IMMEDIATE ATTENTION

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September 5, 1997

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

From: The Secretary

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

Attached for consideration by the Committee of the Whole for the Development Committee is a paper, entitled "Helping Countries Combat Corruption and Improve Governance," which incorporates revisions made to reflect the discussion by the World Bank's Executive Directors on September 2, 1997 of the previous version of this paper (EB/CW/DC/97/3, 8/13/97). The attached paper is proposed for the meeting of the Development Committee to be held on Monday September 22, 1997 and was prepared jointly by the staff of the Fund and the Bank.

Changes have been made only to Section II, the Strategy of the World Bank; no revisions have been made in Section III, The Strategy of the Fund.

It is not proposed to bring this paper to the Committee's agenda unless a member of the Committee so requests by noon on Monday, September 8, 1997. Thereafter, the paper will be issued to the Development Committee.

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.

Att: (1)

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Helping Countries Combat Corruption and Improve Governance

A Joint World Bank/IMF Issues Paper
prepared for the Development Committee, September 22, 1997

Worldwide attention to issues of governance has intensified in recent years. The World Bank and the Fund 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 Fund and World Bank and threatens to erode international support for development assistance.

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 Fund 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 Fund 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.

Poor Governance and Corruption: Consequences and Causes

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 Fund 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.

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 systematically 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 the 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.

The goal of the internal community should be to assist countries improve governance and control corruption by improving transparency, accountability, and 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 government.

The Strategy of the World Bank

The World Bank's 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 the areas of policy reform and building public sector capacity. For many years it has helped countries control corruption indirectly through policy reform and the strengthening of key public management institutions. It has also raised the need to control corruption in its dialogue with some borrowers. More recently, the Bank has set out an expanded strategy for

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

helping countries combat corruption.[2] Under this strategy, the Bank will address the problem at four levels:

- protecting Bank projects from fraud and corruption;
- 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, size and allocation of the lending program, portfolio management 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.

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, to strengthen antibribery provisions. It is expanding its program of Country Procurement Assessment Reviews; and has increased its use of independent audits. And while maintaining strong oversight of Bank-financed procurement contracts, it will in the future increasingly emphasize the building of borrower accountability and procurement and contract management capacity. 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.

Assistance to Countries. The Bank realizes that anticorruption programs will ultimately be effective only if they have strong local ownership and support from government, the private sector and civil society. External agencies also have an important supporting role and the Bank will respond positively, within its areas of expertise, to requests from borrowers for help with anticorruption efforts. 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 building capacity to curtail it.

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 often 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 regulations to ensure that the interests of the consumer are served.

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[2]*Helping Countries Combat Corruption: The Role of the World Bank*, World Bank, 1997.

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 governance activity, tax reform, and public expenditure reduction are examples of policy areas where institutional capacity must be carefully factored into policy design.

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, greater transparency in government actions, and a vigilant civil society protect a country against corruption. Thus the Bank's approach to helping control corruption in public institutions is part of its broader strategy for fostering well-performing government in borrowing countries.

Taking corruption into account in Bank operations. The Bank will consider corruption more explicitly in the policy dialogue, country assistance strategy, lending and portfolio management decisions, studies and research. 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; and
- 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 where the effects of corruption are comparable. In all cases, the Bank's activities will be defined by its Articles of Agreement and focus on the economic issues within its mandate.

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 of 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.

The Strategy of the Fund

The Fund'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 Fund has helped countries to 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 Fund has also helped countries to limit the opportunity for corruption and increase the likelihood of exposing instances of poor governance.

Reflecting a strong consensus on the importance of good governance, and building on the Fund's experience in dealing with governance issues, the Executive Board adopted in July a guidance note on the role of the Fund 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 Fund-supported programs of those governance issues that are within the Fund'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 rent seeking, 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.

General principles. The Fund's primary concerns remain macroeconomic stability, external viability, and orderly economic growth in member countries. Thus, the Fund's involvement is limited to economic aspects of governance. Whatever the mode of Fund involvement, its contribution to improving good 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.

The Fund 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 Fund, the staff would raise their specific concerns with the authorities and point out the economic consequences. Consistent with its mandate the Fund has no intention to adopt the role of an investigative agency or guardian of financial integrity in member countries.

Modalities of Fund involvement. In considering whether Fund 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.

In the context of Article IV consultations, financial assistance (use of Fund 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. Fund 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 Fund-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 Fund resources.

Corruption. Fund 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 Fund'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.

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).

Concluding Remarks

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 the Fund 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.

International cooperation is also critical, as noted above. The World Bank and the Fund 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 Fund 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.

Issues for Discussion

1. Could ministers comment on the Bank and Fund 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?