3 International finance and corruption

A migrant carries a desk salvaged from her home as she moves across the Yangtze River to Fengdu town, upriver from the giant Three Gorges dam project. Citing the potential for environmental damage, the World Bank and the US Export-Import Bank declined to back the project and China turned to competing Export Credit Agencies with lower standards. Amid accusations of widespread corruption, including the diverting of relocation funds, more than a million people are being forced to move due to the dam. (GOH CHAI HIN/AFP/Getty Images)

Financing corruption? The role of Multilateral Development Banks and Export Credit Agencies

Susan Hawley[1]

Infrastructure projects – where the vast majority of construction contracts are won – have had a bad name. Grandiose, unnecessary, 'white elephant' projects have diverted

precious resources away from vital services and saddled developing countries with bad debts. The economic and social benefits of necessary and much-needed infrastructure projects meanwhile have been whittled away, if not eliminated completely, by corruption.

Many of the large infrastructure projects around the world that have been plagued by corruption allegations were backed in part by either a multilateral development bank (MDB) or an export credit agency (ECA). Many of the projects in developing countries mentioned in this report, such as the Lesotho Highlands Water Project, have been backed by one or both types of body. Given their major role in financing, and facilitating finance for, infrastructure projects, MDBs and ECAs have a critical role to play in preventing corruption in the construction sector. While they have taken significant steps in recent years, serious vulnerabilities remain.

The scale of international finance for infrastructure

According to the World Bank, 'the greatest source of finance [for infrastructure in developing countries] traditionally has been commercial banks, often in connection with officially backed export credit agencies and multilateral organizations'.[2] Without support from either an ECA or an MDB, projects in poorer, unstable or high-risk developing countries would often not go ahead.

In 2002, the MDBs, consisting of the World Bank and the regional development banks, together spent US $16.6 billion on infrastructure, which represented 39 per cent of their overall spending.[3] Since 2003 the World Bank has started to re-prioritise infrastructure, and is set to increase its infrastructure lending from US $5.4 billion to US $7 billion by 2005.

Despite the fact that their direct funding for infrastructure is small compared with the total estimated global spending of US $250 billion annually on infrastructure,[4] the MDBs are highly influential in this field, for three reasons:

- *MDBs act as a catalyst for further financial support from the private sector.* MDBs' private sector arms, particularly the World Bank's International Finance Corporation and Multilateral Investment Guarantees Agency, are influential in mobilising private sector support for infrastructure projects.
- *MDB projects are a major source of contracts for companies*. World Bank-financed projects result in 40,000 contracts being awarded annually and account for one-third of total international contracts in developing countries.[5]
- *MDBs help set developing countries' policy on infrastructure*. Privatisation of infrastructure has featured as a condition in many structural adjustment loans to developing countries, and has been a significant factor behind the 58 per cent increase in foreign construction contracts between 1986 and 1998.

ECAs are, for the most part, governmental or semi-governmental agencies that help their domestic companies and banks win investment and export business overseas,

through a mixture of government-backed loans, guarantees and insurance. ECAs tend to provide cover for larger sums, longer periods and higher-risk countries than the private sector is willing to do.

Despite their relative anonymity, ECAs are the largest source of publicly backed finance for private sector projects, and particularly of large-scale infrastructure projects in the developing world. During the 1990s, export credit backing of project finance for infrastructure projects grew dramatically. In 2002, long-term credits (of over five years) from the ECAs of OECD countries to the construction and engineering sectors stood at around US $2 billion, up from around US $900 million in 1998.[6] This figure does not take into account, however, the involvement of construction and engineering companies in other sectors, particularly energy generation and supply (which received US $1.8 billion of long-term credits in 2002) and transport (which received nearly US $7.5 billion of such credits in 2002).[7] Nor does it take into account short-term credits and investment insurance, which would make the total value of ECA backing for infrastructure much higher.

How public international financial institutions aggravate corruption

Until recently, the impact of MDBs and ECAs in facilitating corruption in the construction and other sectors, primarily through negligence, was largely overlooked by these institutions and the governments that support them. As the damage caused by corruption has moved up the policy agenda, however, their role has increasingly come under scrutiny. According to one recent estimate, between US $26 billion and US $130 billion (5–25 per cent) of the US $525 billion lent by the World Bank since 1946 may have been misused or lost to corruption.[8] The World Bank contests this estimate.

High levels of corruption in MDB-backed projects have been blamed on several factors, which include weaknesses in the MDBs themselves. First, the institutional 'pressure to lend' leads to an emphasis on, and staff incentives for, the quantity rather than quality of projects supported.

Second, and equally important, are weak internal controls at the banks, particularly in the supervision and auditing of projects. In the mid to late 1990s, the US General Accounting Office found that audit reports on projects were poor quality, financial management supervision often unsatisfactory, and intensive procurement reviews rare. In 1998–99, only 54 out of 1,500 projects had such a review.[9] At other development banks, observers have reported poor project evaluation, including a 'no fail' culture of internal evaluations.[10] Accounting for how funds disbursed through structural adjustment loans have been spent remains, in the words of one expert, 'the weakest link in the system'.[11]

A third factor exacerbating corruption in MDB-backed projects has been inadequate due diligence and risk assessment. Assessing the risks of corruption to the economic viability of a project, and to its potential environmental and social impacts, whether posed by the country and sector in which the project is taking place or the track record of a company awarded a contract, has not been, until recent years, fully mainstreamed in project assessments.

Two final factors are the banks' lack of accountability and transparency. The legal immunity enjoyed by the banks, and the lack of active oversight by most member countries, undermines the incentive for banks to practise optimal financial management and root out corruption. At the same time, while some banks, particularly the World Bank, have gone a long way to becoming more transparent in recent years, the full and timely disclosure of many documents is still lacking.

Because ECAs have no development or social remit, and exist solely to support domestic exports and foreign investment, preventing corruption has never been high on their agenda.

Almost all ECAs have the potential to underwrite bribes directly, whether knowingly or not, because the cost of commission payments made by companies to win a contract – long recognised as a route through which bribes may be paid – is included in the overall sum that they underwrite. Former Director-General for Development at the European Union, Dieter Frisch, has described this as 'an indirect encouragement to bribe'.[12] Despite the risks involved in underwriting commission payments, the practice of requiring full details on what such payments were for, and to whom they were paid, is only a very recent development, and not universally observed.

ECA negligence towards corruption takes other forms. ECAs have had poor due diligence procedures with regard to risks posed by corruption in the countries and sectors where they operate. For example, many ECAs do not check, let alone require, that contracts they back are won through competitive tender or transparent procurement methods. ECAs have given support for projects, in some instances, despite publicised allegations of corruption and concerns raised by other donor agencies, and have failed to investigate bribery allegations when they have arisen. Companies embroiled in corruption scandals have meanwhile continued to receive ECA support, and faced little sanction. Unlike the MDBs, few ECAs say they will use debarment as a sanction for bribery, and none has ever done so in practice.[13] Finally, ECAs have historically lacked transparency. Until recently, few ECAs disclosed publicly the projects that they supported and, even today, disclosure is patchy.

Recent anti-corruption reforms

In recent years, major strides in recognising the problem of corruption have been taken – partly as a result of external pressure from NGOs – at both MDBs and ECAs. There is considerable room for improvement, however, if corruption in the infrastructure sector is to be rooted out.

The World Bank has led the way on fighting corruption among MDBs. Since 1995, when James Wolfensohn took over as president, the World Bank has introduced various new measures to improve its anti-corruption procedures and has placed corruption firmly on the policy agenda. The other regional development banks have been slower in adopting anti-corruption procedures. All MDBs, however, have now taken a range of steps, including the debarment of companies found guilty of fraud and corruption (see Box 3.1), and have, or are in the process of creating, some form of unit that investigates and penalises fraud and corruption.

Box 3.1 Blacklisting corrupt companies

Juanita Olaya[1]

'Blacklisting' or 'debarment' in the realm of public contracting is a process whereby, on the basis of pre-established grounds, a company or individual is prevented from engaging in further contracts for a specified period of time. Debarment may be preceded by a warning of future exclusion should the conduct persist, be repeated, or occur under aggravated circumstances. An investigation that could lead to debarment may be promoted by an existing judicial decision, or when there is strong evidence of unethical or unlawful professional or business behaviour. Many debarment systems today allow the latter form as judicial decisions are often slow to obtain.

The key function of debarment in public contracting is prevention and deterrence. For companies debarment means a damaged reputation, lost business prospects and even bankruptcy. It therefore increases the opportunity cost of engaging in corrupt practices.

Debarment systems have been around for some time, both at the national and the international level. The US debarment system is among the oldest, and its grounds for debarment include anti-trust violations, tax evasion and false statements, in addition to bribery in procurement-related activities. The World Bank has taken the lead internationally: its debarment system was made publicly available in 1998. Since 2003, the European Commission's financial regulations have included a debarment system that is currently being developed. Almost all development banks now have debarment systems of some kind and, at the national level, many countries have, or are seriously considering, blacklisting systems.[2]

Many of the current debarment systems have been criticised for being closed, poorly publicised or unfair, and for failing to include big companies with proven involvement in corrupt deals.[3] The debarment of Acres International Ltd by the World Bank (see page 33) signals an emboldening of institutions that wish to demonstrate intolerance of corruption. The decision to debar Acres also helps dispel the fear that debarment agencies might face reprisals, such as allegations of slander or misjudgement.

The two main problems Transparency International has encountered with blacklisting are: an unwillingness to debar on the basis of 'strong evidence' (without a court order); and resistance to giving the public access to blacklists.

In order to be effective and to stand up to scrutiny and possible legal challenges, certain steps need to be taken when designing and implementing a debarment system. Effective debarment systems must be fair and accountable, transparent, well publicised, timely and unbiased.

1. **Fairness and accountability.** Clear rules and procedures need to be established and made known to all the parties involved in a contracting process, ahead of time. The process needs to give firms and individuals an adequate opportunity to defend themselves.
2. **Transparency.** Sanctions and the rules regarding the process must be made public in order to minimise the risk of the debarment system being subjected to manipulation or pressure. The outcomes must also be publicised. Contracting authorities and export credit agencies need to be given access to detailed information from the debarment list so that they can carry out due diligence on potential contractors (for overseas tenders this might mean accessing the debarment system in the home country).

This process is especially complicated because owners of debarred companies may simply start up a new company operating under a new name. Up-to-date public debarment lists can help procurement officers and due diligence analysts keep track of such cases. Publicity also has an important impact on the legitimacy, credibility and accountability of debarment agencies, and facilitates monitoring by independent parties. The information made public in debarment lists needs to include the company or individual's name, the grounds for investigation, the name of the project, the country of origin of sanctioned firms or individuals, as well as the rules governing the process.

3. **Functionality.** Publicly available debarment lists facilitate electronic matching and other information-sharing features that organisations such as the World Bank's International Finance Corporation already have in place. Systems could be interconnected internationally, for example, among development banks, or between countries. Such networking may even reduce operating costs, and make systems more effective.
4. **Timeliness.** Debarment systems should be timely. The Lesotho case (see page 31) shows that delays in beginning the debarment process increase costs and erode credibility.
5. **Proportionality.** For some companies, being barred from a particular market might mean bankruptcy, so in certain cases a debarment of five years could be too much. The system should allow for a sliding scale of penalties, and should provide entry and exit rules. If a company has shown that, after the offence, it implemented substantial changes, for example, by enforcing codes of conduct, or changing policies and practices, it should be possible to lift the debarment.

Notes

1. Juanita Olaya is the programme manager for public contracting at Transparency International.
2. These countries include: Bangladesh, Brazil, China, the Czech Republic, France, Germany, India, Kenya, Nepal, Pakistan, the Philippines, Romania, Senegal, Singapore, South Africa, South Korea, Sweden, Tanzania, Turkey, Uganda, the United States and Zimbabwe.
3. See, for example, Steven Schooner, 'The Paper Tiger Stirs: Rethinking Suspension and Debarment', *Public Procurement Law Review*, forthcoming in 2004, and related articles in the same issue.

In addition to imposing sanctions, the World Bank has developed stricter procurement guidelines, and improved financial management and oversight. Anti-corruption efforts are now a key focus of the bank's analysis and lending decisions. Diagnostic work on governance and corruption risks has been expanded, and transparency has been improved. The other regional development banks have in some instances followed suit, though many fall well behind the World Bank in their procedures.[14]

Despite these improvements, many commentators believe that there is considerable scope for enhancing anti-corruption procedures at the World Bank, and even more so at the other regional development banks.

Areas of ongoing weakness in MDB anti-corruption procedures include:

- Staff time for supervision has been reduced and resources for supervision remain low.[15] Resources at the units that safeguard institutional integrity, particularly at the regional development banks, are insufficient.

- MDBs do not require anti-bribery compliance or corporate governance programmes by companies as a prerequisite for receiving contracts. The World Bank's recent requirement for companies bidding on large civil works projects to certify that they have 'taken steps to ensure that no person acting for us or on our behalf will engage in bribery'[16] is a small step in the right direction. However, it will be meaningless unless the World Bank employs active due diligence with regard to companies and their use of agents, and fully inspects and enforces company certification.
- A report in July 2004 from the Government Accountability Project found that 'none of the banks have reliably safe channels for whistleblowers to make a difference against corruption'.[17]
- Mainstreaming anti-corruption has yet to be fully achieved. For example, the World Bank's 2003 Infrastructure Action Plan makes no mention of corruption, despite the fact that support for 'high-risk' projects is to be increased, and despite the known risks of corruption in infrastructure projects. Mainstreaming anti-corruption could include: staff incentives that reward corruption-free projects; rigorous corruption risk assessment throughout project cycles, such as in the calculation of the economic rate of return, and environmental and social impact assessments; and extending the commitment made by the World Bank with regard to the extractive industries sector (to operate governance indicators and refuse support to new investment 'where the risks are deemed too great and cannot be mitigated'[18]) to all sectors, including infrastructure.
- Disclosure and transparency could be improved further and public participation increased. Oversight would be enhanced by the publication of documents throughout a project's lifecycle, including audit reports, all contracts between the government and contractors and subcontractors, and full details of the bidding process on Bank-backed projects, including initial budget and final budget, as well as of more general MDB documents such as board minutes and correspondence, and performance evaluations. Citizen participation in project design and in oversight committees would help reduce opportunities for corruption – a fact the World Bank recognises and in some instances has taken on board.

Over the last four years, the OECD's Working Party on Export Credits and Credit Guarantees (ECG) has undertaken considerable work on the issue of bribery in export credits. This includes:

- In December 2000, the ECG issued an Action Statement on Bribery and Officially Supported Export Credits, under which ECAs agreed to: inform applicants about the legal consequences of bribery; 'invite' applicants to sign a no-bribery warranty; refuse support where there was 'sufficient evidence' of bribery; and take appropriate action against any company where bribery was proven after support had been given.

- Since 2002 the ECG has periodically published a survey of member country procedures to combat bribery in officially supported export credits.
- In November 2003, the ECG issued 'Best Practices to Deter and Combat Bribery in Officially Supported Export Credits' – a document still under negotiation during 2004 that suggested several best practices that should be made official ECA practice. The 11 best practices include: requiring details on commission payments over 5 per cent; requiring companies to declare whether they have been blacklisted by a multilateral organisation or convicted of bribery by a court; automatic referral of suspicions of bribery to national investigative authorities; application of enhanced due diligence where suspicion of bribery arises; suspension of payments and support to companies where sufficient evidence of bribery emerges until an official investigation is concluded; and application of all possible sanctions, including debarment, where a company is convicted.
- During 2004, there were ongoing negotiations about revising and enhancing the OECD's original Action Statement to reflect emerging best practices, and bribery was one of the important priorities for discussion at the ECG.

Despite these important steps, there remain considerable weaknesses in ECA anti-corruption procedures. The best practices outlined by the OECD have by no means been universally adopted, and few of them appear to have been put to the test in practice. Between November 2002 and May 2004, only five countries took any action with regards to suspicions and evidence of bribery.

The main areas of ongoing weakness are:

- *Agents*. Despite the OECD Best Practices paper and the obvious risks of backing agents' commissions without strong safeguards, nine ECAs, including those of Canada, Germany, Italy, and Sweden, still do not require companies to provide any details of the commission payments they underwrite.[19] High standards for due diligence on agents' commissions are essential, and some ECAs, particularly Britain's Export Credits Guarantee Department, are leading the way in this regard.
- *Debarment*. Both the commentaries on the OECD Anti-Bribery Convention and the OECD's 1997 Revised Recommendations on Combating Bribery specifically recommend exclusion from publicly supported commercial activities as a sanction. Only the Swiss, New Zealand, Danish and Canadian ECAs, however, say they would debar companies convicted of corruption, and Canada would not do so if the company puts in place anti-corruption management procedures. Debarment for a specific period of time is a powerful tool for changing company behaviour, and would have a strong deterrent effect.
- *Due diligence*. ECAs by their very nature operate in high-risk environments. Ensuring that the projects they provide support for are free of corruption, and that the companies they back are operating good corporate governance standards, is

key both for the integrity of the project and of the ECA itself. Requiring companies to have an externally monitored anti-corruption compliance programme or ethical code, and that contracts to be backed are won through competitive tender or transparent procurement processes, would be major steps forward.

- *Transparency.* Proper disclosure of both ECA policies and project information is essential for fostering accountability. Recent international developments with regard to ECA disclosure of details on high-risk projects prior to approval need to be extended to all projects. Most importantly, mechanisms to make communities aware of projects under consideration, and to allow for stakeholder consultation for such projects, need to be developed. The involvement of stakeholders and communities could be an important way of helping ECAs become aware of problems and risks posed by possible corruption at an early stage in the project cycle.

Conclusion

Investment in good infrastructure projects in developing countries is fundamental to reducing poverty and meeting the international community's Millennium Development Goals. By some estimates, developing countries need US $300 billion of annual investment in infrastructure.[20] If future investment in infrastructure in developing countries is to be effective, making certain that infrastructure projects are free of corruption and built on the principles of accountability and transparency is fundamental. Those bodies responsible for providing public international finance for infrastructure need to play a lead role, not least by stepping up their anti-corruption reform efforts.

Notes

1. Susan Hawley is a researcher and policy adviser on corruption issues at the Corner House, a UK-based research and advocacy group focusing on human rights, the environment and development.
2. World Bank, *Global Development Finance 2004* (Washington, DC).
3. Ibid. The World Bank group consists of its two lending arms (IBRD and IDA), its private sector development arm (IFC) and its political risk guarantees provider (MIGA). The regional banks are: the Asian Development Bank, the African Development Bank, the Inter-American Development Bank and the European Bank for Reconstruction and Development. The banks are involved in varying degrees; infrastructure accounts for 25 per cent of World Bank spending, while 42 per cent of the Asian Development Bank's portfolio in 2003 was for roads and transport.
4. United Kingdom Department for International Development, 'Making Connections: Infrastructure for Poverty Reduction' (2002).
5. United Nations Conference on Trade and Development, 'Regulation and Liberalization in the Construction Services Sector and its Contribution to the Development of Developing Countries', 12 September 2000, para. 27.
6. www.oecd.org/dataoecd/13/44/7084900.pdf
7. Ibid.
8. Senator Richard Lugar, 'Opening Statement', Combating Corruption in the Multilateral Development Banks, Senate Foreign Relations Committee, US Senate, 13 May 2004.

9. United States General Accounting Office, 'World Bank: Management Controls Stronger, but Challenges in Fighting Corruption Remain' (2000).
10. Martin Erwin Andersen, 'Corruption Corrodes Development Banks', *Insight on the News*, 1 October 2002; www.interaction.org/files.cgi/3086_IDB_Transparency_Accountability_Corruption_Fact_Sheet.pdf; Steve Herz, 'Zero Tolerance? Assessing the Asian Development Bank's Efforts to Limit Corruption in its Lending Operations' (Washington, DC: Bank Information Center and TERRA, March 2004).
11. Professor Jerome Levinson, Washington College of Law (former General Counsel for the Inter-American Development Bank). 'Statement before the committee on Foreign Relations of the United States Senate: Corruption and Multilateral Development Banks', US Senate, 13 May 2004.
12. Dieter Frisch, 'Export Credit Insurance and the Fight Against International Corruption', TI Working Paper, 26 February 1999.
13. OECD Working Party on Export Credits and Credit Guarantees (ECG), 'Responses to the 2002 Survey on Measures Taken to Combat Bribery in Officially Support Export Credits – as of 14 May 2004'.
14. See John B. Taylor, US Under-Secretary for the Treasury on International Affairs, 'The Multilateral Development Banks and the Fight against Corruption', Testimony before the Senate Foreign Relations Committee, US Senate, 21 July 2004.
15. Nancy Zucker Boswell, Managing Director, TI USA, 'Testimony', Combating Corruption in the Multilateral Development Banks, Senate Foreign Relations Committee, US Senate, 13 May 2004; Manish Bapna, Executive Director, Bank Information Center, 'Testimony', Combating Corruption in the Multilateral Development Banks, Senate Foreign Relations Committee, US Senate, 13 May 2004.
16. Transparency International press release, 'World Bank Move to Reduce Private Sector Bribery Welcomed by Transparency International', 23 September 2004.
17. Government Accountability Project, *Challenging the Culture of Secrecy* (Washington, DC: GAP, 2004).
18. World Bank, 'Striking a Better Balance – The World Bank Group and Extractive Industries: the Final Report of the Extractive Industries Review', Draft World Bank Group Management Response, 4 June 2004.
19. OECD, 'Responses to the 2002 survey'.
20. Berne Union, *Berne Union Yearbook 2004* (London: Berne Union, 2004).