INTERNATIONAL SYMPOSIUM ON THE PREVENTION AND CONTROL OF FINANCIAL FRAUD, BEIJING, 19-22 OCTOBER, 1998

Corruption and Development

(Presentation by Pieter Bottelier, Senior Advisor,
The World Bank, East Asia and Pacific Region.)

The Social and Economic Costs of Corruption

Like ignorance, corruption is a great enemy of development. Both need to be conquered for sustainable and equitable development. Helping member countries fighting ignorance had always been part of the World Bank's mandate. But corruption was placed on the institution's agenda only about two years ago. It was a controversial, but necessary and historic decision. Formal recognition of the destructive powers of corruption and acceptance of the need for the World Bank to help member countries address the issues openly and up front, had been delayed too long.

The fight against corruption has rightly been given a central place in China's reform and modernization effort. China's goal to become a prosperous socialist market economy, while maintaining stability, cannot be achieved if corruption is allowed to take over. Important recent research on the links between corruption, development and stability has generated a growing body of empirical evidence that:

- Corruption invariably increases transaction costs and uncertainty in an economy while lowering efficiency. It leads to a misallocation of scarce talent to rent seeking activities while distorting investment priorities and technology choices.There are significant variations in the form and intensity of corruption across and within regions. Some developing countries have less corruption than many industrialized nations.

- Corruption reduces the transparency of economic transactions by both State-owned and private sector firms while undercutting the State's ability to raise revenues. Corruption is therefore often associated with fiscal weakness which in turn may force the State to levy ever-higher tax rates on fewer and fewer tax payers, while reducing its ability to provide essential public goods and services.

- Corruption weakens the State and its ability to promote development and social justice. It is regressive in the sense that its costs and negative economic impact tend to fall more heavily on small enterprises and on individuals in a weak economic position. Corruption is double jeopardy for the poor and unprotected. They pay a high share of monopoly rents and bribes, while they are often deprived of essential government services.

- Corruption undermines the State's legitimacy and, in extreme cases, may render a country ungovernable and lead to political instability, chaos or war.

- Financial fraud - the main focus of this conference - is a particularly pernicious kind of corruption. It can undermine the soundness of financial institutions and contribute to systemic crisis. It is often associated with poor accounting standards, weak supervision of financial institutions, cronyism and nepotism. The Asian financial crisis has underlined that successful participation in global capital markets requires the enforcement of rigorous regulatory standards with zero tolerance for corruption.

There is little or no support left for the view that a moderate degree of corruption or bribery has a positive effect on development by giving firms and individuals a means of avoiding burdensome regulations and ineffective legal systems. If laws and regulations are unnecessarily burdensome or ineffective, the answer lies in improving the system, not in allowing the functioning of the economy to become dependent on a morass of non-transparent favors and payments that are inconsistent with the transparency requirements of a modern society. Small corruption, when tolerated or condoned by society, creates uncertainty and often leads to big corruption. Survey results indicate that there is a strong positive correlation between the incidence of bribery in a country and the share of management time devoted to negotiating licenses, permits, signatures and taxes. The cost of these negotiations, uncertainty and bribes actually paid, can undermine the competitiveness and business confidence of enterprises. Once bribes have come to be an expected part of the "cost of doing business" in a country, the chances that bribes are offered are about as great as that they are demanded.

National legislation in OECD countries treats bribes paid or offered for contracts in developing countries very differently. In some countries (notably some major West European countries) bribes are still regarded and tolerated as part of the "cost of doing business" and may even be tax deductible. Other countries (notably the USA) specifically outlaw bribing as a criminal offense. The need for harmonized anti-corruption legislation to support anti-corruption efforts in developing countries and reduce unfair competition was recognized last year when all 29 OECD member countries agreed to negotiate a convention criminalizing bribery of foreign public officials by the end of 1998. We hope to learn at this conference what progress has been made in this regard. The Organization of American States has already negotiated a convention which calls on signatories to criminalize transnational bribery and to cooperate with one another in the enforcement of anti-corruption legislation and in the recovery of illicit riches. The United Nations General Assembly passed a resolution last year calling on members to take steps against all forms of corruption.

Whilst official international recognition of the problem and the need to fight it is growing, corruption remains a serious problem in many countries, including China. It threatens development, safety, social fairness, the environment and stability in many different ways. For example, corruption undermines regulations that are needed by society for public safety such as building codes and environmental standards such as restrictions on logging, effluent disposal or dangerous emissions. Corruption does not always involve the payment of a bribe. Connivance between business partners - which may include a Government agency or State enterprise - to establish or maintain monopolistic structures to extract rents from society while retarding or preventing modernization, can be especially harmful to development. Obscure insider lending or trading practices and improper or excessively risky financial schemes, often associated with inadequate accounting and disclosure standards and/or weak supervision, are other forms of corruption, usually referred to as “financial fraud”. Pervasive and large scale financial fraud can lead to systemic financial crisis and undermine stability and development.

<u>Causes and Forms of Corruption</u>

The causes of corruption are as varied as the forms in which it finds expression. Broadly, the World Bank defines corruption as "the abuse of public office for private gain." Public office is abused when an official accepts, solicits, or extorts a bribe or when a private agent offers a bribe to circumvent public policies and processes for competitive advantage and profit. Public office can also be abused for personal gain even if no bribery occurs, through patronage (cronyism) and nepotism, underpricing of State assets, or diversion of public resources. Bribery occurs also in the private sector, but, because of its function, the World bank is mainly concerned with corruption in the public sector.

The causes of corruption are usually complex and rooted in a country's policies, bureaucratic traditions, political development and social history. Corruption tends to flourish when standards are lax or poorly defined, regulatory institutions and enforcement practices weak, and government policies generate economic rents. The opportunity for corruption is a function of the size of the rents under the control of a public official, the discretion that official has in allocating those rents and the accountability that official faces for his or her decisions. A well known corruption expert, Robert Klitgaard, uses the equation: **C**(corruption) = **M**(monopoly)+ **D**(discretion) **-** **A**(accountability) to measure the potential for corruption in practical situations. Therefore, to reduce the potential for corruption, we have to eliminate or control monopoly power, reduce discretion by promoting transparency and the rule of law while increasing accountability standards and practices.

Actual corruption is co-determined by many other factors, including cultural and moral values. The motivation to remain honest may be weakened by low civil service salaries, promotion of staff unconnected to performance, dysfunctional government budgets, loss of organizational purpose, bad example by senior officials political leaders, or long established patron-client relationships, in which the sharing of bribes or the exchange of favors has become entrenched. Corruption can be highly concentrated at the top of a political system and associated with political power, or broadly based at lower levels in the system, associated with administrative processes and discretionary powers. Bribes can be blatant or subtle and take many different forms, including cash payments, job offers, scholarships, foreign trips or political and other favors.

Some forms of corruption are more harmful for development than others, but nobody argues anymore that corruption is good for development. Recent econometric studies in several countries indicate that increases in corruption are associated with decreases in economic growth. The cost of corruption to the economy is not necessarily a function of the size of the bribes involved. Similarly, the costs of unnecessary regulations or administrative restrictions cannot be estimated from the size of the rent they create. In cases where government regulatory and commercial functions are performed by the same organization, as is frequently the case in countries in transition from a centrally planned to a market-based economic system, including China, the distinction between corrupt and legitimate business practices may become blurred in the eyes of participants. In those situations corruption may appear, or can be made to appear, near-legitimate with reference to the regulatory functions of the public agency concerned. Yet it is precisely these subtle "system-sanctioned" forms of corruption that are often most damaging to a country's business and investment climate, especially in an economic downturn.

Participants in corrupt practices often rationalize and justify their actions as being in the public interest, particularly when there are elements of apparent legitimacy in the transaction. The fact that it takes two to tango and that the blame for corruption can often be shared, may provide a convenient psychological defence. Dr. Oscar Arias Sanchez, former president of Costa Rica and Nobel Laureate, sums it up by quoting the seventeenth century Mexican poet Sor Juana Ines de la Cruz, who asked: Whose is the greater blame in a shared evil? She who sins for pay, or he who pays for sin?" Klitgaard has noted that in systematically corrupt settings, many politicians and officials have complicated, mixed feelings about corruption. They may sincerely loathe it and wish to eradicate it, while at the same time participating in it or allowing it to occur.

Financial Sector Fraud - Prevention and Control

There are close linkages between financial malpractice at the level of individual firms and at the level of banks and other financial institutions. In both cases, poor accounting, disclosure, and financial management standards, combined with lax internal controls, and inadequate external supervision, foster corruption and facilitate money laundering. The development of a sound, efficient and non-corrupt financial system is one of the most critical and difficult challenges facing China. Since banks are the custodians of savings and allocators of a large proportion of a nation's financial resources, their financial soundness and the elimination of financial fraud, are critical for the stability of the entire economy. Moreover, given the growing global integration of financial markets, the soundness of banks and financial institutions, including China’s, has become an intense international concern. Even though China’s currency is not yet fully convertible for capital account transactions, there is no watertight separation between China’s financial system and that of the rest of the world. In fact, China’s economic integration with the rest of the world has progressed enormously during the past decade.

To reduce the risk of cross border financial crisis contagion, calls for improved international monitoring of national banking supervision systems and practices have become louder. The Asian crisis has intensified international efforts to design and create a new international "financial architecture" that is better suited to the needs of globalized capital markets than the present system. Private banking industry associations, national governments, central banks, the BIS, the IMF and the World Bank are involved in this process. It is very much in China's interest to fully participate in it. A stronger international “financial architecture” will not only reduce the risk of crisis contagion, but also facilitate combatting financial fraud.

Because financial fraud and imprudent financial management can contribute significantly to financial sector weakness and vulnerability, the subject of this conference is of great national and international significance. The Asian crisis provides a rich and timely source of lessons for China on how inadequate corporate governance, poor accounting and disclosure standards, and lax supervision of the financial system, can contribute to sudden crisis and cross border contagion, under certain circumstances.

Of special importance in this context is the need to train and equip China’s banks and other financial institutions for detecting and countering money laundering. Money is “laundered” to conceal criminal activity, including for example tax evasion, theft of State assets, drug trafficking and fraud within the financial system itself. The objective of money laundering is to conceal the true source of funds so that they can be used freely. Financial institutions often serve as vehicles or links within this process, sometimes unwittingly. Managers and staff of financial institutions have a special responsibility to ensure that the accounts and services of their institutions are not used to “whiten” funds that have been obtained illegally. In stead of allowing themselves to be used as transmitters of the corruption disease, financial institutions should serve as safety valves on the system.

Anti Corruption- and Financial Fraud Policies in China

The Chinese authorities have for many years recognized that corruption in all forms, including financial sector fraud, is a threat to social stability and continued modernization. This realization and the political will to tackle the problem is perhaps stronger now that it has ever been. President Jiang Zemin made corruption a central theme in his speech for the 15th Party Congress last year. There are many indications that the Government's fight against corruption represents a serious commitment. The struggle to control and prevent financial fraud requires above all an intensification of efforts to establish sound financial management and accounting practices, combined with regular professional review by internal and external auditors as well as adequate disclosure standards. This applies both to companies (of all types of ownership) and to financial institutions. In addition there will, of course, continue to be a need for legal and prosecutorial mechanisms coupled with punitive measures to combat corruption. A sound system of financial management, accounting and disclosure requirements inhibits, reveals and helps identify and confirm corrupt practices and their perpetrators in many different ways. An effective long-term strategy will focus in particular on prevention. It might include the following elements:

1. Full enforcement of international accounting, auditing and disclosure standards for all corporations, regardless of ownership. Much progress has already been made in the adoption of standards, but implementation is less advanced.

2. Adoption and full enforcement of international accounting, auditing and disclosure standards for banks and financial institutions, regardless of ownership. The formal definition and adoption of accounting standards for the financial system is not yet complete. The Government's recent decision to introduce international loan risk classification and modified provisioning standards for State banks, is a significant step in the right direction. n of A realistic time table for full implementation of this decision has to be set.

3. Setting high standards for the accounting and auditing professions, through training and the promotion of independent professional accounting and auditing associations setting their own professional and ethical standards consistent with government requirements, as well as systems for self-policing.

4. Definition of a clear legal framework for the enforcement of financial management, accounting, auditing and disclosure standards, and conflict resolution.

5. Setting strict due-diligence and commercial risk management standards for all State owned banks and financial institutions. International efforts currently in progress to promote stronger and more uniform risk management standards for banks operating in global capital markets, could be helpful to China in this regard.

6. Requiring all State-owned financial institutions and corporations to present their accounts also on a consolidated basis and to have their accounts audited by independent external auditors on a regular basis.

7. Strengthening of institutional capability for the strict and comprehensive monitoring and supervision of banks and other financial institutions. Progress is being made in this critical area, but the completion of a satisfactory system, fully staffed with well trained and experienced people, is still a long way off. There are many lessons to be learned in this area from the Asian financial crisis. International technical assistance is available from official sources including i.a. Hong Kong, Singapore and the World Bank. Some of these sources are already being tapped by China; staff training and other institutional development efforts require intensification.

8. Development of stronger and more effective tax administration and fiscal auditing capability. Tax evasion is one of the most common forms of financial fraud in many countries, including China. Intensive efforts to strengthen tax administration and tax collection are underway in China, but the development of an effective fiscal auditing capability is still in its infancy.

9. Encourage civil society and the media to play an active role in creating and maintaining an atmosphere in public life that discourages corruption, financial fraud and irresponsible financial management. Corruption is controlled only when politicians and citizens refuse to tolerate it. Public and private civil organizations, professional associations and the media all have a stake in the quality, stability and fairness of society as well as influence on the successful outcome of anti-corruption policies.

10. Separate completely government regulatory functions for the financial sector from participation in commercial financial operations, including banking, insurance, trade in securities, fund-management and the provision of financial information services.

11. Provide adequate official protection for “whistle blowers” through legislation and cultural change.

12. Provide training to the management and staff of financial institutions in the detection and countering of money laundering through their institutions.

The Word Bank's Anti-Corruption Policy

About two years ago the Bank adopted a systematic framework for addressing corruption as a development issue in the assistance provided to member countries and in its own operations. This framework is based on the following components:

1) Preventing fraud and corruption within Bank-financed projects. For this purpose the Bank has specifically improved procurement and financial management policies related to the implementation of projects supported by it.

2) Helping countries that request Bank support to reduce and eliminate corruption. Specialized staff capability is being developed for this purpose and research is undertaken to strengthen the empirical basis for such assistance efforts. It should be noted that the Bank is still in an early stage of building the knowledge and experience needed for assisting member countries in this area.

3) Taking corruption more explicitly into account in the formulation of country assistance strategies, the policy dialogue, analytical work and the choice and design of individual projects.

4) Adding voice and support to international efforts to reduce corruption by other agencies and non-governmental organizations.

The World Bank fully supports the objectives of this conference and congratulates the organizers. We are grateful for the opportunity to participate. We wish you every success in learning from international experience, in identifying the complex and urgent financial fraud and broader corruption problems facing China and in formulating effective remedial strategies. It is a vitally important task; it can make the difference between success and failure in China's historic reform and modernization drive.

Beijing, 16 October, 1998