

# THE ROLE OF THE WORLD BANK IN CONTROLLING CORRUPTION

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Widespread corruption is a symptom that the state is functioning poorly. Ineffective states can retard and misdirect economic growth. International aid and lending organizations have begun to focus on corruption control as part of a general rethinking of their role in the post-Cold War world. Both James Wolfensohn, the President of the World Bank (Bank), and Michel Camdessus, the head of the International Monetary Fund (IMF), have put the control of corruption on their institutions' agendas.<sup>1</sup>

Nevertheless, some argue that corruption is a political issue and is, therefore, outside the purview of the World Bank. Corruption, however, has fundamental economic impacts and is thus an appropriate area for World Bank and IMF concern. Bribes represent illegal user fees, taxes, or access charges paid to public agents. These payments influence economic decisions ranging from the size and character of public investment projects to the level of compliance with business regulations. It is difficult to see how a concern for the economic costs of corruption can be responsibly excluded from World Bank lending criteria.

Of course, bribery is often tied to politics. Some countries have weak laws against bribery; other countries' leaders only enforce the law against political opponents. Corrupt top officials regularly take a cut for themselves of lucrative state activities. Widespread corruption at the top, however, is not itself evidence that most people accept such a state of affairs. Surveys of popular attitudes suggest that such tolerance is

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1. Since this lecture was delivered in March 1997, both the IMF and the World Bank have promulgated new policies against corruption. See INTERNATIONAL MONETARY FUND, Newsbrief 97/15, *IMF Adopts Guidelines Regarding Governance Issues* (Aug. 4, 1997) <<http://www.imf.org/external/np/sec/nb/1997/NB9715.HTM>>; WORLD BANK, *POVERTY REDUCTION AND ECONOMIC MANAGEMENT NETWORK, HELPING COUNTRIES COMBAT CORRUPTION* (1997). In preparing the lecture for publication, I have not tried to incorporate the contents of these documents because they were unavailable in March 1997. However, my own approach has many points of contact with the policies proposed by these organizations.

rare. The fight against high level political corruption is inevitably political because top leaders are involved in malfeasance. A successful effort to reduce corruption may, however, be a condition for efficient economic growth.

The World Bank is a development institution, but it is also a political animal. As a coalition of most of the countries of the world, it has no choice. Firms based in donor countries want to continue contracting with borrower countries under World Bank loans; borrowers want to maintain Bank support. These interests of donors and borrowers form the political coalition that supports the Bank. Thus, there is a bias in favor of making loans without asking too many questions about the integrity of the projects. This bias is exacerbated by the conditions under which loans are made. They are tied to the fiscal health of the borrowing government, not the success of the individual project. Thus, the Bank itself has little *financial* incentive to monitor the integrity of individual projects. Those who wrote the Bretton Woods Convention establishing the World Bank sought to counter this bias with a strong focus on economic rationality. The emphasis on technical and economic training within the World Bank's professional staff is the organizational response to these pressures. Unfortunately, recent experience suggests that it is insufficient and that a more direct approach is needed. An explicit concern with corruption is consistent with a focus on economic rationality and is one way to *counter* some of the political pressures faced by the Bank. The bias in favor of uncritical lending counsels an explicit concern with malfeasance in order to preserve the Bank's commitment to economic efficiency and the alleviation of poverty.

In constructing an overall lending plan for a borrower country, the identification of beneficiaries is a necessary first step. The World Bank need not accept the priorities expressed by a country's rulers if the regime either represents only a portion of the population or is inordinately concerned with personal enrichment. With the growth of commercial lending to the developing world in recent years, the World Bank can focus more firmly on the goals of reducing poverty and aiding institutional development.

Because corruption is usually considered wrong in itself, its mere existence is a cause for concern. An economist, however, takes a more skeptical view—arriving at that conclusion only after understanding corruption's impact on the efficiency and equity of the economic system. I, therefore, begin with an overview of the economic costs and causes of corruption before focusing on policy options for the World Bank.

## CONTROLLING CORRUPTION

### I. THE COSTS AND CAUSES OF CORRUPTION<sup>2</sup>

Research on corruption and on the quality of government institutions indicates that strong legal and governmental institutions and low levels of corruption have beneficial effects on economic growth and other economic variables.<sup>3</sup> Because the corruption indices are highly correlated with other measures of bureaucratic efficiency, such as the level of red tape and the quality of the judiciary, these studies are unable to distinguish the marginal effect of any one of these measures holding the others constant. The data are consistent with the claim that corruption is a function of the level of red tape, but the level of red tape is itself partly a function of the prevalence of corruption. Corruption is a symptom of other underlying problems, rather than an independent variable.<sup>4</sup> Foreign direct investment (FDI) is also negatively associated with high levels of corruption. There is nothing special about East Asian countries; for them, as well, corruption discouraged FDI.<sup>5</sup>

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2. This portion of the Essay is derived from one section of *Corruption and Development*, prepared for the May 1997 Annual World Bank Conference on Development Economics. It will be published in ANNUAL WORLD BANK CONFERENCE ON DEVELOPMENT ECONOMICS 1997 (Joseph Stiglitz & Boris Pleskovic eds., 1998).

3. For example, work by Paolo Mauro at the IMF demonstrates that high levels of corruption are associated with lower levels of investment as a share of Gross Domestic Product (GDP) in a cross-section of countries. See Paolo Mauro, *Corruption and Growth*, 110 Q. J. ECON. 681 (1995) [hereinafter Mauro, *Corruption and Growth*]; see also Paolo Mauro, *The Effects of Corruption on Growth, Investment, and Government Expenditure: A Cross-Country Analysis*, in CORRUPTION AND THE GLOBAL ECONOMY 83–107 (Kimberly Ann Elliot ed., 1997) [hereinafter Mauro, *Effects of Corruption on Growth*]. A one standard deviation (2.4) improvement in the corruption index is associated with over a four percentage-point increase in the investment rate and over a half a percentage-point increase in the annual growth rate of per capita GDP. See Mauro, *Effects of Corruption on Growth*, *supra*, at 91. In *Corruption and Growth*, Mauro uses a subjective index of corruption compiled by Business International (BI) from its correspondents throughout the world. The index, which covers 67 countries, omits Eastern Europe, China, and the Middle Eastern oil countries. It ranks countries on a scale of zero to ten based on a judgment of how frequently corruption was required in business transactions. High numbers indicate low levels of corruption. The BI data also include numerous other measures of the climate for business. The data set is published as an appendix in Mauro, *Corruption and Growth*. In *Effects of Corruption on Growth*, Mauro combines the BI data with an index for 1982–1995 derived from the International Country Risk Guide prepared by Political Risk Services. See *id.* at 88–89. Statistical tests can then be run for a group of 106 countries. The two indices are very highly correlated ( $r = 0.81$ ). When both were available, Mauro averaged them together. Otherwise he used the value of the single available index. See *id.*

4. An overall index of the riskiness of investing in a country, based on nine factors from the BI index (one of which is the corruption index), was associated with both lower investment rates and lower growth rates. See Mauro, *Corruption and Growth*, *supra* note 3, at 683–84.

5. See Shang-Jin Wei, *How Taxing Is Corruption on International Investors?* (Sept. 26, 1997) (draft paper, on file with *Law and Policy in International Business*).

To go beyond these macroeconomic findings, we need to isolate the most important situations where corruption determines who obtains the benefits and bears the costs of political, judicial, and bureaucratic actions. Six broad, and sometimes overlapping, categories capture the most important situations.

- The government may be charged with allocating a scarce benefit to many individuals and firms using legal criteria other than willingness to pay. *Bribes clear the market.*
- Officials in the public sector may have little incentive to do their jobs well, given official pay scales and the level of internal monitoring. *Bribes act as incentive bonuses.*
- Private firms and individuals seek to reduce the costs imposed on them by government in the form of taxes, customs duties, regulations. *Bribes lower costs for those who pay them.*
- Governments frequently transfer large financial benefits to private firms through procurement contracts, privatizations, and the award of concessions. *Bribes divide monopoly rents between private investors and public officials.*
- Bribes can substitute for legal forms of political influence. *Bribery of politicians buys influence, and bribery by politicians buys votes.*
- The judiciary has the power to impose costs and transfer resources between litigants. *Bribes can override legal norms.*

I will discuss the first four items in more detail because they are the most relevant to World Bank policies and programs designed to limit corruption.

#### A. *Payments that Equate Supply and Demand*

Governments frequently provide goods and services for free or sell them below market prices. Often dual prices exist. For example, until recently in China, some producer goods were sold at both state-subsidized prices and on the free market. Not surprisingly, payoffs to obtain supplies at state prices were reportedly common.<sup>6</sup> Multiple

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6. See, e.g., Ting Gong, *Corruption and Reform in China: An Analysis of Unintended Consequences*, 19 CRIME L. & SOC. CHANGE 311 (1993); Y. Hao & Michael Johnston, *Reform at the Crossroads: An Analysis of Chinese Corruption*, 19 ASIAN PERSP. 117 (1995). When oil prices in Nigeria were set artificially low relative to the market price in neighboring Benin, smuggling facilitated by corruption was widespread according to a report in a Nigerian newsmagazine. The price difference provided benefits both to the smugglers and to the officials who were paid to overlook the illegal trade. See NEWSWATCH, *Camel Through the Needle's Eye*, reprinted in ENERGY SECTOR

exchange rates and import quotas are frequent sources of payoffs. When the supply of credit and the rate of interest are controlled by the state (as in Eastern Europe and Korea), bribes may be paid for access.<sup>7</sup>

The incentives to make payoffs are clear enough in these cases, but what are their efficiency consequences? Suppose, first, that the briber is qualified for a scarce benefit, but is required to pay for it. If the corrupt market operates efficiently, the service will be provided to the applicants with the highest willingness to pay. Consider, however, the ways in which inefficient or unfair results can arise even in this simple case. First, the goals of a program may be undermined if the services are provided only to those with the highest willingness to pay. This will obviously be true for programs designed to benefit the needy or the well-qualified.<sup>8</sup> Second, corrupt markets are likely to differ from open, competitive ones.<sup>9</sup> The illegality of bribery induces participants to spend resources to keep the transaction secret. Information about bribe prices will not be well-publicized, and prices may be sticky because of the difficulty of communicating market information. Some potential participants may refuse to enter the market because of moral scruples and fear of punishment, and public officials may themselves

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MANAGEMENT ASSISTANCE PROGRAMME & WORLD BANK WESTERN AFRICA DEP'T, REPORT NO. 11672-UNI, ANNEX 26, NIGERIA: ISSUES AND OPTIONS IN THE ENERGY SECTOR 175-77 (July 1993) (excerpts from Feb. 3, 1991, issue of NEWSWATCH).

7. Interviews with business people in Eastern Europe and Russia indicate that payoffs are frequently needed to obtain credit. See Martha de Melo et al., *Pioneers for Profit: St. Petersburg Entrepreneurs in Services*, 9 WORLD BANK ECON. REV. 425, 434-35 (1995); LEILA M. WEBSTER, THE EMERGENCE OF PRIVATE SECTOR MANUFACTURING IN HUNGARY 59 (World Bank Technical Paper No. 229, 1993); see also LEILA M. WEBSTER & JOSHUA CHARAP, THE EMERGENCE OF PRIVATE SECTOR MANUFACTURING IN ST. PETERSBURG 56-57 (World Bank Technical Paper No. 228, 1993). In Lebanon, a similar survey revealed that loans were not available without the payment of bribes. See ISIL YAPRAK & LEILA WEBSTER, SMALL AND MEDIUM ENTERPRISES IN LEBANON: A SURVEY (World Bank Final Report, 1995).

8. A student of microfinance programs, Marguerite Robinson, found that programs that provide below market credit to the rural poor are often corrupt and provide aid only to elites. See *New Bank Lends Support to Vietnam's Rural Poor*, Reuters World Service, Aug. 18, 1996, available in LEXIS, Nexis Library, REUWLD File. Another example is corruption in public housing programs in the United States where the number of qualified households always far outstrips the number of places in subsidized units. In India, some states provide a means tested pension to the poorest people. The number who qualify exceeds the funds available. Nongovernmental organizations who work with the poor report that applicants must pay to qualify and then must pay postal workers to deliver the benefit checks.

9. See Jean Cartier-Bresson, *The Economics of Corruption in Europe*, in DEMOCRACY AND CORRUPTION IN EUROPE 148, 160-62 (Donatella Della Porta & Yves Méry eds., 1997). See generally DIEGO GAMBETTA, THE SICILIAN MAFIA 195-244 (1993); SUSAN ROSE-ACKERMAN, CORRUPTION: A STUDY IN POLITICAL ECONOMY (1978).

limit their dealing to insiders and trusted friends. A corrupt system may be not only less competitive, but also more uncertain than a legal market.<sup>10</sup>

Furthermore, in practice, many officials can exercise monopoly power by determining the quantity of services provided.<sup>11</sup> The official, like a private monopolist, may seek to set supply below the officially sanctioned level to increase the economic rents available for division. Conversely, under other conditions, the corrupt official might seek to provide an increased supply if the government has set the supply below the monopoly level. In other situations, the service is not scarce, but is, like a passport, a driver's license or an old age pension, available to all who "qualify." Officials, however, may have sufficient monopoly power to create scarcity either by delaying approvals or withholding them unless paid bribes.

Finally, bribes are frequently paid to permit unqualified people and firms to obtain a benefit. Students might pay to alter the results of university admissions tests, or people might pay doctors to declare them eligible for disability payments. Andre Shleifer and Robert Vishny call this case "corruption with theft."<sup>12</sup> Clearly, the unqualified will often have the highest willingness to pay because they have no legal way to obtain the service.

### B. *Bribes as Incentive Payments for Bureaucrats*

Bribes can be incentive payments for quality service. Because time is money, firms and individuals may pay to avoid delay. In some economic models, bribes have desirable incentive properties. For example, pay-offs to those who manage queues can be efficient because they give officials incentives both to favor those who value their time highly and to work quickly.<sup>13</sup> Alternatively, the corruption of tax collectors can be efficient so long as the government can impose a binding overall

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10. For example, World Bank-sponsored surveys of business people in Pakistan and the Ukraine indicate high interfirm variability, with those who obtain services corruptly having no recourse if the bribed official does not live up to his side of the bargain. See also Susan Rose-Ackerman & Andrew Stone, *The Costs of Corruption for Private Business: Evidence from World Bank Surveys* (1996) (paper on file with author).

11. See, e.g., Ronald Findlay, *Is The New Political Economy Relevant to Developing Countries*, in *POLITICS AND POLICYMAKING IN DEVELOPMENT: PERSPECTIVES ON THE NEW POLITICAL ECONOMY* (Gerald M. Meier ed., 1991); ROSE-ACKERMAN, *supra* note 9; Andrei Shleifer & Robert W. Vishny, *Corruption*, 108 Q. J. ECON. 599 (1993).

12. Shleifer & Vishny, *supra* note 11, at 601.

13. See Francis Lui, *An Equilibrium Queuing Model of Bribery*, 93 J. POL. ECON. 760 (1985).

revenue constraint.<sup>14</sup> But the conclusion that the routine corruption of those who manage queues and collect taxes should be tolerated is extremely problematic. First, corruption is efficient only if officials have limited discretion. For example, the tax collector must be able to do no more than “discover” the tax liabilities of citizens and firms. In reality, he might creatively “create” that tax liability as a bribe extraction device, producing an arbitrary and unfair pattern of payments.

Second, noncorrupt alternatives exist that avoid the costs of illegal payment systems. Queues can be managed through a set of differential fees. Revenue collection offices are sometimes permitted to retain a portion of the taxes they collect. Third, firms pay bribes to obtain certainty,<sup>15</sup> but payments made to increase certainty for individual firms result in a wide variance in conditions across firms.

In short, bribes can sometimes be characterized as incentive payments to public officials. A policy of active tolerance, however, especially by outside aid donors such as the World Bank, is likely to be destructive of the prospects for long-term reform. Payoffs that are widely viewed as acceptable should be legalized, but not all “incentive pay” schemes will actually improve bureaucratic efficiency.

### C. *Bribes to Reduce Costs*

Governments impose regulations, levy taxes, and enforce criminal laws. Individuals and firms may pay for relief from these costs. They may collude with tax collectors and customs officials to lower the sums collected. The economic impact of bribes paid to avoid regulations, to supersede the criminal law, and to lower taxes depends upon the efficiency of the underlying programs which are subject to corrupt distortions. Given an inefficient legal framework, payoffs to avoid regulations and taxes may increase efficiency. This defense of payoffs is commonly espoused by foreign investors in the developing world. It is a pragmatic justification that grows out of frustration with the existing

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14. The minister sets a revenue target, a nominal tax liability schedule, and the wage rate of the tax collector. Corruption gives the tax collector an incentive to seek tax revenue and is tolerated so long as the collector turns in an amount equal to the revenue target. The greater the difference between nominal tax liabilities and the revenue target, the higher the rate of corruption. See Frank Flatters & W. Bentley MacLeod, *Administrative Corruption and Taxation*, 2 INT'L TAX & PUB. FIN. 397 (1995).

15. Legal and regulatory uncertainty is frequently mentioned by business people interviewed in surveys in the developing world. See, e.g., Webster & Charap, *supra* note 7, at 55; Webster, *supra* note 7, at 60.

legal order. It attempts to justify corruption carried out to obtain benefits to which one is *not* legally entitled.

But are individuals and firms obligated only to obey laws that they judge to be efficient and just? In the developed world, industry rarely responds to environmental and health and safety rules it finds burdensome by bribing U.S. officials or enlisting the help of criminals to evade the law. Instead, firms work to change the laws in Congress, make legal campaign contributions, lobby public agencies, and bring lawsuits that challenge laws and regulations. One can complain about the importance of wealth and large corporations in U.S. political life, but well-documented lobbying activities and campaign contributions are at least superior to secret bribes in maintaining democratic institutions.

Some of the same firms that engage in legal political activities at home feel less constrained about violating laws in developing and transitional economies. Because the United States outlaws bribes paid abroad to obtain business,<sup>16</sup> U.S. companies face a domestic legal constraint. But the perceived importance of that constraint suggests that multinationals do not generally feel an obligation to obey the law in the developing countries where they operate. Unfortunately, however, investors will pay bribes not only to avoid *inefficient* rules and taxes, but also to reduce the impact of *all* state-imposed burdens, justified or not. It seems strange indeed to tolerate business firms' judgments that a well-placed payoff is justified because it increases their profits. Such an attitude can do serious harm to nations struggling to build a viable state. These states need to develop public institutions that translate popular demands into law, that establish a credible commitment to the enforcement of these laws, and that provide legal recourse to those who think they have been wronged. If, instead, investors and ordinary citizens make individualized judgments about which laws are legitimate, the attempt to create and maintain state institutions will founder. Bribery will determine not only which laws are enforced, but also what laws are enacted.<sup>17</sup>

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16. The act is the Foreign Corrupt Practices Act, 15 U.S.C. §§ 78m(b) & (d)(1) & (g)-(h), 78dd-1, 78dd-2, 78ff (a) & (c) (1988 & Supp. IV 1992).

17. Bribes paid to obtain the enactment of favorable laws by a democratic legislature are a particularly good example of the often large gap between the size of the bribe paid and the impact of corruption on society. If legislators cannot coordinate their actions, they may be inexpensive to bribe because no one lawmaker has much bargaining power. See ROSE-ACKERMAN, *supra* note 9, at 15-32; see also Eric Rasmusen & J. Mark Ramseyer, *Cheap Bribes and the Corruption Ban: A Coordination Game Among Rational Legislators*, 78 PUB. CHOICE 305 (1994) (developing a model of this case).

D. *Payments to Obtain Major Contracts, Concessions, and Privatized Firms*

Corrupt payments to win major contracts, concessions, and privatizing companies are generally the preserve of large businesses and high-level officials.<sup>18</sup> Is there anything distinctive about such corruption, other than the size of the deals? They appear analogous to cases in which government disburses a scarce benefit, only this time the value of the benefit is measured in many million, not a few thousand, dollars. But does the *scale* of the corrupt deal and *involvement of high-level officials* change anything?

One difference is the likelihood that rulers are effectively insulated from prosecution and can thus be less restrained in their corrupt demands than lower level officials. Second, those who obtain benefits through the bribery of low-level officials are rarely thought to behave inefficiently once the benefit is obtained. In contrast, for major deals, the contrary argument is often made. But is there anything to it? To isolate these distinct issues, consider the example of a logging concession obtained corruptly by a company over the higher bids of competitors. If corruption does not restrict entry and if the official cannot affect the size of the concession, the high briber is the firm that values the benefit the most. The losses are the extra taxes that must be collected and the foregone benefits of public programs not undertaken.

Now consider the firm that has obtained a secure, long-term timber concession at a bargain price even when the bribe is included. If it operates in the international market, its subsequent actions should depend upon the market for timber. The fact that it has underpaid for the concession should not affect its production decisions. It still seeks to maximize profits, and the concession payment is a sunk cost. This claim of no impact on firm behavior is too simple to reflect reality. The operative terms are *secure* and *long-term*. Corruption introduces uncertainties into the economic environment that may give the firm a short-run orientation.<sup>19</sup> There are two reasons for this. First, the

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18. See GEORGE MOODEY-STUART, GRAND CORRUPTION IN THIRD WORLD DEVELOPMENT 1 (Transparency International Working Paper, 1994) (calling this "grand corruption").

19. See JACQUELINE COOLIDGE & SUSAN ROSE-ACKERMAN, HIGH LEVEL RENT-SEEKING AND CORRUPTION IN AFRICAN REGIMES: THEORY AND CASES (World Bank Policy Research Working Paper No. 1780, 1997). For an example of the short-run orientation of corrupt timber concessionaires in Malaysia, see Jeffrey R. Vincent & Clark S. Binkley, *Forest-Based Industrialization: A Dynamic Perspective*, in MANAGING THE WORLD'S FORESTS 93 (Narendra P. Sharma ed., 1992); see also Robert T. Deacon, *Deforestation and the Rule of Law in a Cross-Section of Countries*, 70 LAND ECON. 414, 415 (1994) (reporting studies showing that security of tenure is negatively associated with deforesta-

concessionaire may fear that those in power are vulnerable to overthrow because of their corruption. A new regime may not honor the old one's commitments. Second, even if the current regime remains in power, the winner may fear the imposition of arbitrary demands once investments are sunk. Competitors may be permitted to enter the market or the contract may be voided for reasons of politics or greed.<sup>20</sup> Thus the corrupt firm with a timber contract may cut down trees more quickly than it would in less corrupt countries. It may also be reluctant to invest in immovable capital that would be difficult to take out of the country should conditions change.

## II. THE ROLE OF THE WORLD BANK

Given the economic incentives for corruption, we can now ask what the World Bank can do. Subject to limitations of mission and expertise, there are three broad arenas for World Bank involvement. First, the World Bank obviously has an interest in the effective use of its own resources. This involves both better control of existing lending and a willingness to withdraw from countries that are not using funds efficiently to fulfill development objectives. Countries that lack basic checks on malfeasance by top rulers should have to overcome a presumption against Bank loans. Second, in cooperation with sympathetic governments, the World Bank can support anticorruption efforts and help reform underlying substantive laws that produce corrupt incentives. Third, international efforts focus on reducing the willingness of multinational businesses to pay bribes and on checking the flow of illicit funds. Strategies include international treaties and actions by multinational organizations such as the Organization for Economic Cooperation and Development (OECD) and the Organization of American States (OAS), efforts to convince countries to penalize overseas bribery, and the development of voluntary business codes of conduct. Although international efforts are important, and the World Bank ought to be involved in these discussions, I will not discuss them

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tion rates and pointing to case studies showing that when property rights are poorly enforced, deforestation is more rapid). Of course, corruption is only part of the reason why firms might have a short-run orientation. Deacon shows that deforestation rates are associated with political variables reflecting insecure ownership, but the explanatory power of his model is low. *See id.*

20. For example, in Malaysia, firms involved in the privatization of both electricity and telecommunications have complained that the government has subsequently admitted numerous additional competitors with strong political links. *See* Kieran Cooke, *Malaysian Privatization Loses Allure*, *FIN. TIMES*, Oct. 13, 1995, at 6.

further. Instead, I focus on the Bank's own lending activity and on efforts to encourage reform in borrower countries.

A. *Controlling Corruption in Project Loans and Grants*

The World Bank, concerned with the success of the projects it supports, will obviously be troubled by endemic corruption. For example, suppose that twenty percent of aid funds is lost due to corruption. The twenty percent does not represent bribes per se, but rather the inflated contracting costs and the loss of equipment and other inputs from tolerating bribery. Thus, a project with a budget of \$100 million could have been completed for \$80 million in an honest system. Consider a simple project where funds invested at time zero earn a return in time one (and only in time one). Suppose that an investment at time zero must earn a return of ten percent at time one in order to pass Bank muster. Then an honestly administered project would need to generate gross benefits of \$88 million. The corrupt project would need to produce returns of \$110 million—a difference of \$22 million. A project that should have cost \$80 million must return \$110 million in order to be worthwhile—a rate of return on productively used resources of 37.5%. Even in the developed world, not many projects have such a high return. In the absence of corruption, many more projects would seem worth doing.

Designing effective strategies for the World Bank requires a mixture of analysis and political realism. Some countries have kleptocratic rulers, often acting in concert with powerful private interests. Other countries have weak governments, but are dominated by organized mafias. In these cases, the Bank has only four choices: in kleptocracies, it can pressure the ruler to reform as a condition for receiving Bank loans; it can refuse to make new loans and can review old loans; it can seek to reform self-contained portions of the state apparatus such as tax and customs collection; and, when the state is weak, the Bank can design programs to strengthen it in relation to powerful outsiders. The first option may sometimes succeed, but it is a high risk strategy because if it fails, the Bank is then entangled with a venal ruler. The second option is an admission of defeat, but will be the only defensible strategy in some cases. The third option requires extreme care or it can simply become a device for entrenching a corrupt ruler and permitting him to extract the country's wealth more efficiently. The fourth option may have some promise, so long as the reformed institutions are not themselves co-opted by corrupt outsiders. None of these options is very attractive. The Bank should be willing to discontinue lending to countries that do not use its funds efficiently.

Until recently, the Bank's main focus has been on analytical rigor at the project approval stage and on transparent procurement processes under Bank loans. Some projects with strong support from a country's rulers were not supported out of a concern that they would simply create pools of rents for the powerful. Procurement guidelines sought to assure competitive bidding on most large contracts, but worries about corruption were implicit. In 1996, however, the Bank revised its procurement guidelines to state explicitly that corruption and fraud would be grounds for canceling a contract if the borrower did not take appropriate action. Companies found to be corrupt by the Bank can be excluded from bidding on future projects. The new rules permit Bank audits of contractors and require contractors to record all payments to agents both before and after the bidding, because such payments are frequently the route by which payoffs are made.<sup>21</sup> The importance of these changes will depend upon how they are implemented in the field, but they represent a promising first step.

Some anticorruption activists, such as the nonprofit group Transparency International, urge that potential bidders sign an Integrity Pact, under which they pledge to refrain from corruption. If, *ex post*, a firm is found to have made payoffs, the Bank's new procurement provisions would come into effect. Although such pledges look redundant be-

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21. On July 23, 1996, the Executive Directors approved changes in the Bank's General Conditions Applicable to Loan and Guarantee Agreements. See Memorandum from Myrna Alexander, World Bank, to Staff Recipients of the Operational Manual (Sept. 9, 1996) <<http://www.worldbank.org/html/opr/opmanual/double.html>>. Section 6.03 was expanded to include corruption or fraud by representatives of the borrower or by the beneficiary of the loan as a grounds for canceling the part of the loan affected. The borrowing country can, however, defend itself against cancellation by taking "timely and appropriate action satisfactory to the Bank to remedy the situation." *General Conditions Applicable to Bank/IDA Loan/Credit Agreements* § 6.03 <<http://www.worldbank.org/html/>>. Furthermore, the *Guidelines for Procurement under IBRD Loans and IDA Credits* amended to add a new paragraph 1.15 stating that the Bank will reject a proposal for an award "if it determines that the bidder recommended for award has engaged in corrupt or fraudulent practices in competing for the contract in question." World Bank, *Guidelines: Procurement under IBRD Loans and IDA Credits* ¶ 1.15 <<http://www.worldbank.org/html/opr/procure/intro.html>>. In other words, it is not sufficient to know that the bidder engaged in corruption to obtain other contracts. However, the Bank will also cancel a contract if corrupt or fraudulent practices are revealed after a contract is awarded. Firms found to have engaged in corrupt or fraudulent practices with respect to Bank-financed projects will be declared ineligible for further contracts "either indefinitely or for a stated period of time." The Bank can require that it be able to inspect the records of suppliers and contractors relating to their Bank contracts. The Bank also requires that all commissions paid to agents, both before and after the contract is signed, be disclosed to the Bank. For an overview, see generally Ibrahim Shihata, *Corruption: A General Review with an Emphasis on the Role of the World Bank*, 15 DICK J. INT'L L. 451 (1997); Stuart H. Deming, *Foreign Corrupt Practices*, 31 INT'L LAW. 695 (1997).

cause corruption is, in any case, illegal, they have the advantage of highlighting the issue in countries with little respect for the formal law on the books. Nevertheless, a serious attempt to implement the Bank's new procurement provisions will require institutional solutions. The procurement changes put the responsibility on the Bank and do not give any explicit rights to disappointed contractors. Nevertheless, disappointed contractors are likely to be an important source of information for the Bank. However, losers have an incentive to accuse the winner of corruption even if none occurred. The Bank needs a way to make constructive use of the information contractors can provide without becoming enmeshed in investigating the claims of every disappointed bidder. It may need to consider a forum for the hearing of such claims.<sup>22</sup>

The Bank may place too much emphasis on International Competitive Bidding (ICB). Although other forms of procurement are possible, there is a presumption in favor of ICB although it may actually encourage corruption and poor performance in some cases. When the risks of corruption are high, projects could be designed with the fragility of a country's procurement processes in mind. Project officers would favor off-the-shelf items sold in international markets over special purpose goods. They could develop external benchmarks for certain types of procurement.<sup>23</sup> In such cases, the price of comparable products in the private sector can help limit the price inflation that often accompanies payoffs in procurement.

Sometimes the procurement process works well, but problems arise during implementation. In addition to outright theft of such useful items as vehicles, medicines, or computers, outsiders may bribe officials for privileged access to the benefits of the project, be they jobs, building materials, or subcontracts. The World Bank's Controllers Office is exploring ways to improve monitoring. Instead of relying mostly on paper records, Bank auditors are considering increasing the number of physical inspections and on site reviews.

The World Bank must acknowledge the political and organizational dynamics that make corruption control difficult. They need to monitor the performance of ongoing projects and be ready to discontinue those that have been undermined by corruption. They also need to review

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22. See Daniel D. Bradlow, *A Test Case for the World Bank*, 11 AM. U. J. INT'L L. & POL'Y 247 (1996) (for a discussion of the experience of the Inspection Panel, which was established in 1993).

23. See generally Augustine Ruzindana, *Combating Corruption in Uganda*, in UGANDA: LANDMARKS IN REBUILDING A NATION 191 (P. Langseth et al. ed., 1995) (discussing methods to combat corruption).

their lending priorities and discontinue lending to kleptocratic countries.

B. *Supporting Reform Programs*<sup>24</sup>

The World Bank can be most effective in countries where a relatively honest top level official faces systems of low-level corruption. The goal is to eliminate the conditions that produce a high incidence of corruption among public officials. Four types of reform falling within the Bank's mandate are worthy of focus: improved law enforcement, civil service reform, increased governmental accountability, and reductions in the discretion and monopoly power of government officials.

1. Credible Law Enforcement

A basic condition for corruption control is a viable legal framework that enforces the law without political favoritism or arbitrariness. The goal is both to deter those tempted to engage in corrupt acts and to educate the public to resist criminal conduct by officials. Tough laws are not sufficient. Many highly corrupt countries have exemplary formal statutes which lack real meaning because they are seldom enforced. A country serious about reform must have effective investigation and prosecutorial bodies and a well-functioning judicial system that is not itself corrupt.

An independent judiciary can be invaluable in checking official malfeasance. In India, the supreme court pushed forward a corruption investigation that the government had sought to quash.<sup>25</sup> In Brazil, the supreme court's insistence that the congressional vote on the president's impeachment for corruption be made public helped keep the process honest.<sup>26</sup> The World Bank is beginning work on judicial reform, especially in Latin America, but the projects are all at an early stage.<sup>27</sup>

Some countries have had success with independent anticorruption commissions or inspectors general reporting only to the chief execu-

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24. This section is a revised version of a portion of Rose-Ackerman, *Corruption and Development*, *supra* note 2.

25. See Christopher Thomas, *Court Removes Rao as Head of Political Bribes Investigation*, *TIMES* (London), Mar. 2, 1996, at 13.

26. See Barbara Geddes & Artur Ribeiro Neto, *Institutional Sources of Corruption in Brazil*, 13 *THIRD WORLD Q.* 641, 658 (1992).

27. See Ibrahim Shihata, *Judicial Reform in Developing Countries and the Role of the World Bank* (World Bank Technical Paper No. 280, 1995), in *JUDICIAL REFORM IN LATIN AMERICA AND THE CARIBBEAN* 219, 226 (M. Rowat et al. eds., 1995).

tive or the parliament. The most well known is Hong Kong's Independent Commission Against Corruption (ICAC), which reported only to the Governor General and had extensive powers.<sup>28</sup> The Commission apparently succeeded in transforming citizens' beliefs and expectations. Surveys of the public carried out between 1977 and 1994 indicate that public perceptions of corruption fell in the early years of the ICAC. Indirect evidence suggests that corruption did, in fact, decline along with public perceptions. A number of other jurisdictions have similar institutions, including Singapore, Malaysia, Botswana, Malawi, and the Australian state of New South Wales.<sup>29</sup> Yet, an independent anticorruption commission is not without problematic aspects. Its widespread powers could be abused in systems less committed to the rule of law. The Hong Kong case indicates that a tough, independent anticorruption agency can be a potent tool so long as it represents a credible long-term commitment and includes checks on its own ability to be misused for political ends.

## 2. The Civil Service

Many developing countries have very poorly paid civil servants. Officials must supplement their pay with second jobs or payoffs. World Bank and IMF data suggest that there is a negative correlation between civil service wages (relative to private sector wages) and the level of corruption.<sup>30</sup> Civil service reform projects supported by the World Bank should be designed to include an explicit concern for reducing corruption.

If officials are paid much less than people with similar training elsewhere in the economy, only those who possess weak qualifications and are willing to accept bribes will be attracted to the public sector.<sup>31</sup> Civil service pay should be set at least equal to that of equivalent

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28. See ROBERT KLITGAARD, *CONTROLLING CORRUPTION* 98-121 (1988); Melanie Manion, *Policy Instruments and Political Context: Transforming a Culture of Corruption in Hong Kong*, prepared for the Annual Meeting of the Association for Asian Studies in Honolulu, HI (Apr. 11-14, 1996).

29. See Max J. Skidmore, *Promise and Peril in Combatting Corruption: Hong Kong's ICAC*, 547 *ANNALS AM. ACAD. POL. & SOC. SCI.* 118, 122 (1996).

30. See CAROLINE VAN RIJCKEGHEM & BEATRICE WEDER, *CORRUPTION AND THE RATE OF TEMPTATION: DO LOW WAGES IN THE CIVIL SERVICE CAUSE CORRUPTION?* (International Monetary Fund Working Paper No. 73, 1997); see also BARBARA NUNBERG & JOHN NELLIS, *CIVIL SERVICE REFORM AND THE WORLD BANK* (World Bank Discussion Paper No. 161, 1995).

31. Some claim that Botswana's status as a relatively uncorrupt African country stems from its rulers' commitment to a professional and well-paid civil service. See, e.g., NIMROD RAPHAELI, *PUBLIC SECTOR MANAGEMENT IN BOTSWANA* (World Bank Staff Working Paper No. 709, 1984).

positions in the private sector in order to make it possible to recruit based on merit and to permit those selected to serve without resorting to corruption. Wages in the formal sector, however, will not be the correct benchmark in countries with a large informal sector. Alternative employment for most civil servants will often be in small scale private businesses that operate "off-the-books." There must also be a transparent, merit-based system of selecting civil servants; otherwise, people who are unable to command comparable private sector wages will pay the powerful to be allotted desirable government jobs.

Pay reform is necessary, but not sufficient. Penalties must be tied to the *marginal* benefits of accepting payoffs. In cases where corruption's only efficiency cost stems from its illegality, the payments should be legalized. In the design of such systems, however, it is important to avoid giving bureaucrats monopoly power that they can use to extract increased levels of rents.

Civil service reform will generally need to be a thoroughgoing effort. Small increases in wages and improvements in working conditions may have little impact. The system may be caught in a trap where high corruption levels beget high corruption levels. If almost everyone expects to pay bribes, the result may be a self-fulfilling prophecy.

One reason why civil service pay has fallen so rapidly in recent years is the fiscal pressure on governments. An across-the-board pay cut, often accomplished through inflation, is politically easier to manage than the selective firing of workers. Conversely, countries making good progress in achieving fiscal balance may jeopardize their success by bowing to pressure from civil servants for across-the-board pay hikes. For example, in 1992 Ghana increased all civil servants' wages by eighty percent.<sup>32</sup> Given the importance of resisting such pressures, international institutions can be helpful in easing the transition to a competent, less numerous, and well paid civil service.

### 3. Accountability to Citizens

The private sector can be an important check on the arbitrary exercise of power by government, but only if the government provides information on its actions and if people can organize into associations. Accountability to the public requires both that individuals can find out what the state is doing and that they can use this information to hold public actors accountable.

Governments must publish budgets, revenue collections, statutes

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32. See ROBERT P. ARMSTRONG, GHANA COUNTRY ASSISTANCE REVIEW 20 (World Bank, 1996).

and rules, and the proceedings of legislative bodies. Financial data should be independently audited. Secret funds available to chief executives and top ministers are an invitation to corruption. Several World Bank projects have helped transitional economies and developing countries publish timely and accurate documents about the basic operations of government. Other Bank projects have helped countries, especially in Latin America and Africa, reform their budgetary accounting processes to make them more transparent.<sup>33</sup> These reforms provide an important background for anticorruption efforts.

Procurement regulations must keep the process open and fair. Scandals frequently occur because top officials overrule tender boards or because lower level officials operate without formal controls on their purchasing decisions. The Bank has helped some countries, especially in Eastern Europe, develop procurement codes. But putting good laws on the books is not sufficient; countries need help in implementing them in an effective way.

Freedom of Information acts in the United States and in a number of European countries are an important precondition for effective public oversight. These laws permit citizens to request information as members of the public without showing that their own personal situation will be affected. The Bank could help countries develop such statutory safeguards.

Finding out what is happening is of little value unless people can use the knowledge to influence government. In countries without democratic electoral systems or independent courts, other forms of citizen voice need to be encouraged. Publicity through the media is an important option. Even an undemocratic ruler is likely to be sensitive to public opinion. The World Bank's Educational Development Institute has made a start in this area with educational programs for African journalists to teach them how to engage in investigative reporting.

Individuals face a familiar free rider problem in seeking to control political and bureaucratic processes and to limit malfeasance. Information may be available in principle, but no one may have an incentive to look at it. Laws that make it easy to establish associations and nonprofit organizations will help. For example, Transparency International, a Berlin-based nonprofit organization committed to fighting corruption worldwide, has local chapters that carry out a range of activities, including participation in Integrity Workshops organized with the help of the World Bank and the bilateral aid agencies. These workshops

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33. *See id.*

bring together concerned people from both the public and the private sectors to discuss the problem of corruption.

Nonprofit organizations can carry out and publish public opinion surveys that reveal public attitudes toward government services. Pioneering work of this sort has been carried out by the Public Affairs Centre in Bangalore, India. It produces "report cards" on services to the urban poor in five cities. The center found that "speed" money was ubiquitous with up to one-third of the slum dwellers reporting that they needed to pay bribes to obtain services.<sup>34</sup> An alternative is the creation of telephone hotlines so citizens can complain directly to the government.

Some countries, worried that nongovernmental organizations will be used to monitor their performance, limit such groups or make it very costly for them to organize. Formal legal constraints may be high, and groups and their members may be subject to surveillance and harassment. The Bank should help countries promulgate permissive statutes governing the incorporation of nonprofit organizations.

Individuals are unlikely to complain peacefully about government operations unless the legal structure protects individuals against state crackdowns. When an official tries to extort a bribe from individuals or firms, do the individuals have any recourse? The Bank can help countries obtain routine services for poor people without bribery through experience with lower-level tribunals and ombudsmen.

#### 4. Reducing the Incentives for Payoffs

Reforms that simply make corruption risky are not sufficient. Reform must also reduce the level of benefits under the control of public officials. The strategy must do this without eliminating programs that have strong public justifications and without simply shifting the benefits into the private sector where they will show up as monopoly profits. Such reforms are particularly in tune with Bank priorities and expertise.

The most obvious option is simply to eliminate laws and programs that are permeated with corruption. If the state has no authority to restrict exports or license businesses, no one will pay bribes in those areas. If a subsidy program is eliminated, the bribes that accompanied it will disappear as well. If price controls are lifted, market prices will

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34. See Samuel Paul, *Evaluating Public Services: A Case Study on Bangalore, India*, 67 NEW DIRECTIONS FOR EVALUATION 155, 160-62 (1995).

express scarcity values, not bribes. If a parastatal is the locus of corrupt payoffs, move it into the private sector.

Reforms that increase the competitiveness of the economy will reduce corrupt incentives. Policies that reduce the controls on foreign trade, remove entry barriers for private industry, and privatize state firms in a way that assures competition can contribute to the fight against corruption. But any move toward deregulation and privatization must be carried out with care. Deregulation in one area may increase corruption elsewhere.<sup>35</sup> Privatization processes can be corrupted, as well as the new regulatory institutions needed in the privatized world. Of course, privatization and deregulation are, on balance, desirable in a wide range of cases, but World Bank reformers should look carefully at the incentives for rent-seeking that remain.<sup>36</sup>

Many regulatory and spending programs ought to be reformed, not eliminated. Corruption in the collection of taxes cannot be solved by failing to collect revenue. One solution is to clarify and streamline the necessary laws to reduce official discretion. Rules could be made more transparent with publicly provided justifications. Governments might favor simple nondiscretionary tax, spending, and regulatory laws as a way of limiting opportunities for corruption. Obviously, the value of

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35. For example, a successful effort to reduce corruption in the transport of agricultural products in one African country increased the corruption in neighboring countries on the same transport route. A USAID-sponsored project was successful in reducing the number of bribe-extraction checkpoints established by police and customs officials along onion transport routes in Niger. Unfortunately, the ultimate outcome was an increase in payoffs and tax levels in Côte d'Ivoire as the onions neared their destination—the food markets of Abidjan. See Glen Rogers & Sid Mohammed Iddal, *Niger: Reduction of Illegal Road Payments*, in GOVERNANCE AND THE ECONOMY IN AFRICA: TOOLS FOR ANALYSIS AND REFORM OF CORRUPTION (1996). This example illustrates that corruption can be reduced through a concerted effort, but it also highlights the importance of taking a systemic approach to corruption reform, even if that means crossing national boundaries.

36. The integrity of the privatization process is especially at issue in countries in transition. Although some industrial plants in Eastern Europe and the former Soviet Union are out-of-date, these countries are nevertheless largely developed countries rich in natural resources. The value of sharing in the privatization of a socialist state dwarfs the benefits of sharing in the privatization of a public utility in Western Europe or a steel mill in the developing world. In formerly socialist countries, the risk is not simply corruption and insider deals, but domination by organized criminal groups. Criminal groups, wealthy from both illegal and legitimate businesses, seek to share in the distribution of the countries' wealth. If they can create an atmosphere of uncertainty and the threat of violence, they will drive competitors away, especially western firms. The risk of organized crime driving away legitimate investment suggests that great care ought to be taken to establish a transparent and reliable legal environment before privatization is undertaken. This was not done in many countries that had already privatized, with predictable results. See Susan Rose-Ackerman, *Reducing Bribery in the Public Sector*, in CORRUPTION & DEMOCRACY 21 (Duc V. Trang ed., 1994); Louise I. Shelley, *Post-Soviet Organized Crime*, 2 DEMOKRATIZATSIYA 341 (1994).

such reforms depends upon the costs of limiting the flexibility of public officials. Sometimes a certain risk of corruption will need to be tolerated because of the benefits of a case-by-case approach to program administration. Economists have long recommended reforms in areas such as environmental protection, that introduce market based schemes to limit the discretion of regulators. They also recommend user fees for scarce government services. These reforms have the additional advantage of removing corrupt incentives by replacing bribes with legal payments. The sale of water and grazing rights, tradeable pollution rights, and the sale of import and export licenses can improve the efficiency of government operations while limiting corruption.

The final proposals involve the introduction of competitive pressures within government to lower the bargaining power of officials. When bribes are paid for such benefits as licenses and permits, which are not constrained by budgetary limits, overlapping, competitive bureaucratic jurisdictions can reduce corruption. Because clients can apply to any of a number of officials and can go to a second one if the first turns them down, no one official has much monopoly power. Thus, no one can extract a very large payoff. For qualified clients, bribes will be no larger than the cost of reapplication. Unqualified clients will still pay bribes, but even they will not pay much so long as they, too, can try another official. If some officials establish an honest reputation, qualified applicants will prefer those officials, thus reducing the gains to the corrupt. A few honest officials can overturn a corrupt system if congestion is not a serious problem. This dynamic, however, only works if individuals are qualified for the benefit. If, instead, they are unqualified, the honesty of some officials increases the gains to those who are corrupt, inducing more to become corrupt.

When officials, such as police officers, can impose costs, another type of overlapping jurisdiction model should be considered. Police officers seeking to control illegal businesses can be given overlapping enforcement areas. Gamblers and drug dealers will not pay much to an individual policeman if a second one may come along later and also demand a payoff. The first one is simply unable to supply protection. This system may work better if law enforcement officers belong to different police forces—local, state, or federal, for example. Then collusion among officers to defeat the system will be less likely.

### III. CONCLUSIONS

Efforts by the World Bank to keep its own projects clean while ignoring the rest of a borrower government's activities will be ulti-

mately ineffective as corrupt officials and private individuals and firms seek opportunities elsewhere. Clearly, the Bank ought not to abandon efforts to keep its own projects free of corruption, but the more serious that effort becomes, the more it will need to help countries reduce corruption throughout their institutions. This should involve projects to help reform public sector institutions and to create a viable environment for private sector development. In addition to general programs to improve government performance and public accountability, however, more targeted projects are likely to be worthwhile. Each country will need to make its own assessment, but surveys and case studies suggest three areas where corruption imposes the most costs in many countries. First, in many countries, tax and customs revenues are very low, and the pattern of payments is inequitable due to payoffs. The response should be both to simplify the tax laws to reduce bureaucratic discretion and to reorganize the bureaucracy to improve oversight and incentives for good performance. Second, the regulation of business is often so complex, time-consuming, and intrusive that the development of a healthy private sector is affected. Here, the answer is a hard look at tax and regulatory laws to see which can be eliminated, which can be simplified, and which require improved enforcement. Third, states sometimes sponsor capital projects that are too large and complex. Evidence of the inappropriate scale and design of projects should be sufficient to cancel them. Cancellation should be combined with improved procedures for future project approvals or the pattern will repeat.

To reiterate my basic recommendations, the World Bank should address corruption on three fronts:

- First, the Bank needs to make it more clear than it has in the past that corruption will not be accepted as normal in its own grants and loans and must move to cancel projects where corruption is uncovered or where cost overruns suggest that either venality or incompetence is pervasive. It may need to discontinue lending to some countries where corruption at the top levels of government appears endemic.
- Second, the Bank should actively support international efforts to reduce the acceptability of bribery in international businesses and assist efforts to establish international budgetary, accounting, and procurement standards and to train officials to use them.
- Third, grant and loan projects should focus on creating an environment favorable to shared growth and the alleviation

of poverty. The Bank could select a few countries with supportive governments and work with them to design programs that could serve as examples for others. Country officials, working with Bank staff, should design programs that reduce underlying corrupt incentives, facilitate civil service reform, open government to outside scrutiny, and strengthen formal institutions of oversight and control (such as the courts). This sounds like a large order, but piecemeal efforts are unlikely to do much lasting good.