IMMEDIATE ATTENTION

EB/CW/DC/97/3

August 13, 1997

To: Members of the Committee of the Whole for the Development Committee

From: The Secretary

Subject: **Helping Countries Combat Corruption and Improve Governance**

The attached paper, "Helping Countries Combat Corruption and Improve Governance," is for consideration by the Committee of the Whole for the Development Committee. It has been prepared by the staffs of the Bank and the Fund to provide the basis for consideration of agenda item 2 of the draft provisional agenda for the meeting of the Development Committee to be held on Monday, September 22, 1997. The paper is based on the recent Board paper, "The Role of the Fund in Governance Issues—Guidance Note," (EBS/97/125, 7/2/97 and Supplement 1, 7/11/97) and "Helping Countries Combat Corruption: The Role of the World Bank" (Report of the Corruption Action Plan Working Group) that was discussed by the Bank's Board on July 15, 1997.

This paper is scheduled to be considered at a meeting of the Bank's Board on Tuesday, September 2, 1997 together with a revised report of the Working Group and a guidance note to the Bank staff on corruption issues.

It is not proposed to bring this paper to the Committee's agenda unless a member of the Committee so requests by the close of business on Wednesday, August 27, 1997. The paper may be revised after the Committee meeting to reflect discussions in the Bank's Board; if so, the paper would be brought back to the Committee for its consideration.

Mr. Dicks-Mireaux (ext. 35699), Mr. Andrews (ext. 38318) or Mr. I.H. Lee (ext. 36763) is available to answer any technical or factual questions relating to this paper prior to the Committee meetings.

Att: (1)

Other Distribution:
Department Heads
Development Committee Secretariat

Helping Countries Combat Corruption and Improve Governance
A Joint World Bank/IMF Issues Paper
Prepared for the Development Committee, September 22, 1997

1. Worldwide attention to issues of governance has intensified in recent years. The World Bank and IMF increasingly recognize that weak capacities and poor accountability in public sector institutions and lack of a transparent and stable regulatory environment conducive to private sector activities undermine policy reforms, project outcomes, macroeconomic stability, and sustainable growth. Corruption is one manifestation of weak governance and is a major concern of governments, citizens, and NGOs in developing and industrial countries alike. It is a global problem and exists in all countries to varying degrees. Poor governance and corruption are undermining macroeconomic stability and development objectives in many of the member countries of the IMF and World Bank and threaten to erode international support for development assistance.

2. The opportunities to combat corruption and improve governance have never been greater. New standards of behavior appear to be emerging, driven partly by changing attitudes toward transnational bribery, and partly by the effects of information technology in both developing and industrial countries. At the same time, the greater role given to market forces in many countries has led them to rethink the role of the state and its capacity to achieve macroeconomic stability, deliver core public services, provide appropriate market regulation, and promote the rule of law. The IMF and the World Bank have both heightened their focus on these topics in recent years and have developed strategies to help countries strengthen governance and deal with corruption. This note reviews the link between governance and, more specifically, corruption and economic activity, and outlines the strategies of the IMF and the Bank on improving governance and reducing corruption, including their participation in international actions led by others. Ministers' views are sought on these strategies and on how countries' ability to combat corruption and improve governance can be further strengthened.

I. Poor Governance and Corruption: Consequences and Causes

3. The body of research that addresses the impact of poor governance and, more narrowly, corruption on economic activity has grown significantly in recent years. Numerous disciplines—including, among others, economics and political science—have contributed important insights and perspectives. The strong conclusion of this research, and of Bank and IMF experience more broadly, is that good governance and the control of corruption contribute strongly to sustainable growth and social development. Conversely, poor governance and corruption lead governments to intervene where they need not, and undermine their ability to enact and implement good policies in those areas where government is clearly needed—such as environmental regulation, health and safety regulation, social safety nets, macroeconomic stabilization, and contract enforcement.

4. The causes of poor governance and corruption in a country will always be contextual, rooted in the country's politics, bureaucratic traditions, and social history. Poor governance is a reflection of weak institutions, characterized by a lack of public management capacity and the rule of law. Capacity for public sector management increasingly is seen as a key requirement of sustained economic growth, and is underpinned by transparency and accountability. Corruption, the abuse of public office for private gain, challenges every country, although the nature and degree vary from isolated events to systemically entrenched corruption, formal laws notwithstanding. Bribes may be seen as the product of inappropriate economic policies that generate extensive "economic rents" and weak institutions. Monopoly profits can be very large in highly regulated economies, and corruption may breed demand for more regulation. The discretion of many public officials may be open to abuse because of badly-defined, ever-changing, and poorly disseminated rules and regulations. Institutions are equally critical. Accountability will suffer if the ethical values of a well-performing bureaucracy are eroded or never built, rules of conduct and conflict of interest are not enforced, financial management systems are dilapidated, no formal mechanisms exist to hold public officials accountable for results, and the "watchdog" bodies that should scrutinize government performance (such as ombudsmen and external auditors, the press, and civil society) are ineffectual or disorganized. Critical to accountability is transparency of government budgets, financial reports, and department and agency activities generally, so that performance is open to scrutiny.

5. The goal of the international community should be to assist countries improve governance and control corruption by improving transparency, accountability, and the capacity of public institutions. The aim should be to assist countries create conditions in which corruption is a sporadic and individual event, rather than systemic, and where a country's governance institutions keep corruption in check and foster well-performing governments.

II. THE STRATEGY OF THE WORLD BANK

6. The World Bank approach to governance is already well established and documented in several reports.[1] The Bank aims to help countries establish a predictable and transparent framework of rules and institutions for the conduct of private and public business, primarily by assisting in areas of policy reform and building public sector capacity. Its strategy for helping countries combat corruption, recently endorsed by its Board of Executive Directors, is to address the problem of corruption through several channels:

- protecting Bank projects from fraud and corruption;

---

[1] "*Governance and Development*," World Bank, 1992, and "*Governance: The World Bank's Experience*," World Bank, 1994.

- helping borrowing countries address corruption by responding to specific country requests for assistance in areas of Bank expertise (including policy reform and institutional strengthening);

- considering corruption more explicitly in the policy dialogue, country assistance strategy, allocation of the lending program, the design of projects, economic and sector work, and research; and

- lending the Bank's voice, knowledge, and full support to international efforts against corruption.

7. *Protecting Bank projects.* A top priority is to ensure that Bank projects are as free as possible from fraud and corruption. The Bank has recently revised its procurement guidelines, increased its program of Country Procurement Assessment Reviews, expanded its use of independent audits, and taken other steps to strengthen anti-corruption controls in Bank projects. Staff will work with governments to identify and address corruption risks in project design, ensure the Bank's procurement and disbursement procedures are closely followed, and supervise projects carefully and thoroughly.

8. *Assistance to countries.* The Bank will respond positively, within its areas of expertise, to requests from borrowers for help with anti-corruption efforts, and it will consider corruption more explicitly in policy dialogue, country assistance strategy, allocation of the lending program, the design of projects, economic and sector work, and research. The Bank can help countries analyze the causes and economic impacts of corruption, suggest approaches to control it, furnish information on best practice from other countries, and directly assist in measures to curtail it. At the same time, the Bank realizes that anti-corruption programs will ultimately be effective only if they have strong local ownership and support from the government, the private sector, and civil society.

9. Advice on economic policy reform will continue to be a main pillar of the Bank's anti-corruption work with borrowers. Markets discipline participants more effectively than public sector accountability mechanisms generally can. Enlarging the scope and improving the functioning of markets strengthens competitive forces in the economy and curtails opportunities for monopoly profits, thereby eliminating the bribes public officials may be offered (or may extort) to secure them. Markets also require fair and effective regulation to ensure that the interests of the consumer are served.

10. Even though there is ample scope for expanding markets in most developing countries, government will continue to have an important role (see *World Development Report 1997: The State in a Changing World*). The design of public policy in these areas should consider institutional capacity. Without sufficient institutional capacity, well-intended policies can lead to poor outcomes and even greater corruption. Infrastructure privatization, environmental regulation, decentralization of government activity, tax reform, and public expenditure reduction are examples of policy areas where institutional capacity must be carefully factored into policy design.

11. Building strong institutions is a central challenge of development and key to good governance and the control of corruption. Well-functioning public sector management systems, accountable organizations, a framework of laws, an independent judiciary and a vigilant civil society protect a country against corruption. Thus the Bank's strategy for helping control corruption in public institutions is part of its broader strategy for fostering well-performing government in borrowing countries.

12. In strengthening institutions to control corruption, countries have made progress in three areas:

- The traditional systems of effective government: a professional civil service, sound financial management, disciplined budgetary and policy-making processes, and the allocation of responsibilities between central, state, and local governments;

- The legal framework and judicial system;

- Greater transparency and other measures that can strengthen the role of civil society in demanding more effective government.

13. The Bank has helped countries for many years strengthen governance through building well-performing public sector institutions, and it has increasingly recognized the important role played by civil society. The Bank's work in public sector reform is expected to expand still more in the future. But institution building is hard work. Continued efforts are needed both within the Bank and outside to understand how to design and implement successful institutional reforms.

14. Although the Bank needs to take into account the potential impact of corruption on project and program objectives as it considers the appropriate scope and design of operations, there is no intention to link Bank lending in some formalistic way to explicit or implicit measures of corruption in borrower countries. This is a complex and sensitive topic, and Bank staff must address the issue with humility, realizing that they have as much to learn as to offer. Approaches that may help in one setting can have unintended consequences in another.

15. *Strengthening international cooperation.* Corruption is a global problem that requires complementary action by both industrial and developing countries. Although corruption of national officials is a criminal offense in most countries, transnational bribery is not. Several international organizations—including the OAS, the OECD, the European Union, the Council or Europe, and the United Nations—have sponsored international conventions making bribery (including international bribery) a crime. International organizations, business associations, and NGOs have also addressed related issues such as money laundering, business ethics, and domestic anti-corruption programs. The Bank strongly supports these international efforts, which are an important complement to its country-based work, and is growing increasingly active as an observer, advisor, and/or participant.

III. THE STRATEGY OF THE IMF

16. The IMF's role in governance issues has been evolving pragmatically as more has been learned about the contribution that greater attention to governance could make to macroeconomic stability and sustainable growth in member countries. The IMF has helped countries improve governance through policy advice and technical assistance that has reduced the scope for ad hoc decision making and promoted transparency in public sector financial transactions. In doing so, the IMF has also helped countries limit the opportunity for corruption and increase the likelihood of exposing instances of poor governance.

17. Reflecting a strong consensus on the importance of good governance, and building on the IMF's experience in dealing with governance issues, the Executive Board adopted in July a guidance note on the role of the IMF in governance issues. These guidelines, which have been published, seek to provide greater attention to governance issues through:

- a more comprehensive treatment in the context of both Article IV consultations and IMF-supported programs of those governance issues that are within the IMF's mandate and expertise;

- a more proactive approach in advocating policies and the development of institutions and administrative systems that aim to eliminate the opportunity for rentseeking, corruption, and fraudulent activity;

- an evenhanded treatment of governance issues in all member countries; and

- enhanced collaboration with other multilateral institutions, in particular the World Bank, to make better use of complementary areas of expertise.

18. *General principles*. The IMF's primary concerns remain macroeconomic stability, external viability, and orderly economic growth in member countries. Thus, the IMF's involvement is limited to economic aspects of governance. Whatever the mode of IMF involvement, its contribution to improving governance, including the avoidance of corrupt practices, arises principally in two spheres: improving the management of public resources, and supporting the development and maintenance of a transparent and stable economic and regulatory environment conducive to efficient private sector activities.

19. The IMF recognizes that the responsibility for governance issues lies first and foremost with the national authorities. The staff will, whenever possible, build on the national authorities' own willingness and commitment to address governance issues. However, in instances where the authorities are not actively addressing governance issues of relevance to the IMF, the staff will raise their specific concerns with the authorities and point out the economic consequences. Consistent with its mandate, the IMF has no intention to adopt the role of an investigative agency or guardian of financial integrity in member countries.

20. *Modalities of IMF involvement*. In considering whether IMF involvement in a governance issue is appropriate, the staff will be guided by an assessment of whether poor governance would have significant current or potential impact on macroeconomic performance in the short and medium term, and on the ability of the government to credibly pursue policies aimed at external viability and sustainable growth. At the same time, it is recognized that there are clear practical limitations to the ability of the staff to identify deficiencies in governance; staff enquiries will need to be handled with due discretion and regard for the sensitive nature of the issue.

21. In the context of Article IV consultations, financial assistance (use of IMF resources) and technical assistance missions, the staff will be alert to aspects of poor governance that would influence the implementation and effectiveness of economic policies and private sector activities. Greater attention will be paid to inconsistencies or improbabilities in the various data and accounts in member countries. IMF policy advice will make use of the broad experience of countries with different economic systems and institutional practices and will be based on the broadly agreed best international practices of economic management, such as transparency. Weak governance should be addressed early in IMF-supported programs and conditionality will be attached to policy measures, including those relating to economic aspects of governance, that are required to meet the objectives of the program and safeguard the use of IMF resources.

22. *Corruption*. IMF staff will continue to raise individual instances of corruption with the authorities where there is a reason to believe they could have significant macroeconomic implications, even if these effects are not precisely measurable. Such implications could arise either because the amounts involved are potentially large, or because the corruption may be symptomatic of a wider governance problem that would require changes in the policy or regulatory framework to correct. Instances could include, for example, the diversion of public funds through misappropriation, tax (including customs) fraud with the connivance of public officials, the misuse of official foreign exchange reserves, or abuse of powers by bank supervisors that could entail substantial future costs for the budget and public financial institutions. Corrupt practices could also occur in other government activities, including the regulation of private sector activities that do not have a direct impact on the budget or public finances, such as ad hoc decisions made in relation to the regulation of foreign direct investment. Instances of corruption that do not have significant macroeconomic implications are best addressed through the IMF's efforts to promote transparency and remove unnecessary regulations and opportunities for rent seeking, i.e., consistent with the broad principles that apply to other issues of economic governance.

23. In the case of international transactions that involve corruption, the staff will pay equal attention to both sides of corrupt transactions and recommend that such practices be stopped if they have the potential to significantly distort economic outcomes (e.g., the tax deductibility of bribes in member countries or certain operations of official agencies).

IV. Concluding Remarks

24. Corruption flourishes when governance is weak, and it remains a serious challenge to both industrial and developing countries. This paper summarizes the variety of ways the World Bank and IMF can help countries combat corruption and improve governance. It is important to remember, however, that the citizens and governments of member countries will always be the central players in this effort. The steps that countries take to foster economic stability, reform fiscal and regulatory policies, strengthen public institutions, and promote transparency in government activities are critical to combating corruption and improving governance.

25. International cooperation is also critical, as noted above. The World Bank and the IMF will cooperate closely with each other and with other international organizations, multilateral development banks, and bilateral aid donors in supporting country and international efforts to control corruption. Collaboration between the Bank and the IMF in such areas as expenditure policy and management, tax policy and administration, public enterprise reform, banking reform, trade policy, budget procedures, and measures to increase transparency in government operations is particularly important.

V. Issues for Discussion

1. Could ministers comment on the Bank and IMF strategies to address poor governance and corruption more specifically, as summarized above?

2. Could ministers comment on the efforts of the OECD and other international organizations to encourage member governments to criminalize international bribery?

3. Could ministers suggest how domestic economic policies can best be designed to improve governance and minimize opportunities for corruption?

4. What further steps do ministers recommend to increase transparency and accountability in government?