



# INTERNATIONAL ANTI-CORRUPTION CONFERENCE (IACC)

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## 8th INTERNATIONAL ANTI-CORRUPTION CONFERENCE

### The Papers

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#### I. Introduction

During the last few years there has been a remarkable renewal of interest in corruption in the public sector. Although corruption is presumably as old as the world, the openness, frankness and vigor of the ongoing debate is without precedent. From scholarly studies in academic journals, the debate has been shifted to the public fora<sup>1</sup>. The emphasis has shifted too. While in the past corruption was viewed as a problem of unethical and in many cases, criminal behavior on the part of public officials, today, it is acknowledged that the deleterious effects of corruption in the public sector are a major obstacle in the path of development, affecting not only the effective use of public resources but also the political process and the social fabric of a country.

It is, therefore, not surprising that international organizations as well as NGOs, concerned with developmental issues, are paying increasing attention to the effects of corruption on development. During, and since the Annual Meetings of the IBRD and the IMF in September 1996, the Managing Director of the IMF, Michel Camdessus and the President of the IBRD, James Wolfensohn, have publicly declared war on corruption<sup>2</sup>. A year earlier, in "Finance and Development" a joint official publication of the IMF and IBRD, corruption and its effects on governmental activities were discussed by Vito Tanzi, Director of the Fiscal Affairs Department of the IMF<sup>3</sup>. At a seminar organized in March 1997, chaired by Vito Tanzi, several academics, well known for their work on corruption, presented papers with specific country examples proving that R. Klitgaard's assertion to the effect that "corruption is no more a taboo subject," is well founded.

The present paper was prepared for the specific purpose of serving as a discussion paper for a workshop on corruption in the public expenditure management process, to be held in Lima within the framework of the "Conferencia Internacional Anti Corrupcion (September 7-11)." Its scope is, therefore, limited. Also, in preparing the paper we have taken it for granted that the reader will be familiar with what has been written on the subject during the last few years and, therefore, a general introduction to the issues and controversies which are debated in the literature is not needed herein.

Notwithstanding the above statement, it is necessary to discuss what is regarded as corruption or corrupt behavior for the purpose of the present paper. Obviously, for a study on the corruption in the PEM process, a definition(s) that take(s) into account the nature of the public sector, or just as importantly, the decision-making process in the public sector, is of necessity.

When analyzing the many definitions of corruption (all relevant but none specific enough for our purpose), it becomes evident that one definition will not suffice because corruption has different dimensions (political, administrative, criminal, etc.), and occurs at different levels in the PEM process. Therefore, we will introduce different definitions as we proceed with our analysis.

A definition which captures the essence of corruption best, is the one proposed by Vito Tanzi<sup>4</sup>. "The term **corruption** comes from the Latin verb to break, **rompere**. It, thus, implies that something is broken. This something might be a moral or social code of conduct or, more often, an administrative rule." V. Tanzi's definition will serve us all along our study because, as we will show, at every level of the PEM process, corruption involves breaking the law, the public trust or rules of behavior.

A definition which brings us to the heart of the public sector is proposed on page 1 of the TI Source Book<sup>5</sup>.

"Corruption involves behavior on the part of officials in the public sector, whether politicians or civil servants, in which they improperly and unlawfully enrich themselves, or those close to them, by the misuse of the public power entrusted to them." The TI definition summarizes well the many aspects of corruption, shedding light on unethical and unlawful behavior with the purpose of personal enrichment.

There is, however, another aspect of corruption, which in the public sector is paramount, and that is, the subversion of not only the means but also the ends of public sector activities. This aspect of corruption is perfectly captured by Susan Ros-Ackerman on page 2 of her book<sup>6</sup>, "Whenever an agent is given discretionary authority, corruption provides a way for the objectives of the higher authority to be undermined." In the present paper we will strongly emphasize this aspect of corruption because we believe that subverting the ends of public sector activities has an effect far more severe and damaging than the personal enrichment of unscrupulous officials.

## II. Corruption in the Public Expenditure Management Process

### A. Government financial management

An analysis of corruption in the public expenditure management process cannot be analyzed in isolation of government financial management and therefore, at this point, a description of the nature of governmental activities is needed. The government of a country consists of the public authorities and their instrumentalities, established through political processes, exercising a monopoly of compulsory powers within a territorial area or its parts, motivated by considerations of public purposes in the economic, social, and political spheres and engaged primarily in the provision of public services differing in character, cost elements, and source of finance from the activities of other sectors.

The principal function of government, as indicated above, is to carry out public policy through the production of nonmarket services primarily for collective consumption and the transfer income, financed mainly by compulsory levies on units in other sectors. Thus, government performs primarily the functions of supplying certain public goods and services and fulfilling certain public purposes not for commercial or financial reasons, or, if a commercial or financial nature, not on a major basis or not primarily for a profit.

Government financial management in this context, is the management of revenue, expenditure, cash, lending, borrowing, and debt operations associated with governmental activities. Within the government financial management, the task of public expenditure management is the management of all operations except revenue operations.

### B. The analytical framework

The analytical framework of our study is illustrated in Figures 1, 2, and 3. [Figure 1](#) shows the allocation of resources between

the private and public sectors in a market-oriented economy. It also shows that public sector resources are allocated through the central and local governments.<sup>7</sup> Resources of the central government are allocated to different functions such as education, public health, infrastructure, agriculture, etc. Within one function resources are further allocated to the payment of wages and salaries, the purchase of goods and services, interest payments, etc.<sup>8</sup>. Added together, these resources make up the **budget of the central government**.

[Figure 2](#) shows the process of identification of public needs and the determination of the quantity of goods and services to satisfy these needs through the political process, assisted by economic analyses (budget making, budget preparation). [Figure 3](#) shows how the delivery of goods and services is organized through the implementation of the budget. The budget implementation process is carried out under the constraints of; **accountability, effectiveness, efficiency, and transparency**<sup>9</sup>

**Accountability** is defined as the obligation for those officials, who are empowered to commit and disburse public funds to account for each transaction. Depending on the nature of the transaction, officials may be, not only administratively, but also legally responsible for carrying out transactions as prescribed by relevant laws and regulations.

**Effectiveness** measures the contribution of the output, produced by expending resources, to the stated objective.

**Efficiency** is a measure of how much output is produced with a given amount of input (resources spent).

**Transparency** dictates that all transactions should be easily and clearly identifiable.

This analytical framework, although highly simplified, will allow us to make a distinction between political decisions, on the one hand and economic and budgetary decisions on the other. Such distinction is necessary because we want to show that corruption may be present at every level from the political process of budget making to the disbursement of public funds. Thus, all along our study, we will distinguish between **political** and **administrative (bureaucratic corruption)**. However, in view of the stated purpose of our study we will analyze administrative corruption in more detail.

### C. Political corruption in the PEM process

In her book "*Corruption: A Study in Political Economy*," Susan Rose-Ackerman proposes a useful distinction between legislative (political) and bureaucratic (administrative) corruption. In the present paper, we will follow a similar but not identical distinction. Corrupt behavior or/and corrupt activities which take place during the budget preparation phase, where political decisions are predominant, will be qualified **political corruption**<sup>10</sup>. Political corruption occurs when political decision-makers independently, or in collusion with corrupt officials, will divert public resources in a way that will reduce the welfare of society or will be contrary to public interest<sup>11</sup>. Corrupt behavior and/or corrupt activities which take place during the budget execution phase, where economic and administrative decisions are predominant will be qualified **administrative corruption**<sup>12</sup>. Political corruption has particularly damaging effects on the allocation of resources because it will produce an allocation that will be different from the one that would have been arrived at through a corruption free process. In other words, political corruption will divert resources from functions to which a corruption free legislative decision-making body would have allocated a given amount of resources based on its interpretation of public needs and priorities.

Let us suppose that the legislative decision-making body, free of corruption, would have approved a budget represented by the following function:

$$G = Q_1F_1 + Q_2F_2 + Q_3F_3 + \dots + Q_nF_n$$

where  $Q_1$  represents the amount of resources allocated to function  $F_1$

Let us suppose that because of corrupt political behavior the budget approved will be as follows:

$$G' = Q'_1F'_1 + Q'_2F'_2 + Q'_3F'_3 \dots + Q'_nF'_n$$

where

$$Q'_1F'_1 < Q_1F_1$$

$$Q'_2F'_2 < Q_2F_2$$

$$Q'_3F'_3 > Q_3F_3$$

If for the sake of argument we suppose that  $Q_1F_1$  represents the budget of the health sector;  $Q_2F_2$  the budget of the education sector; and  $Q_3F_3$  the budget of public works, it is clear that resources have been diverted from social functions to public works. There might be many reasons for this. The search for political gain by building roads or bridges in selected regions of a country, misguided construction projects for political prestige purposes, or simply because public works provide a fertile ground for obtaining substantial monetary rewards from privileged contractors, who in return, will not have to submit to a rigorous bidding process to win contracts.

Political corruption will also have an effect on the allocation of resources among economic categories. when public sector employment is used as a reward for political loyalty, more resources will have to be devoted to wages and salaries. The use of

the budget as an instrument for channeling subsidies to state enterprises for the purpose of providing employment to political allies will have the same effect on resource allocation<sup>13</sup>.

As a result of political corruption, the budget may end up to be larger than macroeconomic consideration and a realistic fiscal policy would dictate, requiring more borrowed resources to finance a larger deficit -- imposing increased interest charges in the years to come.

The extreme case of political corruption is the capture of the apparatus of the state by a political group in order to use the redistributive functions of the state to divert public resources to the members of the group. By also capturing the legislative powers of the state, the political group in power will use legislation to lock-out rival political groups. In such situation those who are locked out will have to buy access to state economic activity (which will be restricted by appropriate legislation) by paying bribes. Thus, political corruption will generate administrative corruption.

#### D. Administrative corruption as rent-selling by government officials

In the literature on corruption, corrupt behavior is often seen as rent selling by government officials, who, because of their participation in the process of governing might facilitate or impede the process, using or misusing their discretionary powers (granted to carry out their official duties) or through the influence or relationship they have with other government officials<sup>14</sup>.

In countries where economic activities are heavily regulated by the State, officials who are entrusted with the task of making sure that these regulations are observed, are in a position to augment their official salaries by manipulating these regulations in favor of economic agents who are willing to pay bribes. In some cases, very high-level officials are in a position to directly issue regulations beneficial to economic agents who are willing to pay the price for such favors.

Economic agents who will benefit from the manipulations of rules as described above, and who will reward the corrupt activities of government officials are **rent-seekers**. If, for instance, the regulations restrict the production of a given commodity, then successful rent-seekers will be able to sell their product at high price and earn substantial profits. In other cases, rules and regulations, manipulated or "custom made" by corrupt officials, may fix prices at an artificially low level and restrict the access to a selected few who, then will have the opportunity to purchase goods and sell them at substantially higher prices. Agents who were not granted access will also try to purchase the right of access by offering bribes to officials, and therefore, will provide a further opportunity to officials to secure illegal income from corrupt behavior.

If rent "selling" and "buying" is pervasive enough, resource allocation will not be effected through the market but by the actions of corrupt government officials. Many authors have emphasized that the type of "rent buying" by economic agents and the manner in which corrupt officials "sell" rent, is strongly correlated with the nature of the political system of a country. Because the purpose of our paper is limited to the examination of corruption in the public expenditure management process, we cannot engage in an extensive discussion of this issue in the present paper. We have to mention, however, that corruption appears to be much more pervasive in dictatorships than in democratic- regime countries. (This is amply corroborated by the corruption index prepared by Transparency International.) This is so, first: because in a dictatorship, the ruler civilian or military, is in a position to issue regulations in favor of selected economic agents without any restrictions; second, it is highly unlikely that government officials who engage in corrupt activities, within the limits tacitly agreed with the dictator, will be punished.

#### E. Administrative corruption<sup>15</sup>

As shown in [Figure 3](#), once the budget is approved by the legislative decision-making body, the budget preparation phase comes to an end and budget implementation begins. Budget implementation is the responsibility of the administrative units of the executive branch, specifically of the Ministry of Finance, spending ministries and spending units. In most countries of the world (in theory at least) the implementation of the budget will take place within well defined rules and procedures provided by a legal framework, accompanied by a set of administrative rules.

The processes of the implementation of the budget can also be viewed as the operating of a **delivery system**. In fact, the very reason for having a government budget, is the delivery of goods and services to the citizenry. The operational framework for the delivery system is provided by laws and regulations, as mentioned above, and by well specified procedures and techniques. The system is operated by officials in charge of specific tasks such as commitments, verification, disbursements, accounting, controlling, etc. The recipients of the system are all those who are entitled by virtue of being citizens or residents, or by specific entitlements, to receive goods and services free or against payment of well-defined fees. The **business partners** of the system are suppliers of inputs which are necessary for the delivery of goods and services.

#### The implementation of the budget: delivery of goods and services

After the budget has been approved by the legislative decision-maker, it is the task of the executive branch of the government to implement it exactly as prescribed in the budget approved.

In almost every country in the world the budget document is rather detailed, showing the approved allocation of resources not only by ministries but also within ministries among different categories of expenditures. For instance, if we look at the budget of the Ministry of Education, the budget will show the total amount of resources allocated to primary schools. Within this total,

resources allocated to the payment of salaries and wages, to the purchase of goods and services and to other purposes will also be shown. In the budgets of many countries, the allocation of resources will be shown down to the level of expenditure items such as, for instance, the purchase of a piece of equipment for a given primary school.

In our analysis we will follow the phases of the budget implementation process as shown in [Figure 3](#).

### **Budget appropriations**

Spending ministries and spending agencies are notified by the Ministry of Finance of their budget appropriations for the fiscal year. Although this information is exactly the same as the one provided in the budget document, there is one important difference. The notification by the Ministry of Finance is also a spending authorization for the fiscal year. During the phase there appears to be little or no room for corrupt activities.

### **Apportionment**

Before ministries and spending agencies may incur an obligation to make expenditures they must secure spending authorization from the Ministry of Finance. Spending authorizations are not granted in block for a whole year but rather . The length of period of spending authorization is determined in function cash flow forecasts for the period when payments are anticipated. There are times when cash resources are so scarce that a "cash rationing" must be imposed. In that case, spending authorizations are given on a daily basis at the discretion of a high level official invested with the power of deciding immediate priorities.

During this phase of budget implementation there are many possibilities for **interventions** and **manipulations** in view of the fact that one official, or a group of officials has (have) a great amount of discretionary power to decide which spending ministry or agency will be granted spending authorization. If the spending authorization is not granted on schedule, a ministry will not be able to make commitments and, therefore, goods and services will not be ordered on schedule.

The official in charge of issuing spending authorizations might favor a given ministry because of political affiliation or he/she might do so because he/she will be rewarded for this corrupt action. The official, for instance, might favor the Ministry of Public Works in order to make sure that the ministry is able to contract major suppliers from which he/she will receive monetary rewards.

### **Commitment**

During this phase, goods and services are ordered and resources are committed up to the concurrent amounts meaning that these resources will become unavailable for other purposes. Generally, budget laws are very specific regarding commitments. They prescribe that resources may be committed only for ordering goods and services that are authorized in the budget for a given fiscal year and only up to the limit authorized in the budget.

In spite of the specific nature of budget laws, the commitment phase of the expenditure process is a fertile ground for corrupt activities. The most frequent, and perhaps the most damaging of these is the partial or total disregard of procurement laws and procedures. **Procurement laws and procedures** specify the price and quality of goods and services that are authorized in the budget. They also specify the delivery schedule, terms of delivery and payment as well as contingent supplementary services such as maintenance and warranties. Last, but not least, they specify the procedure which will have to be followed by competing bidders. Prescriptions for prices, quality, quantity as well as for terms of delivery can be disregarded in favor of one supplier who is ready to offer a bribe to corrupt officials.

As the government is a major purchaser of goods and services, bending the rules in favor of a few suppliers will have a serious effect on others, who in some cases will be shut-off from governmental businesses for years. These practices will also discourage potential entrepreneurs from entering the market and therefore "privileged enterprises" will find themselves in a more and more dominant position. They will not fail to profit from such position by gradually increasing their prices<sup>16</sup>.

Another possible case of corruption is the ordering of goods and services which are not authorized in the budget. In this case corrupt officials will simply disregard the budget as approved by the legislator and will purchase, for instance luxury cars instead of trucks or other needed equipment Needless to say, commitment of resources for goods and services not authorized in the budget will pre-empt commitment for those that are authorized, unless, of course, the size of the budget is increased.

### **Receiving/Verification**

Possibilities for corrupt behavior during this phase are narrowly linked to those in the preceding phase because without collusion between officials who are in charge of commitments and those who are responsible for receiving/verification, corrupt activities would be discovered. The task of officials who are entrusted with receiving and verification is precisely to check if all the specifications mentioned previously were respected. Budget laws of many countries prescribe that if at the receiving/verification phase it is discovered that goods and services non conforming to specifications, or not authorized in the budget, were ordered, commitments must be canceled. Unfortunately, because of collusion among corrupt officials verification procedures are not carried out and the existence of illegal commitments will not be revealed at this stage.

Goods non conforming to specifications might, in the end, turn out to be very costly. The use of substandard material in a

construction project, or of an insufficient quantity of material, might well have catastrophic effects. Needless to say, the purchase and the subsequent use of medical products which do not conform to specifications might have extremely tragic consequences.

### **Preparation and issuance of payment orders**

Corrupt behavior during the phase of preparation and issuance of payment orders is essentially the same as during the precedent phases. It is based on the disregard of laws, rules and regulations, principally for illicit monetary gains. Officials in charge of the preparation and issuance of payment orders have the obligation to verify that transactions made during the preceding phases were carried out exactly as prescribed by laws and regulations in effect. They are in a privileged position to contradict the expectations of corrupt officials and advantage seeking suppliers by simply not issuing payment orders.

#### Payment arrears and the issuance of payment orders

If cash is not available for payment when goods and services are delivered in due form, the government will incur arrears; that is, invoices will not be paid when due and suppliers will have a claim on the government. Incurring arrears is a "time honored practice" in many countries and is accepted as such. When a government incurs arrears because of shortage of cash and/or inadequate cash management practices, payments might be postponed for a few days, or perhaps a few weeks. Suppliers will go along with these practices and accept the inconvenience as the "cost of doing business with the government."

However, the behavior of suppliers is markedly different if payments are late by months or in some cases, not too infrequent, by years. As these suppliers depend on government business for their survival, they have no alternative but to wait. Naturally, they will try to recuperate their losses and will, at the very first opportunity, overcharge the government, or will deliver substandard goods. There is also a "time honored practice."

Some suppliers will, of course, find other ways to ensure that they will get paid as soon as possible. They will bribe the official in charge of issuing payment orders, who in turn will establish an unofficial schedule for paying arrears. Usually the bribe may take the form of a simple payment, the amount of which will be negotiated with the official, or a percentage of the payment made to the supplier.

In cases where a small number of suppliers will be paid first and others later, or not at all, the "ranking" of invoices will have a detrimental effect on some enterprises. Those enterprises not willing to pay bribes to corrupt officials will be quickly eliminated, while those which are paid late but regularly (thanks to their "investments in bribes") will have their position on the local market reinforced. Needless to say, they will not fail to make every effort to recuperate their "investments in bribes" by increasing their prices as soon as possible.

### **Payment**

Possibilities for corrupt behavior are less numerous if payments are made through the banking system. Once a check is issued it is difficult to interfere with payments. However, in some countries payments can also be effected through "Cashier's Offices", especially in countries where the banking system is not sufficiently developed. These offices are provided with cash from the Central Cashier's Office and/or might keep revenues collected at the local level. Such system is not immune from corrupt practices. The practice of "ranking" invoices representing arrears will be profitably repeated.

The payment phase is often exploited by unscrupulous officials to organize large scale fraudulent schemes involving the payment to fictive (ghost) employees. As the payment of salaries and wages is not subjected to the standard expenditure process corrupt officials will make payments to nonexistent (often deceased) employees and/or will make unauthorized entitlement payments to existing employees. Needless to say, in the end, the proceeds of these illegal transactions can be shared with all the participants of these fraudulent schemes.

Regarding pension payments, the behavior of corrupt officials will be different. In that case, they will slow down or stop payments until "speed money" is offered and paid. It is not unusual that retirees are obliged to wait twelve to eighteen months before their monthly checks begin to arrive.

In cases of severe cash shortages, when daily cash rationing must be imposed, spending ministries and agencies will be competing for cash to pay the wages and salaries of their employees as well as to pay their suppliers for goods and services delivered. In such situation the establishment of an order of priority among competing claims is essential. The official in charge of the task is a high-level official, frequently a Deputy Minister of Finance.

It must be observed that the official in charge of daily cash allocations is invested with an enormous amount of discretionary power, which can be used, and is frequently used, for corrupt purposes. Usually, cash shortages will not disappear at the end of the year, therefore, some spending ministries or agencies will not be able to make expenditures up to the limit authorized in the budget. In other words, they will not be able to pay their employees and deliver goods and services as authorized in the budget. The official in charge of the daily cash rationing will be able to rearrange budget priorities for the year by manipulating the allocation of cash resources for the purpose of favoring selected spending ministries and agencies.

We would argue that in this case, the motivation of the corrupt official (political or personal gain) is not the most important consideration. What is important is to realize that in this case, the decision-making power of the legislative body, which

approved the budget, was usurped by an official of the executive body. The argument can be made that this should be seen as the most serious form of corruption, the **corruption of the public decision-making process**.

### III. Extrabudgetary Transactions

The process described above is not applicable to transactions effected through extrabudgetary funds, special accounts and earmarked funds. The very purpose of establishing these funds and accounts is to exempt some transactions from standard budgetary procedures. There are many justifications for creating such funds and accounts, some honorable, others dubious. The result on the public expenditure management process is, however, the same. The legislative as well as the executive branch will have given up their rights to control a part of public resources. While it should not be assumed automatically that these resources will be misappropriated, misspent or stolen, it remains true that a lack of appropriate control procedures will create a fertile ground for corrupt behavior.

There is ample evidence to the effect that "little empires" were built with public resources through the use of extrabudgetary or/and earmarked funds. In some cases the bank accounts of these funds are flush with cash, when the Ministry of Finance lacks resources for financing general budget expenditures, and in the end has to borrow at considerable cost, or is obliged to incur arrears. Often times, the result is that expenditures of the general budget are not made and, therefore, goods and services are not delivered to the citizenry.

Extrabudgetary funds, special accounts and earmarked funds provide a good example of an area where political and administrative corruption are entwined. In some cases extrabudgetary funds as well as earmarked funds are set up for perfectly valid reasons and might function corruption free. However, as soon as these funds accumulate resources they will be coveted for political reasons as well as for personal enrichment. It is a well known fact that in many countries, including some of the most industrialized ones, political parties are financed through these funds. A certain level of "political tolerance" will not fail to foster an environment where corrupt activities for personal gain will have to be tolerated. It is, therefore, not surprising that the political will to fight administrative Corruption is lacking in many countries.

### IV. Departmental Enterprises

Similarly to extrabudgetary funds, departmental enterprises might be established for perfectly honorable reasons and might function corruption free. Departmental enterprises were especially numerous in Central and Eastern European countries at the time when the then centrally planned economies began to experiment with a somewhat less centralized economic regime. At the time, it was argued that budgetary control had to be relaxed in order to allow these enterprises to be "managed" more efficiently. Over the years, the combination of a relatively more efficient management as well as a privileged position as suppliers of goods and services made some of these enterprises into powerful economic entities. It is therefore, not surprising that even after the transition to market-oriented economic regimes these enterprises continue to exist.

Departmental enterprises offer an interesting case for studying the collusion between political and administrative corruption. In spite of the fact that some of these enterprises have accumulated substantial cash resources they continued to receive yearly transfers from the general budget, regardless of their financial situation. Although, it is difficult to document individual cases and show exactly how funds were diverted to private use, it remains true that the "powers that be" of these enterprises lived well beyond the means of their official salary and accumulated substantial wealth. It was an indication of their power that the Government had to request **yearly budgetary contribution from these funds** while it was still transferring budgetary resources to these enterprises. It could be argued that departmental enterprises, organized along the lines described above, represent a good illustration of total confusion between **public** and **private** resources.

### V. Private Production on Public Premises

During the last days of the Communist regimes in Central and Eastern Europe, employees of selected ministries were given the possibility to set up "cooperatives" on the premises of the ministry. Thus, for instance, the employees of the Ministry of Finance were allowed to set up a consulting group providing Computing services for the Ministry of Finance itself, as well as to other ministries. The group was given the permission to use, after regular working hours, all the facilities of the ministry. Work of the ministry that could not be finished during the day was frequently "contracted out" to the cooperative to be completed after hours.

Some of the cooperatives became successful very quickly as the quality of the services they provided were far superior to those provided by officials during regular working hours. These officials/consultants saw themselves as the precursors of private entrepreneurs and took great pride in their accomplishments as well as enjoyed substantial revenue generated by their "Consulting" work. Also, they competed successfully against private consulting groups, which in the first years of the transition period tried to enter the market.

Strangely, members of these cooperatives were oblivious to the fact that their success was principally due to three factors which had very little to do with competitiveness. First, they did not have to incur any investment cost to set up their "cooperatives;" everything was provided by the state from public resources. Second, their operating costs were also paid from public funds. Third, they were the sole providers of services to the government<sup>17</sup>.

### VI. The Cost of Corruption

In the preceding pages, in line with the purpose of the present paper, we have discussed corruption in the PEM process. We have seen that, because of the discretionary power they are invested with, officials might divert public resources to enrich themselves, the members of their families, the political group or party they belong to. They might also extract payment for performing their official duties.

The literature on corruption has extensively discussed the consequences of this rent seeking corrupt behavior emphasizing its illegal and criminal aspects. While we fully agree with such emphasis, we believe that in order to appreciate the total cost of corruption, the other dimensions of corrupt behavior should also be discussed.

What should be discussed is the full cost of corrupt behavior in terms of resources wasted, the opportunity cost of resources misused, and the inefficiencies introduced in the system. For instance, what would be the full cost of an interrupted construction project that is an important element in a larger project? What would be the repercussions on health care if this project is a major health care center? What is the cost of factories which will not reach the operational stage as scheduled, because resources are not available due to corrupt actions. These questions are, of course, difficult to answer without extensive analyses for which information probably is not available.

The point we would like to make is that the downstream effects of corrupt actions might be very costly and totally out of proportion of bribes received by corrupt officials. We would also argue that if the full cost of corrupt activities could be easily calculated, corruption would be seen as much more serious activity as it is seen today. It can be safely surmised that arguments such as "corruption is necessary to make transactions easier" or "corruption is a necessary lubricant for machinery of the state" would not be so easily accepted.

Another dimension of corruption that we would like to emphasize is its effects on the decision-making process which cannot be measured in monetary terms. As expressed by Susan Rose-Ackerman, "corruption provides a way for the objectives of the higher authority to be undermined." Corrupt officials, by diverting resources from their intended purposes, will change the allocation of resources as intended and approved in the budget. Thus, the decisions of the legislative body will be undermined and in the end, the budget implemented will be different from the one approved. What has to be appreciated in this regard is the fact that the democratic process had been altered by the action of corrupt individuals. In our view, this is the most serious consequence of corruption far more damaging than the personal enrichment of corrupt officials.

## VII. How to Lessen Corruption in the PEM Process

In the previous chapters, we have discussed how corrupt activities occur in the different phases of public expenditure management process. The purpose of the present chapter is to discuss measures which would help to lessen corruption. At the outset we must acknowledge that eradicating corruption in the PEM process is probably not possible, principally for three reasons. **First**, whenever discretionary power is granted, there is the possibility that it will be misused--and without discretionary power, the management of a complex process would not be possible. **Second**, although, in theory, it is conceivable to set up a system of controls where checks and balances would ensure that every action of every official would be controlled in such a way that corrupt activities would be precluded, in practice, the cost of operating such a system would be prohibitive. **Third**, such a control system would be cumbersome and would produce too many bottlenecks.

In discussing measures which would help to lessen corruption, it is necessary to revisit the distinction between **political** and **administrative** corruptions discussed earlier. Political corruption occurs mainly during the budget preparation phase where political decisions are predominant. The perpetrators of corrupt activities are political decision-makers (elected officials) or individuals who have the power to influence such decision-makers. Administrative corruption occurs during the budget execution phase, where economic and administrative decisions are predominant. During this phase, civil servants (appointed officials) will be the perpetrators of corrupt activities.

It has to be acknowledged, however, that it does not seem to be possible to design a strategy aimed at lessening corruption in the PEM process independently of a wider strategy which would take into account legal, political, economic, societal and behavioral aspects of corruption. It is not difficult to see why. In a country where the legal system, the socio-political rules as well as behavioral norms are such that Corruption is pervasive at all levels, efforts to fight corruption in one segment of the society, or in a given area of activity, would be an exercise in futility. If corruption in the political class is a well-accepted fact, government officials will not be restrained from engaging in corrupt activities. In fact, the argument can be made, that in many cases, officials will not be able to observe rules and regulations because politicians will want them to engage in corrupt activities in order to divert resources to the benefit of the political class.

Concerning anti-corruption strategies, it is important to consider two political aspects of such an undertaking. First, the decision to organize an anti-corruption campaign is eminently political. To the knowledge of the author of the present paper there is no known example of an anti-corruption campaign which was initiated at another level than the political level. Second, an anti-corruption effort, if to be successful, must have the commitment of the political leadership<sup>18</sup>.

It is widely acknowledged that in addition to the commitments of the political leadership, a successful anti-corruption campaign must have the following features (1) a set of measures designed to reduce both the opportunities and need for corruption and (2) the creation of an agency which would be in charge of supervising the implementation of these measures.

The narrow scope of this paper will not allow us to discuss all the aspects of an anti-corruption campaign. As explained earlier,

our purpose is to explore how to lessen corruption in the PEM process and to propose relevant measures for doing so. Notwithstanding this self-imposed restriction, it must be emphasized that the measures proposed herein for lessening corruption in the PEM process must be viewed as a part of a broader anti-corruption campaign, the elements of which have been described above. It bears repetition, that undertaking an anti-corruption campaign limited to the PEM process would be an exercise in futility.

### **A. Measures to lessen administrative corruption**

In the present chapter, we will follow an approach similar to the one followed in the first part of the paper. We will examine each phase of the PEM process and try to propose measures that would help in lessening corruption.

In the first part, we have seen that public officials were able to engage in corrupt behavior essentially for three reasons. **First**, the lack of an adequate legal framework accompanied by relevant rules and regulations is easily exploited by astute officials who can engage in quasi illegal activities without the risk of being punished. **Second**, and by far the most frequent, the blatant abuse of discretionary power. **Third**, collusion among corrupt officials to circumvent checks and balances built into the system. The measures we are going to discuss must therefore be aimed to these areas.

#### **Adequate legal framework**

There are very few countries without a legal framework regulating public expenditure management<sup>19</sup>. However, often times, it lacks in coverage and/or not detailed enough. Regarding the lack in coverage, a case in point is the extensive use of extrabudgetary funds, earmarked funds and special accounts. While the legal framework might cover adequately transactions effected through the general budget, those effected outside of it are not covered in a way which would preclude the possibility of officials engaging in quasi-illegal activities. It is also the case when the government is a seller of natural resources, state property or other marketable goods to the private sector. In the countries in transition, this is perhaps the most fertile ground for misappropriation of public resources, exactly because of the lack of an adequate legal framework.

Procurement procedures in many countries provide a good illustration of a legal framework not providing precise rules and regulations. It is, therefore, with impunity that corrupt officials will use these procedures to favor suppliers who are ready to offer bribes and other monetary incentives to secure contracts.

#### **Issues in designing an adequate legal framework**

A legal framework for public expenditure management should combine legal principles with economic consideration as well as management rules. It should ensure that public resources are used within the limits set by the Legislative Branch and in compliance with the allocation schedule authorized in the budget document<sup>20</sup>. Therefore, changing or amending the budget legislation is always a lengthy and painstaking process. The real or perceived difficulties in doing so might be an explanation why it often becomes inadequate in coverage or in details.

These difficulties should not be exaggerated however, because in many countries, and even the most developed ones, the legal framework does not always provide a complete coverage for all the PEM functions. Rather, some functions are covered by regulations and administrative instructions issued on an ad hoc basis by the Executive Branch. Regulations and administrative instructions can be issued simultaneously with the annual budget law and can remain in effect for a year or for several years as long as they are included in the successive budget laws.

Although problems of lack of coverage concerning extrabudgetary transactions cannot be easily remedied through issuing regulations, other issues such as procurement, selling of government properties, can be effectively addressed<sup>21</sup>.

#### **The abuse of discretionary power**

The most frequent source of corruption in the public expenditure management process is the abuse of discretionary power. Discretionary power, as we defined earlier, is a power of decision or choice granted to a government official to carry out an official duty. This duty might be the making of an expenditure commitment, expenditure payment, selling government property, calculating the amount of subsidy payment, procurement of goods and services, etc. In some areas, such as payment of expenditures committed, the discretionary power given to an official might be almost inexistant, and very substantial in other areas, such as the selling government property. As corruption is the use of the discretionary power for private purposes, the temptation is great to argue that in order to eradicate corruption, discretionary power should not be granted to officials. Unfortunately, experience shows that a public expenditure management system without discretionary power will not work, and, therefore, other solutions will have to be found.

In the earlier chapters we have defined the public expenditure system as a delivery system the objective of which was to deliver goods and services to the citizenry. The elements of the system are procedures, processes, and techniques and operators of the systems, i.e., public officials. Therefore, if we want to lessen corruption, we should propose measures which would be aimed at the **system** and/or at the **operators of the system**.

#### **Systemic measures**

In general, systems can always be improved by introducing more checks and balances. However, as there is a trade-off

between complexity and the ability to operate a system with ease, the multiplication of checks and controls should not be envisaged lightly. Nevertheless, reinforcements in four areas would make it more difficult for officials to engage in corrupt activities.

### **Controls at the commitment phase**

As explained earlier, the commitment phase is crucial in the PEM process. During that phase, resources are committed for a purpose and thus will be unavailable for others. A control exercised by an official, independent from the official of the spending ministry who is authorized to make commitments, would certainly lessen the possibility of corrupt behavior at this stage. In some countries, notably in France and Belgium, an official of the Ministry of Finance assigned to a spending ministry, will oversee the commitment process and verify not only the legality of commitments made by the departmental authorizing officer but will also make a judgment on the effectiveness and efficiency of the committed expenditure.

### **Strict separation of administrative and financial functions**

Commitment, verification, and the issuance of payment orders are administrative functions. Only payment is a financial function when money has to be paid out from public coffers. A basic principle of financial administration is that the official responsible for making payments should not be the same as the one who authorized the payment. Also, the official who is disbursing public monies should have the power to check that all previous operations (commitment, verification and the issuance of payment orders) were carried out according to rules and regulations. It is also important that the official making the payment be from the Ministry of Finance and not from the spending ministry. Thus, the possibilities of collusion between officials will be reduced.

### **Adequate accounting records**

The maintenance of adequate accounting records for each transaction is a safeguard against corruption. If each transaction is properly accounted for and adequately documented, and records are kept by the spending units for each phase of the transactions, corrupt officials will find it more difficult to divert public resources for private use. In any event, if they engage in such activities, they will know that subsequent auditing will reveal their corrupt activities.

### **External audit and controls**

Control, audit and evaluation are viewed as valuable instruments for improving government fiscal management and for increasing the efficiency in the allocation of public financial resources. Current budgetary practices in many countries suggest that after the completion of the budgetary cycle--budget preparation and implementation--results must be assessed retrospectively so that officials can be held accountable for results achieved.

Traditionally, parliamentary scrutiny of whether the executive had used public funds in manners intended and approved by the legislators was defined narrowly, usually as compliance auditing.

With the rapid growth in the scale and complexity of government operations, the audit function has evolved to take a more comprehensive view of the economic and social implications of the way resources have been used. This approach to auditing, which has many dimensions, is usually summed up as the "three Es"--economy, efficiency, and effectiveness-- what is termed in many countries as "value-for-money" (VFM) auditing. In other countries, this type of audit is referred to as performance or operational audit. With this move toward VFM, audit and evaluation can better serve to "close the loop" of the budgetary resource allocation cycle and are thus increasingly viewed as valuable instruments for improving budget preparation and budget execution.

The reinforcement of both traditional and VFM auditing should be seen as essential measures against corruption. The introduction or reinforcement of VFM auditing would be particularly important because it intervenes before resources are committed. Therefore, corrupt activities could be stopped before they would have an impact on the use of resources.

### **Actions aimed at officials**

In the previous sections, we have discussed measures aimed at reinforcing the public expenditure management system in order to prevent possibilities of corrupt behavior. In the present section, we will explore measures aimed at the operators of the system, i.e., officials.

As explained previously, it would be very difficult, if not impossible, to design and operate a system without officials having discretionary power. Therefore, the measures we will be discussing herein, should aim at lesser corruption by offering incentives to officials not to engage in corrupt behavior. Unfortunately, we will not be able to offer anything new. The literature on corruption is replete with proposals to that effect. Over the years, there have been committees set up, studies published, laws passed, all without tangible success. Officials were removed, fined, and sometimes jailed, and corruption still persisted. What are then the conditions for a successful effort to influence the behavior of public officials?

The **first condition**, as discussed earlier, is an effective reform of socio-political and judicial rules which would lessen political corruption, because as long as political corruption is pervasive, efforts to lessen administrative corruption will not be successful. It is not realistic to expect public officials not to engage in corrupt behavior when the head of the state and his

ministers are diverting public resources for their own enrichment, or more widely to the members of the politically dominant group.

In discussing other measures we, therefore, suppose that, indeed, such efforts are under way. The futility of trying to eradicate administrative corruption without, at the same time, addressing the causes of political corruption had been extensively documented in the literature and need not to be repeated here.

*The first line of defense* against administrative corruption is a good public administration based on an efficient and professional civil service. Such civil service would not only be a safeguard against corruption but would also guarantee that goods and services would be delivered efficiently. The establishment of a professional civil service would require that hiring decision and promotions should be based strictly on merit and that remunerations should be based on a realistic pay scale, at a level which would not oblige civil servants to accept bribes in order to make ends meet<sup>22</sup>.

*The second line of defense* against administrative corruption is the strict enforcement of rules and regulations. If an official knows that rules and regulations are strictly and consistently enforced he/she will less likely engage in corrupt behavior. The swift imposition of criminal penalties, where justified, will, of course, have the same effect.

*A third line of defense* against administrative corruption is legal action against those who enter into illegal transactions with public officials, i.e., those who pay the bribes. There seem to be no good reason to spare such people since they know perfectly well that by paying bribes they initiate and sustain illegal activities.

### Centralized versus decentralized PEM management

When discussing how to lessen corruption, the argument is sometimes made to the effect that a centralized management is preferable to a decentralized one because it offers more safeguards against corruption. In a slightly different form the argument is also used against the decentralization of PEM management.

It is true that decentralization, if not accompanied by appropriate changes in the control system, would increase the risk of corruption in the system. However, there is no reason to believe that a dedicated control system cannot be set up at any level of PEM management. Moreover, information technology available today offers the possibility to have accounting information in real time on any transactions at any level of the PEM process.

The danger lies in the lack of an appropriate legal framework or regulations which would prescribe the obligations of officials at the decentralized level. Often times, processes (not only PEM processes but others as well) are decentralized without any modifications of relevant regulations. In these cases "everything goes." Needless to say, in an environment of pervasive political corruption, the possible effects of decentralization on corruption, is not really an issue.

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### Notes and References

[1] In the words of R Klitgaard "Another issue of poor governance has recently gained salience, the formerly taboo subject of corruption." R Klitgaard, *Cleaning Up and Invigorating the Civil Service*, Report prepared for the Operations Evaluation Department, the World Bank, February 1997

[2] *The Search of the Smoking Gun*, *Euromoney*, September 1996, and also *IMF, World Bank Target Third-World Bribery*, *The Washington Post*, October 4, 1996

[3] Vito Tanzi, *Corruption, Governmental Activities and Markets*, *Finance and Development*, December 1995

[4] Vito Tanzi, *Corruption, Government Activities and Markets*, *IMF Working Paper*, WP/94/99, August 1994.

[5] *National Integrity Systems* the *TI Source Book* edited by Jeremy Pope, Berlin, February 1996

[6] Susan Rose-Ackerman, *Corruption, A Study in Political Economy* *Academic Press*, New York, 1978

[7] The analysis in the present paper will be limited to the PEM process in the central government.

[8] For the classification of expenditure according to functions or to their economic nature, see *A Manual on Government Finance Statistics* (GFS Manual), IMF, 1986, Washington, D.C

[9] It is often argued that there is an additional constraint "macroeconomic compatibility," i.e., the size of the budget should not exceed of what is desirable for fiscal policy. We would argue that macroeconomic compatibility is a constraint for fiscal policy and not for public expenditure management.

[10] In this paper we will not try to establish a link between corruption and different political systems. We will assume for the sake of simplicity and brevity that officials in any system can be corrupted. We do not ignore however that according to the ranking published by Transparency International, corruption is much more widespread in dictatorships than in democracies.

[11] In the political science literature "political corruption" is often defined in a broader sense. In its highest form, it includes the falsification of electoral results through practices such as vote-rigging, fraudulent registration of voters and the buying and selling of votes. For the purposes of our study, however, we will follow the definition proposed above.

[12] Establishing a clear distinction is, of course, much more difficult in practice. As it will be shown, corruption for political reasons may well occur in the budget implementation phase.

[13] See Paolo Mauro, *The Effect of Corruption on Growth, Investment, and Government Expenditure*, *IMF Working Paper* WP/96/98, September 1996. Mauro shows that corruption may alter the composition of government expenditures, specifically by reducing the share of spending on education. Mauro also found that corruption might, in some cases, lower investment outlays and therefore, the rate of economic growth.

[14] Working through the relationship with other officials will create a "social capital" of mutual inter-dependence and obligations, see V. Tanzi, paper op. cit., p.6.

[15] There are other forms of corruption in addition to those which occur in the PEM process. One of the most frequent and most profitable is the manipulation of regulations by corrupt officials. This includes the issuance or non-issuance of regulations according to the objectives of those who are paying the bribes and the unlawful application of regulations. Examples of such manipulation can be found in V. Tanzi *Corruption, Government Activities and Markets*.

[16] It has been argued by several authors that in some cases corruption is necessary and even beneficial because procurement rules and regulations are cumbersome and are an impediment to "efficient ways of doing business." Therefore "efficient" businesses will find a way to lessen the burden of these regulations by paying bribes to corrupt officials. We see several problems with such arguments. First, there is no guarantee that those enterprises which are ready to bribe officials are the most efficient ones. In engaging in these corrupt activities they have proven that they are, indeed, efficient in offering bribes. Second, it would be difficult to argue that corruption is beneficial in any form. Because by its illegal nature, it cannot be regulated, it will spread and diversify, unchecked by any authority.

[17] A few years ago, the author was given the opportunity to participate in a discussion with representatives of several "cooperatives" in a Central European country. When the author pointed out these facts during the meeting, he was harshly accused of not being aware of "local conditions," and even more harshly of not being in favor of "private enterprises."

[18] There are other important political aspects such as the political context, scope and targets, the reasons behind the anti-corruption campaign, the political instrument used, the stimuli internal or external, political strategies used, etc. For a comprehensive discussion of these aspects, see K. Gillespie and G. Okruhlik, *The Political Dimensions of Corruption Cleanups*, in *Comparative Politics*, October 1991.

[19] In this paper, legal framework is defined as including laws and the accompanying rules and regulations.

[20] As explained earlier in the paper, the implementation of the budget will have to take place under the constraints of accountability, efficiency, effectiveness, and transparency.

[21] For a discussion of preparing a framework budget law for economies in transition, see Bill Allan: *Public Expenditure Management and Budget Law*, *IMF Working Paper* WP/94/149.

[22] Adequate civil service pay is only a necessary condition, not a sufficient one. As Susan Rose-Ackerman had observed, "Paradoxically, an official whose pay is boosted may demand higher bribes - to offset the risk of losing what is now a very desirable job" in Susan Rose-Ackerman *Redesigning the State to Fight Corruption*, World Bank, April 1996.

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## Figures

### Figure 1

#### Allocation of Resources in a Market-Oriented Economy

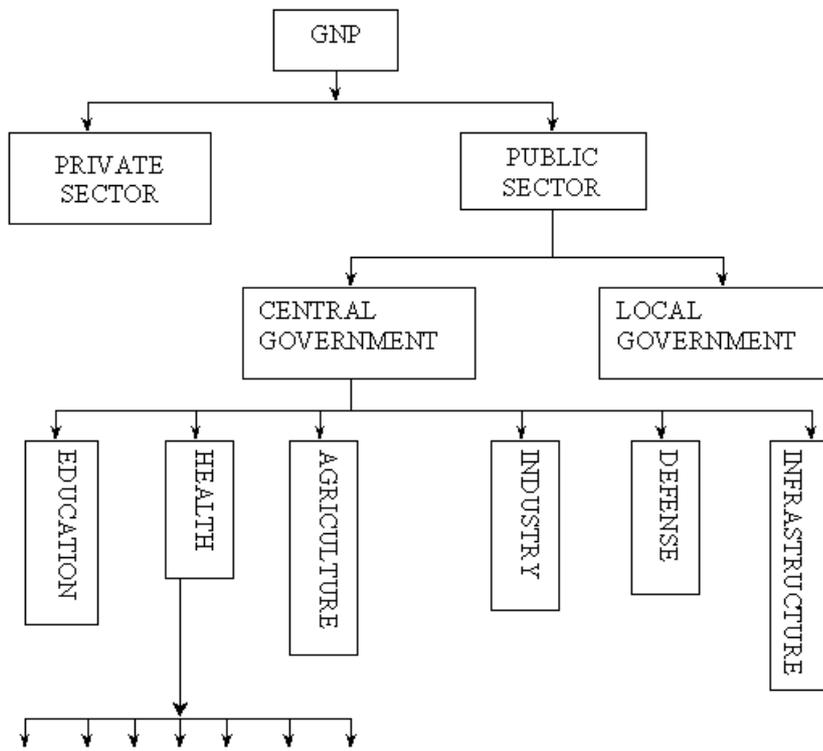


Figure 2

**Budget Preparation and Budget Implementation**

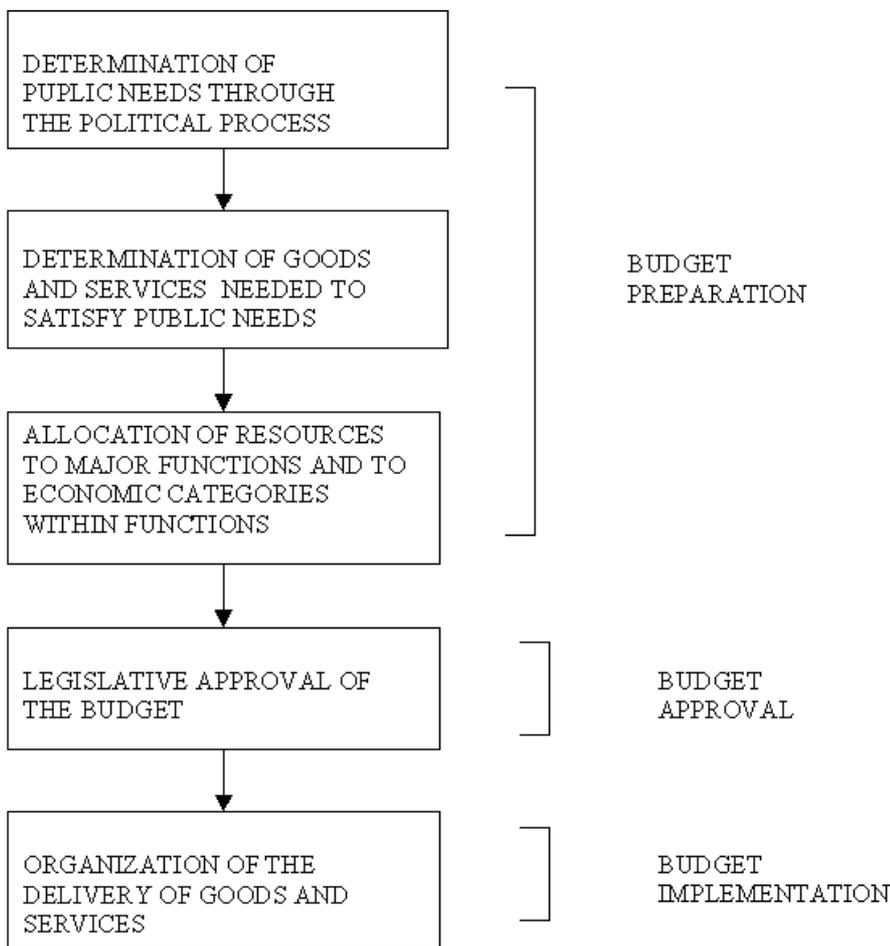
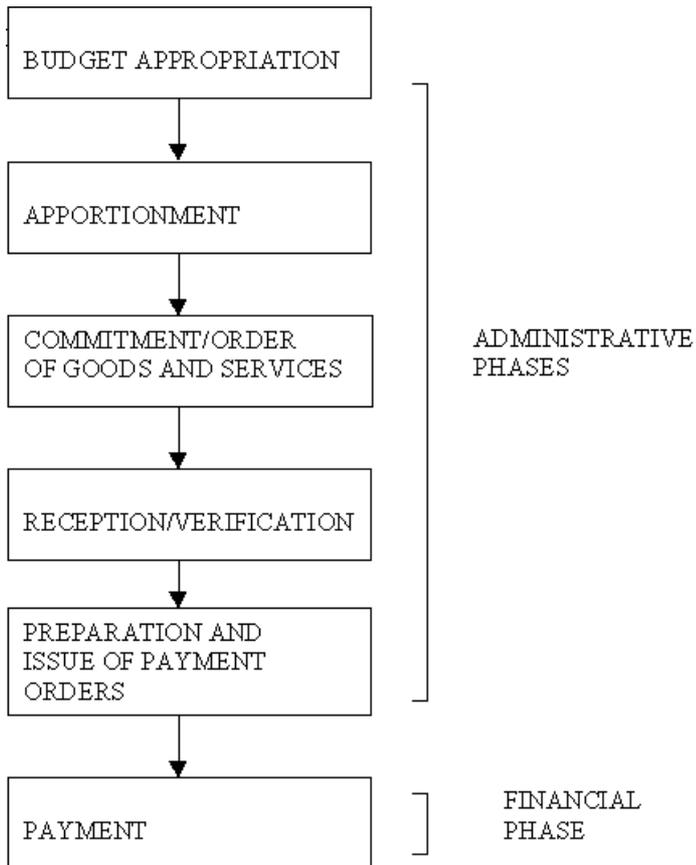


Figure 3

**Phases in the Budget Implementation Process**



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