown that progress in this area tends to be slow.[35] 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 by the Bank in partnership with other agencies and governments if countries are to make headway in controlling corruption. Personnel policy, including recruitment, promotion, and pay, is clearly a vital issue.[36] Public sector pay in some countries collapsed in the 1980s and has yet to recover. The longer pay remains grossly inadequate, the more bureaucratic corruption becomes entrenched. Defining what is meant by the civil service and differentiating more clearly between a core civil service and other public employees is also important. So are mechanisms to protect the civil service from unwarranted political interference, such as public service commissions. 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, governments are trying to carry out too many tasks, or some functions are best contracted out, staff reductions may be needed. The Bank will therefore consider afresh the direct financing of severance pay as a component of civil service reform. Finally, the links between civil service reform and the labor market need to be better understood.

Budget reform. Government should undertake only what it can do well within its resource constraints. In many countries matching policy and affordability means changing assumptions about the role and optimal size of government.[37] The Bank can help governments develop 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.[38]

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 many of the Bank's borrowers have weak government financial management systems. Inoperative control systems permit widescale fraud, and in many cases auditing is impossible.[39]

The Bank has helped strengthen financial management systems and audit institutions in a number of countries, often using systems that better integrate budgeting, cash management, accounting, and auditing.[40] But in many countries the Bank's emphasis has been on measures to improve financial management in Bank projects. This does not necessarily create a capacity for better financial management outside the confines of the project. While the Bank will always have a fiduciary responsibility for its projects, it will pay greater attention to broader financial management systems, especially in countries in which standards are low. It has already carried out a number of Country Financial Accountability Assessments (CFAAs) to help identify institutional capacity weaknesses. The Bank can help governments install and operate modernized systems where appropriate, and will give more weight to financial management as a factor in country assistance strategies.

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 (relative to normal civil service rules) to hire and fire staff and to set pay levels while subjecting their performance to close 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.[41] Organizational restructuring (for example, separating the tax assessment function from the collection function) and staff rotation can also help reduce opportunities for corruption, as can control systems that require supervisors to attest that they have checked the work of subordinates. Tax policy may also affect anticorruption goals. 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. Sound macroeconomic policy also plays a role by reducing the risks of distorted valuations. How governments spend the revenues they collect also matters. If taxpayers do not see their taxes put to good use, evasion and corruption may become socially acceptable.

The Bank has provided policy advice and technical assistance on tax and revenue reform and is 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 that help governments control corruption.

Government procurement. Government procurement and contract management systems in both rich and poor countries are highly vulnerable to fraud and corruption. These risks are exacerbated when budgets come under pressure. Payments are delayed and incentives to bribe increase. Institutional capacity weakens if civil service pay and conditions are inadequate and the processes that ensure transparency and good record keeping are eroded. In terms of size, governmentwide procurement far outweighs procurement under Bank projects.

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 sound procurement are well known and are reflected in the Bank's approach to its projects. The Bank also has provided procurement training and has helped a number of countries (mostly transitional) enact procurement legislation that specifies open, competitive bidding for public contracts.[42] Although these efforts have been valuable, there has not been enough systematic effort to assess governmentwide systems and to incorporate the findings in country assistance strategies.

An increased effort is needed to help interested borrowers build capacity to procure goods and services and manage contracts. The Bank intends that country procurement assessment reviews be developed into a more effective vehicle for improving public procurement. The Bank's public sector management and procurement specialists will work to integrate the development of sound public procurement into country strategies for public sector reform and continue to search for new techniques and approaches that help minimize opportunities for corruption and improve value for money.

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 setting. Decentralization can help reduce corruption if it improves government's ability to handle tasks while increasing transparency and accountability to local beneficiaries.[43] But decentralization can also increase corruption if local and regional governments have stronger incentives (because of lower formal pay levels, for example) or more opportunities to carry out fraudulent activities and are less constrained by financial management and auditing systems (which are often in even shorter supply in regions than in the center). In many countries, industrial and developing, more corruption is thought to exist in state and, in particular, local governments than in the national government. This is not an argument against decentralization, which for many other reasons may still have a positive economic impact. Rather, decentralization initiatives must take into account the relative accountability and capacity of national and subnational levels of government when considering the structure of power sharing and must work to develop the capacity of decentralized entities alongside the devolution of functions.

Legal and judicial reform

A country's legal system—its 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, enforcing property rights, and defining the limits of state power. Laws and regulations that delineate market-friendly policies are powerful anticorruption tools (see chapter 4). The Bank has long been involved in helping to design macroeconomic and sector policies, and the laws through which they are implemented, in many countries.

Judicial reform. Enforcement of anticorruption legislation requires an efficient, predictable, and accountable judiciary. In recent years the Bank has gained 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 caseflow 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 to counter corruption by court staff who, as gatekeepers to the adjudication system, may extract bribes.

Assessing the effectiveness of the judicial system should be part of the diagnostic framework that Bank staff apply when asked to help 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, debate new approaches, draw in outside expertise, and gather lessons from experiences elsewhere.

Special anticorruption bodies. There is now extensive experience worldwide with independent bodies, typically set up by statute, to increase integrity in public life. These include 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.

Corruption commissions and special fraud units have been highly successful in Chile, the former territory of Hong Kong, and New South Wales (Australia). In a number of developing countries, however, they have been used as instruments of partisan politics, undermining their effectiveness and public support.[44] In the wrong hands powerful anticorruption legislation can be abused. In some Latin American countries independent attorneys general have proven effective in bringing charges against those at the highest level of government (Brazil, Colombia, and Venezuela). Had they been part of the executive branch, they would not have had the independence necessary to act decisively against high-level corruption.

Anticorruption bodies appear to be 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 better understand the experiences of these bodies—where they have been effective and where they have failed—before recommending them to governments.

Civil society and the media

Civil society and the media are crucial to creating and maintaining an atmosphere in public life that discourages fraud and corruption. Indeed, they are arguably the two most important factors in eliminating systemic corruption in public institutions.

Corruption is controlled only when citizens no longer tolerate it. Private organizations, professional organizations, religious leaders, and civil groups all have a stake in the outcome of anticorruption initiatives and an interest in the process. They also may play an important role as watchdogs of public sector integrity, and there is scope for expanding this role and sharing the experiences among countries. The Bank, as a lender to governments, can play only a limited role in supporting civil society in the fight against corruption. But 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.[45]

National coalitions. In countries where the government has sought Bank assistance in developing an anticorruption strategy, policymakers may be interested in taking a nonpartisan approach. EDI's integrity workshops can facilitate this process by providing a forum for the discussion of international experiences and local alternatives. This is a new and promising activity for the Bank, but it requires careful preparation and sensitive handling.[46] This type of activity should be carried out only in response to a request from the national authorities, and in partnership with them.

Open and transparent government. Corruption thrives in the dark. The Bank supports efforts 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 some of the foundations of open and accountable government. Government departments and agencies should be encouraged to produce annual reports on their activities, achievements, and financial results, and national governments should report these in consolidated form. 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 before making policy or program decisions) and freedom of information laws (which require governments to make information surrounding decisions available unless there are supervening public policy reasons 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.

Notes

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

36. See Figures 5.5 and 5.6 in *World Development Report 1997: The State in a Changing World*, New York: Oxford University Press, 1997.

37. In many countries decisions to introduce new policies are made without regard to the long-term costs of implementation. This is because policymaking 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.

38. There is tentative empirical evidence that corruption affects the allocation of budget resources between sectors, specifically of a negative relationship between corruption and government spending on education. Since educational attainment is an important determinant of economic performance, this could have adverse long-run consequences for economic growth. See Paulo Mauro, "The Effects of Corruption on Growth, Investment, and Government Expenditure: A Cross-Country Analysis." Washington, D.C.: IMF, 1996.

39. This is a particularly serious problem in Sub-Saharan Africa, where auditors general frequently complain that audits cannot be completed in departments and agencies because accounting records are incomplete and audit queries go unanswered. Consolidated government accounts are presented to parliament years after spending takes place, if ever.

40. The Bank is working with a growing number of governments to strengthen the capacity of the supreme audit institution 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.

41. When corrupt tax or customs officials systemically collude with taxpayers to substitute a lower tax assessment and pocket the difference (bribery with theft), businesses operating in competitive markets have an incentive to comply. Insisting on paying the official tax or duty would put them at a competitive disadvantage in relation to colluding firms. If a strong financial management system can be installed that controls theft (for example, recording assessments made by individual officials and requiring superiors to sign off on work performed by subordinates; reporting valuations, assessments, and collections; and adding spot checks and independent valuations), firms may instead have an incentive to abide by the law and avoid bribery and collusion. See Andrei Shleifer and Robert Vishny, "Corruption," *Quarterly Journal of Economics*, 1993, 108.

42. Using a model law (UNCITRAL) adapted to individual country legal systems, the Bank has helped many countries, especially those in transition, establish legal frameworks for public procurement. This work has been funded from loans and Institutional Development Facility grants.

43. In a growing number of countries the Bank, through EDI, has helped governments carry out service delivery surveys. These surveys ask program beneficiaries questions about the quality and reliability of government services and in so doing may bring to light patterns of petty bribery. The surveys reveal how programs are delivered and can help build demand for more accountable and more effective government. If beneficiaries complain of bribes, surveys can help

to foster a dialogue with the government on corruption. The surveys are best carried out as part of a broader reform program aimed at improving performance rather than at specifically exposing corruption.

44. A recent survey of public and private participants from developing countries attending some high-level training in the United States found that the creation of anticorruption 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," Harvard Institute for International Development, January 1997.

45. Public education, for example, is strongly emphasized in the anticorruption strategy of Hong Kong's Independent Commission against Corruption.

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

CHAPTER 7

Mainstreaming a Concern for Corruption in Bank Activities

If the Bank is to help countries tackle corruption, it needs to take corruption more explicitly into account in its own economic work and in its internal processes. This chapter sets out how the Bank is moving forward in mainstreaming a concern for corruption across the range of its operational work. From the Bank's perspective, anticorruption is best thought of not as a set of new initiatives but rather as a more explicit integration of the problem (of which staff and management have long been aware) into country strategy formulation, Bank lending, economic and sector work, research, and country dialogue.

Economic work

Increasing transparency. The first requirement in mainstreaming a concern for corruption is for the Bank to bring the issue out of the dark. To a significant extent this is already happening. Discussions about the effects of corruption on development have been intensifying within the Bank in recent years, especially since President Wolfensohn's 1996 Annual Meetings speech. But corruption needs to be addressed more systematically in the Bank's analytical work. Until that happens corruption will not be sufficiently understood or integrated with management decisions. And to some extent the Bank is playing "catch-up," acknowledging that corruption threatens development but doing so in the wake of media attention and international recognition of corruption as a major problem.[47]

Economic and sector work. The Bank will not be able to provide governments with sound policy advice if it does not make the required intellectual investment. Economic and sector work has not dealt with corruption much, referring to it elliptically with phrases like “rent seeking,” “leakage,” and “misappropriation.” In the future more effort is needed to address corruption directly and openly in economic and sector work when it is relevant. In particular, poverty assessments will need to discuss petty corruption, since in many countries the poor experience extortion by public officials daily. Public expenditure reviews, with their focus on the allocation of government spending, will also have to grapple with the issue, since corruption may mean that inputs are used to produce outputs and have outcomes quite different from those represented in budgets approved by the legislature. And country economic memorandums, sector studies, and environmental assessments will need to address corruption where it represents an impediment to sectoral and economywide performance. Private sector assessments, which already regularly survey corruption issues, should continue to focus on this dimension. In some countries EDI’s service delivery surveys, which ask beneficiaries about the quality of government services, have also yielded information on corruption.

Research. Outside the Bank, research on corruption has grown considerably. A substantial body of academic literature is starting to shed light on the complexities of corruption and its effects on 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 accumulate. Inside the Bank little explicit research on corruption is under way. Still, research in several areas, such as property rights and aid effectiveness, touches on the issue.

The Bank will devote more resources to research on corruption. The Development Research Group and the Poverty Reduction and Economic Management Network are developing a research program on corruption, which can be carried out by Bank staff or contracted out. As this research yields insights, they will be reflected in the Bank’s policy advice and in its contributions to international discussions on corruption.

Dissemination. As discussion and analysis of corruption becomes more explicit in economic and sector work, in staff dialogue with country counterparts, and in project design, a body of best-practice knowledge will be built. It will be important to capture this knowledge and disseminate it through the Knowledge Networks and in staff training. An advisory service on anticorruption is being created in the Poverty Reduction and Economic Management Network, drawing on the knowledge and insights of other networks. The Network’s staff, with the assistance of the Legal

Department, will provide guidance to staff on the treatment of corruption issues in economic and sector work, on the design of projects, and on how to help countries design anticorruption strategies.

Country assistance strategies and the country dialogue

A review of current country assistance strategies reveals that they seldom address corruption as a factor affecting Bank projects or as a development effectiveness issue. The reasons are similar to those for not addressing corruption in economic and sector work—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 on how to deal with systemic corruption when it is found. For all these reasons, Bank staff feel more at ease assessing a government's economic policy record than whether its programs are affected by corruption.

But a failure to address corruption in cases in which it undermines a country's development prospects and the effectiveness of Bank activities diminishes the value of the country assistance strategy as a mechanism for programming Bank lending and economic and sector work and for raising important matters with the government. To rectify this, future country assistance strategies will discuss any serious effect that corruption has on a country's development prospects and, in turn, define ways in which the Bank could help mitigate the problem, consistent with the Bank's mandate. This does not mean that every strategy should include a paragraph on corruption, regardless of country circumstances. Rather, there should be a substantive discussion of corruption and its implications for Bank operations in any country in which corruption affects Bank projects and development prospects more generally.

Addressing corruption in the country dialogue and the country assistance strategy requires sensitive handling. It will be important to view corruption not in moral terms but as a constraint to development. The more corruption can be presented in terms of its effect on the outcomes of government policies, programs, and projects, the more constructive the dialogue is likely to be. The objective is not to rate countries on the extent of corruption but to shed light on how corruption affects government objectives, particularly in areas that we deem important for sustainable development. Cross-country indices of corruption open up avenues for empirical research but are not themselves a measure of economic impact.

Lending program

Lending allocations. The Bank will take corruption into account more explicitly in its decisions on country operations. In the past, donor agencies, including the Bank, have been criticized for continuing to support countries in which corruption was pervasive and a clear obstacle to development. However, it would be wrong to move from a position in which little notice was taken of corruption to one in which the level of corruption alone determined the size of the lending program. The Bank's interest in addressing corruption arises because it can be 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 goals.

Assessing corruption's effect on development will seldom be a precise exercise, and it will require the exercise of judgment based on the available evidence. Corruption comes in many forms, and its impact varies greatly among countries, according to circumstances. One type of bribery may be relatively benign in one setting but economically crippling in another. Moreover, the harm may be mitigated or magnified by the government's macroeconomic or sector policies.[48] Thus corruption should always be assessed in the context of other factors affecting development. Furthermore, if corruption is directly addressed in economic and sector work, insights will be gained, evidence on its effects will accumulate, judgments will become more informed, and its costs will be better articulated to governments.[49] These tools will help governments prepare and implement strategies to combat corruption.

Corruption should be explicitly taken into account in country risk analysis, lending decisions, and portfolio supervision if it affects project or country performance and the government's commitment to deal with it is in question. The following considerations will guide lending and, with due respect to legal obligations, disbursement decisions:

- Whether Bank projects are likely to be affected by corruption during design or implementation, or thereafter.
- The extent to which the achievement of development objectives is compromised by corruption.
- The willingness of the government to act to control corruption if it threatens the effectiveness of Bank projects and/or economic and social development.

The response in individual cases should be tailored to the nature of the problem. If corruption is found to taint a particular Bank project, current Bank procedures will be applied and should in general be adequate to address the issue. If corruption is thought to taint the achievement of development objectives in an entire sector, the design and size of Bank assistance in that sector should be reconsidered. In extreme cases of far-reaching systemic corruption that affects most sectors, Bank assistance may need to be focused on a few unaffected sectors, limited to institution-building or nonlending activities, or curtailed altogether. This cannot be a mechanistic assessment but will always call for careful judgment based on accurate information and the specifics of the situation. Every effort will be made to ensure even-handed treatment of countries. And in all cases, the Bank's actions will be governed by the Articles of Agreement and will focus on the economic issues within its mandate.

Within this broad framework and consistent with existing loan agreements country operations may need to be adjusted according to the extent to which corruption affects both Bank projects and development objectives and to reflect the efforts of government to control it. This can be done without changing IDA and IBRD allocation criteria, which are based on country and portfolio performance.[50] However, this revised approach does imply a greater capacity on the part of staff to acknowledge the costs of corruption and factor them into performance assessments when they are significant. In some cases corruption may be a country risk factor that will require special Bank attention.

Project design and portfolio management. Projects need to be prepared in a way that integrates institutional considerations and assesses corruption risks more explicitly at the design stage. Many Bank staff already do this, but experience is not widely shared, and thus institutional learning has been low.

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

Lending instruments. 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 has been used extensively to finance innovative public management activities, and we expect this to extend into anticorruption work under the umbrella of the proposed new Development Grant Facility. Technical assistance loans, often accompanying structural adjustment loans and sectoral adjustment loans, have been a mainstay of Bank efforts to help countries implement public management reforms.

Structural adjustment loans and sectoral adjustment loans can continue to be used to support economic policy reform. New lending approaches—such as 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.

Procurement and financial management

Procurement. The Bank is redesigning its Country Procurement Assessment Reviews (CPARs), so that these can become more effective tools for helping countries strengthen public procurement systems. Strengthening capacity to procure goods, works, and services is good not just for the control of corruption but for government performance in general.

Financial management. In keeping with the changes under way in the Bank's disbursement systems, greater emphasis will be placed on borrower accountability and government financial management systems. This means increasing the intensity of Bank work on financial management and carrying out Country Financial Accountability Assessments (CFAAs) for a wider range of countries. These assessments look at financial management capacity, skills, and standards in both the private and public sectors and offer governments recommendations on how capacity in this critical area could be strengthened.

As the Bank places more responsibility on managers for achieving results on the ground, simplifies internal processes, and shifts functions to resident missions, the Bank must ensure that the risks of fraud and corruption in Bank-financed projects remain well controlled. As noted above, review of large-scale procurement decisions will remain a headquarters function, while more staff based in the field should strengthen project supervision and portfolio management.

External agency practices and public sector management

Some of the Bank's (and bilateral donors') modes of operation might impede national anticorruption efforts, and certain Bank practices associated with "enclaving" may need to be changed. 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 in industrial 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.

Enclaving. A frequently debated issue in the Bank is the tendency to "enclave"—safeguarding Bank operations from the weaknesses of a borrower's public sector by insisting on an implementation environment separate from prevailing government management systems. A long-acknowledged (and now less common) example is the project implementation unit, appropriate in some circumstances but now viewed as overused. An egregious 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.[51] The reasons for enclaving are understandable, given the Bank's fiduciary responsibilities and the desire for smoothly running projects in situations in which government budgeting, accounting, auditing, procurement, and personnel management systems are weak. To some extent these reasons are inherent in any project-centered approach to lending. But they reduce the pressure on government to reform, and they may weaken domestic systems by replacing them with donor-mandated procedures.

This tension may never be fully resolved, but it needs to be better recognized. Bank staff need to pay more attention to the government's budgeting, accounting, auditing, procurement, and personnel management systems and to how they affect the sustainability of Bank projects. Doing so would focus management and staff attention more explicitly on the condition of those systems and on how the Bank might help governments improve them. In turn, this would help governments control fraud and corruption.

Soft budget effects of aid. Concern has been voiced that the way aid traditionally has been provided by the Bank and bilateral donors may undermine governance in countries receiving large amounts of aid, by expanding government's reach, softening budget constraints, and discouraging a rationalization of functions and redeployment of resources. Donor preferences for funding projects in public investment programs, channeled through a dual budget structure, may have helped bloat 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 the tradeoffs involved in the allocation of resources. Furthermore, when poorly managed, aid softens the budget constraints that should discipline policy choice.[52] When accountability is externalized, national accountability mechanisms are weakened, which may allow corruption to flourish.

One way to promote discipline in policymaking and better financial management in countries that depend on aid could be to shift a portion of aid flows from project- to program-based financing and to conditional general budgetary support, within a medium-term expenditure framework. Such budget support lending could be conditioned on the installation and operation of transparent budgeting and financial management systems (with the control of corruption as one objective), just as earlier policy-based lending supported economic policy reform. As part of its efforts to consider new lending instruments, the Bank will consider the feasibility of such an approach.

Staffing implications

Staff training. The experience and expertise of staff are vital for the success of the Bank's efforts against corruption. Experience will build over time as staff begin helping countries, and it can be augmented through training. 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. Current training proposals for mainstreaming the control of corruption involve adapting existing training courses as well as launching new ones.

- Training programs oriented to a particular sector progressively will include material showing how projects can be designed to minimize the 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.
- Public sector management training programs will be modified to include a module on anticorruption, to sensitize staff, and to show how corruption can be addressed within a public sector management and governance framework.
- Workshops on the analysis of corruption and the development of anticorruption strategies will be organized, aimed initially at Bank staff working on countries that have approached the Bank for assistance in combating corruption.[53] Diagnostic frameworks will be developed and provided to staff. Guidance on dealing with this

sensitive subject will be included in staff media training. And training courses should help Bank staff understand the political as well as the economic and social dimensions of corruption.

• Staff guidelines on addressing corruption have been prepared and are being distributed to all staff.

Staffing implications. The bulk of the responsibility for mainstreaming corruption in Bank work will fall on existing staff. Thus the additional staff required to implement the recommendations are limited, and many needs can be accommodated through training.

In three areas, however, staffing levels are inadequate and will be increased.

• The number of skilled financial management specialists in operational units has declined in recent years, a trend the 1994 *Financial Reporting and Auditing Task Force Report* drew attention to. Specialists are overloaded, and new staff are needed to enable the Bank to assess borrowers' financial management systems and to provide assistance to countries seeking to improve them.

• The Bank also needs more procurement specialists. In theory, some relief may be obtained by shifting the emphasis from prior review to post-audits. But these, too, require budget funds to hire local external auditors. If the Bank is to help more governments improve their procurement systems, there will inevitably be additional staff costs.

• Additional expertise is needed in public sector reform. Building better institutions helps control corruption. This means that the demands placed on public management and institutional specialists are likely to grow, requiring an increase in their numbers. Lessons of experience and best practice should be duly collected and disseminated through the Knowledge Networks.

Personal security and risks. Finally, this chapter 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. Anticorruption 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.

Notes

47. An 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, held in Miami in 1995.

48. A 10 percent bribe on the cost of a good public investment project depresses the project's 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.

49. As noted elsewhere in this report, private sector assessments are yielding information on the extent to which entrepreneurs see bribery as a constraint to business development. Service delivery surveys 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 major fraud to the authorities' attention by comparing customs revenue receipts with central bank balance of payments data.

50. IDA resources 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: macroeconomic stability, structural policies, and portfolio management. Pervasive corruption will have an impact on all three criteria.

51. 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 when the financing of an activity (for example, building a public primary school) results in recurring departmental staffing and maintenance responsibilities or involves policymaking, a social fund may not be appropriate.

52. Faced with an offer of concessional project aid, a government in a poor country has every incentive to accept it even when the government doubts that 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.

53. A pilot workshop took place in the beginning of February 1997, coordinated jointly by the Poverty Reduction and Economic Management Network and the Learning and Leadership Center. This workshop has been evaluated for lessons that can be reflected in future training events.

CHAPTER 8

International Efforts

Corruption is an international problem that requires international solutions. Much corruption occurs in international business, including international government procurement, where the Bank has a special interest. To be successful, efforts to reduce this kind of corruption must deal with it at its source in capital-exporting countries as well as in developing countries. Work along these lines is being carried out by international organizations, particularly regional organizations, and by international business groups. Acts of internal corruption often have international ramifications, as is the case when their authors flee to another country to avoid detection or prosecution or try to launder the proceeds abroad. Bank secrecy laws in some countries may hinder efforts of national investigators to trace the proceeds of bribery or other corrupt actions. Efforts are under way to improve international cooperation in the detection and prosecution of corruption and money laundering. Governments that are starting to deal with corruption have much to learn from those that have already mounted successful campaigns against it. Here too international organizations have started to collect the experiences of their members and to organize training and other programs aimed at sharing these experiences and developing the skills of the officials charged with dealing with corruption in their member countries.

Most of the efforts of international organizations are directed at the criminalization of corruption. Only to the extent that bribery is punished as a crime can the full government machinery, including police and the judiciary, be mobilized to fight it. Most common forms of corruption, such as bribery of public officials, are a criminal offense in most countries. Only the United States has enacted a statute specifically to criminalize international bribery. Regional international organizations, such as the Organization of American States and the Council of Europe, are drafting international conventions to establish minimum standards in defining corruption as a criminal offense. In addition, the OECD is drafting an international convention whose signatories would criminalize international bribery of foreign public officials.

As has been explained in the preceding chapters, the Bank's efforts to help its member countries combat corruption will focus on economic and policy reform and institutional strengthening. These efforts will complement those of other international organizations and business groups. The Bank's borrowers can benefit from the mutually reinforcing combination of the assistance the Bank is offering on economic and sector reform and institutional strengthening and the assistance the other organizations are offering on detecting and prosecuting corruption and related matters.

Current international initiatives

Although corruption of national officials is a criminal offense in most countries, transnational bribery generally is not. Making international corruption a crime will require changing laws or adopting new ones, as well as mechanisms to enforce them. Both will require 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 in which to agree on common definitions and standards and to coordinate actions. Regional organizations have sponsored international conventions making bribery (including international bribery) a crime.The Bank will lend its voice in support of these efforts.

The Organization of American States' Convention. The most advanced effort so far is the Organization of American States' (OAS) Inter-American Convention Against Corruption, adopted in Caracas, Venezuela, March 29, 1996. Twenty-three of the OAS' thirty-five members have signed the convention. The convention is now in force between the countries that have ratified it: Bolivia, Costa Rica, Ecuador, Mexico, Paraguay, Peru, and Venezuela. The convention is open to ratification by all OAS member states, and any other state may accede to it.

Building on the convention, the OAS General Assembly adopted a comprehensive Plan Against Corruption at its meeting in Lima, Peru, in June 1997. Under this plan the OAS will provide support to its member countries and cooperate with local populations and other international organizations—including the Bank, the Inter-American Development Bank (which is also preparing a plan of action), and the OECD—in preventing and controlling corruption.

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 legislation to reflect this recommendation. At its ministerial-level meeting in May 1997, the OECD Council endorsed the Revised Recommendation on Combating Bribery in International Business Transactions, prepared by the OECD Working Group on Corruption (in which the Bank participates as an observer). In particular, the ministers reaffirmed their commitment to criminalizing bribery of foreign public officials in an effective and coordinated manner. They recommended that member countries submit criminalization proposals to their legislative bodies by April 1, 1998, and seek their enactment by the end of 1998. They also decided to open negotiations on a convention to be completed by the end of 1997 with a view to its entry into force as soon as possible in 1998. Ministers also urged the prompt implementation of the 1996 recommendation on ending tax deductibility for foreign bribery.

In related work, at the May 1996 High Level Meeting the OECD's Development Assistance Committee recommended that members "introduce or require anti-corruption provisions governing bilateral aid-funded procurement." Many countries have followed the same path as the Bank in making more explicit the action that will be taken if bribery is found.

The European Union. On May 21, 1997, the European Commission (EC) adopted a Communication to the Council and the European Parliament on a Union Policy against Corruption. This communication sets out the EC's comprehensive policy on corruption inside the EU as well as in its relations with nonmember countries. 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, eliminating the tax deductibility of bribes, reforming public procurement, accounting, and auditing systems, and so on. In the case of nonmember countries, the communication proposes to "establish a coherent anticorruption 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 anticorruption programs, particularly in the applicant countries of Central and Eastern Europe.

The Council of Europe. The Council of Europe Programme of Action Against Corruption, prepared by the Multidisciplinary Group on Corruption and adopted by the Committee of Ministers in November 1996, serves as the basis for the preparation of a convention on corruption under which parties would agree to legislate (if necessary) to criminalize certain corrupt behavior. In addition, the Multidisciplinary Group on Corruption has undertaken work on the administrative and civil law aspects of corruption. The Council of Europe also provides technical assistance to its Eastern European member countries, and the Bank will participate in some of its activities.

The United Nations. In December 1996 the United Nations (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 criminalizing foreign bribery and ending its tax deductibility signifies broad political agreement in the international community on this matter. In February 1996 the UN General Assembly recommended that the Economic and Social Council take steps to prevent illicit payments.

Financial Action Task Force. The Financial Action Task Force on Money Laundering has been active in addressing money laundering and expanding the list of offenses, including corruption, that constitute money laundering. The task force's forty recommendations include nondrug predicate offenses and 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 crimes should be designated as money laundering offenses. This opens the way for countries to include corruption as an offense. Originally targeted at OECD countries, the forty recommendations are now also being addressed to middle-income countries in the hope that governments adopt them and cooperate with other authorities in international efforts to control money laundering. In this way national efforts can be supported by international action and vice versa.

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 has set up a standing committee of business executives, lawyers, and academics. ICC national committees mobilize support for the rules in their countries.

Nongovernmental 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 (TI), based in Berlin, Germany, aims to curb corruption through international and national coalitions encouraging governments to establish and implement effective laws, policies, and anticorruption programs; build public support for anticorruption programs and enhance public transparency and accountability in international business transactions and public procurement; and encourage all parties to international business transactions to operate at the highest levels of integrity, guided by TI's Standards of Conduct. Transparency International has more than seventy national chapters that fight corruption at the national level, 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.

Bank actions at the international level

The Bank's efforts to fight international corruption will focus on ensuring that its member countries derive the greatest benefit from the synergy between its activities and those of other international actors. To this end the Bank will work closely with other development finance institutions and the IMF and bring its experience to bear in deliberations with other organizations active in the fight against corruption. The Bank will:

- *Cooperate with the other multilateral development banks and with bilateral donors* by informing them of how it plans to help its member countries in this area, and undertaking joint or coordinated activities as appropriate.
- *Cooperate closely with the IMF,* recognizing the complementary roles of the Bank and the Fund, with each institution focusing on its area of expertise. Especially important is the IMF's work with member countries to establish sound

macroeconomic policies and strengthen government budgeting and financial management. Support for central bank supervision of the banking system is another vital area, which complements the Bank's work on financial policy.

- *Continue to contribute to the work of the regional organizations engaged in the fight against corruption,* including the OECD, the Council of Europe, and the OAS, and participate in technical assistance and other activities as appropriate.

- *Develop and maintain contacts with other agencies active in this area,* such as the UN Development Programme, the UN Drug Control Program, the UN Center for Crime Prevention and Control, the World Customs Organization, the World Trade Organization, the Commonwealth Secretariat, and professional bodies such as the International Commission of Jurists, the International Organization of Supreme Audit Institutions, the International Bar Association and the International Federation of Accountants, and the Financial Action Task Force, which coordinates international efforts against money laundering.

- *Consult with the business community to better understand its perspective on corruption.* For many firms bribery is a reality of the business environment. How firms cope with corruption, the influence it has on business decisions, and the measures they believe will be effective in controlling it are of considerable interest to the Bank and its borrowers.

- *Consult with NGOs to gain their insights and exchange views on the Bank's approach.* The World Bank/NGO Committee can organize such consultations.

- *Explain in the country dialogue how international efforts complement domestic action.* Borrowers embarking on domestic programs should know they are not acting alone but are supported by international efforts to control transnational bribery and money laundering. They will also be interested in the experiences of other countries combating corruption.

- *Use conferences and the media to explain the need to control fraud and corruption and to maintain international public awareness of the Bank's contribution to this effort.* The Bank can explain the costs of corruption and actions countries can take to address its causes. In particular, the Bank is well placed to demonstrate how economic policy reform can reduce rents and thus contribute significantly to the control of corruption.

- *Research transnational aspects of bribery.* There is scope for empirical research on the effects of corruption on foreign direct investment, trading patterns, and the prices countries pay for imported goods.

CHAPTER 9

Concluding Thoughts

This final chapter offers some concluding thoughts as the Bank moves forward in helping countries and international bodies address the problem of corruption.

First, there is both a growing awareness of the costs of corruption and a growing demand for Bank support for national and international efforts to combat this problem. The time is right for a more active and higher profile Bank role in this area, which respects the institution's mandate and builds on its comparative advantage.

Second, for the Bank anticorruption work is best thought of not as a set of new initiatives but rather as a more explicit integration of the problem (of which staff and management have long been aware) in country strategy formulation, Bank lending, economic and sector work, research, and country dialogue.

Third, if the Bank is to help its member countries, it has some catching up to do. It will have to learn more about what works and what does not in the fight against corruption. Notwithstanding longstanding efforts to control corruption in the projects it finances and a strong record of policy advice, the Bank is at an early stage in building up the knowledge it requires to help countries develop and implement broader anticorruption 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. The Bank's new knowledge management systems will be crucial in gathering and disseminating this information.

Fourth, while corruption has clear economic costs, it is also a dimension of the way power is exercised, and it is thus a sensitive issue of governance. Although many governments are more open to discussing corruption than they were several years ago, the subject still requires careful handling. Thus the Bank's management is not making a blanket recommendation for regional action plans. While this approach may be appropriate for some regions, it is by no means the choice for all. Nevertheless, corruption is no longer a taboo subject in the Bank, and it will be dealt with in its operational work in ways that support borrowers' development objectives.

Fifth, institutions are central in the fight against corruption. Getting economic policy right, enforcing laws, maintaining financial management systems, and practicing sound procurement across the public sector require well-functioning institutions. Seen in this way, corruption is as much a symptom as a cause of malaise. The Bank needs to deepen its understanding of how institutions evolve and of what external agencies can do to help countries develop strong institutions. It needs to place more emphasis on high-quality public sector management and governance work. This has implications for staff skills and for the resources the Bank devotes to this area.

Finally, the Bank should not think of itself as working alone in this area. If countries are to make progress in combating corruption, it will come about only through national efforts that external agents like the Bank can support with policy advice and financial resources. In providing this support, the Bank needs to develop partnerships with other agencies and NGOs that are active in this area.

The International Finance Corporation'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, International Finance Corporation (IFC) is deeply concerned about the potential for corruption in the projects it finances. In congruence with the World Bank's perspective, the 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 the IFC's investments are successful, that its resources are being used effectively, and that its developmental objectives are met.

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

- Control of fraud and corruption in projects.
- Institutional strengthening.

The IFC's efforts to combat corruption in the private sector will complement those of the Bank in the public sector to the extent that the IFC's activities focus in the private sector.

Control of fraud and corruption in projects. The IFC controls fraud and corruption in the projects in which it invests by employing appropriate methods and procedures at every stage of the investment process.

The IFC's investment staff conduct a due diligence review of the individuals involved and their primary businesses. On-site visits are made to both project and nonproject installations to obtain a first-hand impression of the sponsor/operator and its affiliated companies. The IFC generally will not invest in a project if it does not know the identity of its partners, or if it believes that a sponsor/operator may be controlled by an undisclosed third party, or if 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 the IFC must be persuaded that the interests of the sponsor/operator in undertaking the project are compatible with those of other investors. The appraisal must establish to the IFC's satisfaction that the contractual undertakings made to structure the project (such as 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 the IFC and judged to be commensurate with the risks taken and the contributions made by the party. This analysis is a necessary step to uncovering potential conflicts of interest, as a project typically brings together both strategic and passive investors with different agendas and motivations.

The 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. The 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. Thus the team can identify significant price anomalies and distortions that may mask corrupt practices. The IFC will not finance a project if material deviations from fair pricing cannot be explained by specific, acceptable circumstances.

The IFC will not invest in a project if 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. At an early stage in the process of evaluating a proposed project—the initial project summary—IFC management reviews the structure of the project and examines the relationships between the parties. If a project is found wanting in any of these areas, management directs staff to agree on improvements with the various parties to the transaction.

After making its investments, the IFC supervises them closely and on a regular basis. The 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. The IFC requires, in its capacity as lender, that investee companies provide it with quarterly and annual financial statements (the latter are 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.

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

Institutional Strengthening. The strengthening of institutions in developing countries sometimes occurs as a secondary effect of the IFC's efforts to control fraud and corruption in projects. However, the IFC also engages in activities whose primary purpose is to build and strengthen institutions—and these activities help combat corruption. In this regard the IFC advises its member governments on how to create new institutions and 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. The IFC's Capital Markets Department plays an important role in this area—for example, providing advisory services for the establishment of stock exchanges and securities commissions in IFC member countries.

The IFC also combats corruption through operations of the Foreign Investment Advisory Service (FIAS), a joint service of the IFC and the Bank. FIAS works at the request of IFC member governments, helping them to build effective institutional frameworks for investment promotion strategies and to interact with potential foreign investors. FIAS helps governments achieve their foreign direct investment objectives. Its advisory services seek to stimulate inflows of foreign direct investment by creating a more favorable investment climate in the member country. FIAS's advice typically focuses on reforming laws, policies, and procedures needed to increase those inflows.

The Multilateral Investment Guarantee Agency'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, the Multilateral Investment Guarantee Agency (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, such as the United States are prohibited from paying 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 corruption comes through both its guarantees activity and its technical assistance programs. In terms of guarantees, MIGA can cancel a contract with an investor if it learns that the investor is not complying with the legislation of the host country. Moreover, MIGA is not legally obliged to pay compensation on a claim against its insurance if it can prove that the investor did not comply 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, includes corruption in its training sessions on attracting and retaining foreign investment. The topic is treated under the heading of investor decisionmaking, stressing the need for transparency and clearly identifying the payment of bribes as an important issue that needs to be addressed.