CONSEQUENCES OF CORRUPTION AT THE SECTOR LEVEL AND IMPLICATIONS FOR ECONOMIC GROWTH AND DEVELOPMENT

Contribution by the OECD, in collaboration with the World Bank Group, to the G20 Anticorruption Working Group

9-10 June 2014

FOREWORD

This document has been prepared by the OECD, in collaboration with the World Bank Group, in response to a call by the G20 Leaders at their St Petersburg Summit in September 2013 to work further on corruption and growth, building on a previous *OECD Issues Paper on Corruption and Growth.*

It is comprised of two parts:

- Part I: Cover Note: Cross-sectoral analysis and policy implications on corruption and growth. It highlights the main policy conclusions that can be drawn from the analytical paper in Part II.

- Part II: Analytical Paper: Consequences of corruption at the sector level and implications for economic growth and development

This document is a first draft in progress, submitted in advance of the meeting of the G20 Anticorruption Working Group (AWG) in Rome on 9-10 June. Members are invited to pay specific attention to sections II.a and Next Steps of the Cover note which outline concrete proposals for step forward.

The draft will be reviewed after the meeting in light of the comments and views shared by the members of the AWG. A revised draft would be prepared and submitted to the AWG at its October meeting in Paris.

PART I

CROSS-SECTORAL ANALYSIS AND POLICY IMPLICATIONS OF CORRUPTION AND GROWTH

Prepared by the OECD in collaboration with the World Bank Group

Introduction

The G20 highlighted that corruption is a severe impediment to economic growth as early as the adoption of its first Anti-Corruption Action Plan in 2010. The OECD's 'Issues Paper on Corruption and Economic Growth', presented to G20 Leaders at the St. Petersburg Summit in September 2013, demonstrated that, "*while the direct link between corruption and GDP growth is difficult to assess, corruption does have significant negative effects on a host of key transmission channels, [...] – which impact significantly on economic welfare and, in the case of trust, also a country's development potential.*" Following encouragement by G20 Leaders in St Petersburg for the OECD to continue, in collaboration with the World Bank Group, work in this area, the G20 Anticorruption Working Group (AWG) agreed at its meeting in Sydney in February 2014, on the preparation of a paper to complement these results by examining the corruption-growth relationship in specific sectors, and looked for preliminary analysis and recommendations at the G20 AWG meeting in Rome in June 2014.

In response to this request, the paper annexed to this cover note, entitled '*Consequences of Corruption at the Sector Level and Implications for Growth and Economic Development*', provides an analysis of the impact of a range of corrupt practices on economic growth and development in four key sectors: utilities and infrastructure, extractive industries, health and education. These sectors were selected because of their unique contributions to growth and development and of specific corruption risks they face.

The OECD and the WBG hope that the findings can provide guiding input into the G20 AWG's discussion on the development of the next two year anticorruption action plan, by drawing lessons from the cross-cutting analysis, and also by identifying policy recommendations for the design of anticorruption strategies aimed at promoting growth. In this context, the conclusions may also contribute to the broader growth agenda of the G20 which has been focused, under Australia's leadership, on lifting the collective GDP of G20 members by at least 2%. To achieve this objective, G20 members are in the process of identifying country-specific policy measures that could be taken to enhance growth. In support of this process, a *Working Group on Investment and Infrastructure* was created which, among other things, focuses on discussing measures to improve countries' respective investment climates and to stimulate investment in quality infrastructure, such investment having a clear correlation to levels of corruption. The findings of this analysis could therefore provide useful inputs into G20 reflections in other pillars as it builds the case for a global anticorruption agenda where anticorruption measures, both at international and national levels, form an integral part of pro-growth policies.

This cover note summarizes the lessons drawn from the cross-sector analysis developed in the paper, provides policy recommendations to inform the G20 AWG on the design of anticorruption strategies and identifies sector specific initiatives and thematic priorities for a more concrete and action oriented approach, where the G20 would lead by example and add value to existing international initiatives. It is complemented by two snapshot tables prepared in the context of the study.

I.   **Lessons from cross-sectoral analysis**

Quantification of the impact of corruption on economic growth at the macro level remains difficult. Still, the analysis provides significant basis to identify avenues for action, by presenting evidence at the micro-level of the consequences of corruption, in particular through a better understanding of the transmission channels. Further, as indicators of economic performance do not necessarily capture social damage, the impact of corruption needs to be examined in a broader context.

Corruption has a direct specific impact on the cost of a project both for the business and for the public sector. The study shows corruption causing *higher prices* in all the sectors; higher

prices for medicine, health services, textbooks, utility services, infrastructure, extra payments on import of inputs needed for petroleum production or mining .

But corruption also has indirect consequences, damaging public institutions, impairing citizen's trust in their government and causing lower incentives for innovation and higher inequality. For example, high levels of perceived corruption are associated with lower spending on social services, including both health and education, which in turn can undermine social welfare, skills in the work force and trust in institutions. Further, the poor are often the first victims of corrupt practices in the education sector since for them, the illegal fees, bribes for promotion to the next grade or to obtain a diploma, etc. are a heavy burden that leads many of them to drop out. Thus it is fair to say that **corruption tends to increase social inequality.**

Corruption burdens market players by adding an *unpredictable tax* on their operations. This unpredictability may prevent entry of foreign players and thus also the benefits of competition and technology spill-overs. The mere fact that officials collect bribes, which may accumulate to large sums for those involved even if each single bribe is small, reflects serious institutional dysfunctions – often an indicator that conditions and incentives for economic activity can be made more efficient. For example, in the power infrastructure sector, investors' decision to enter a market is significantly driven by the perceived risks of corruption.

Distortions of political decisions due to corruption are likely to cause the clearest economic damage. They result in budget allocations, sector regulation and trade barriers contrary to the public interest, and eventually losses of revenue for the State. This is particularly the case in extractive sector. The available evidence suggests that such distortions have severe consequences, in particular where governance institutions and integrity systems are weak. Large resource revenues facilitate rent seeking and patronage, potentially resulting in higher levels of corruption, diversion of time and talent from productive activities, inefficient public spending, and low political accountability. Several factors make extractive sectors prone to corruption, including high-level discretionary political control, frequent blurring of public, shareholder, and personal interests, limited competition among firms which can result in collusive behaviour, complex financial structures requiring stringent auditing, and lucrative opportunities resulting from the control of resource export channels (e.g. via exclusive export licenses) as well as the control of imported goods (e.g. exclusive import licenses) in these often highly import-dependent economies The ultimate function of the development of mining and petroleum operations for resource rich countries is to create out of their natural resource endowment, a reliable long-term source of financial flows that can be converted into sustainable economic activities through sound revenue management. **In view of all the points exposed above this sector requires special scrutiny and strong action.** This is also a particular challenge in construction, for example with large infrastructure projects that are not really needed as one of the consequences of too tight connections between politicians. In the utilities sectors, corruption may undermine the independence of the regulator with distortive impacts on prices, service delivery and expenses. This in turn results in too expensive subsidies and over-inflated costs, leading to losses for tax payers. In the health and education sectors, one key consequence of corruption is sub-optimal budget allocation.

Corruption hampers the quality of product and services and reduces their availability. For example, among the factors linking corruption in education to economic growth are the lower value for money in terms of inefficient utilization of public resources and fewer people trained given the amount of resources. In a particular city, a reform consisting of the reduction of distorted practices in the area of teacher management made it possible to serve 120,000 additional pupils without an additional recruitment of teachers, demonstrating the impact of corruption on efficiency.

Finally, corruption has a clear impact on the rise of other criminal activities, which have their own negative consequences on growth. Corruption is closely related to activities such as money laundering, tax evasion, illicit trade and misuse of corporate vehicles.

II.   Policy conclusions

a.   General policy considerations

A corruption free environment is by essence a public good in particular in a globalised world and should be treated as such. In light of such governments' international responsibilities, the design of national and international anticorruption strategies matters, and should ensure sustainable growth and good governance.

> ➢ **G20 countries should send a collective signal that the design, adoption and proper enforcement of anti-corruption measures is a critical national and collective priority, integral part of the G20 growth and development agenda**.

Such anti-corruption strategies should focus on clear outcomes and cost effectiveness. Political corruption, bureaucratic corruption and specific sector corruption have their own characteristics and pose their own individual problems which also differ according to a country's systems. A micro-level analysis of the specific challenges will often be necessary to ensure relevance and value for money. Anticorruption initiatives should provide key general features, addressing both the demand and supply side of corruption and ensuring even enforcement across the board.

First and foremost, the sectors review carried out in the study demonstrate the importance of independent, competent and better regulatory and law enforcement systems and auditing rules and systems. **Increasing the risk of detection is essential to combat financial crime.**

> ➢ **G20 countries should act decisively for a business environment free from extortive corruption**. They should call on firms to have strong internal controls to prevent bribes. G20 countries should not only stress the importance of collective action against solicitation but should enforce vigorously the existing laws against both bribe payers and bribe givers. They should assess how the legal and institutional framework can be misused by indelicate public officials and take action accordingly.

> ➢ **Tackling collusive corruption is much more challenging**, and exclusive reliance on compliance systems within institutions and firms will not be effective. G20 countries should highlight the importance of external controls, regulatory and law enforcement systems and a general set of checks and balances to detect, deter and prosecute collusive corruption, addressing both the supply and demand side. In this context, effective international cooperation between various jurisdictions becomes even more essential.

> ➢ One key finding of the cross-sectoral micro analysis is that **effective integrity frameworks require targeting both collusive and extortive corruption.** The analysis identifies several elements which are relevant to both forms of corruption, which are summarized in the table 'Key elements of an integrity framework to mitigate corruption risks', annexed to this cover note.

> ➢ **Transparency should be an integral component of all anticorruption strategies**. Access to information makes it more difficult for corruption to go undetected. Transparency initiatives, particularly in the areas of construction contracts and financing and extractive industries, are necessary but still insufficient steps in the right direction. There is scope for further transparency initiatives, focused on ensuring that purchasers receive what they are paying for.

> ➢ Other important transparency initiatives are those that compare prices for products and services purchased by the public, those which test what information is actually achievable (and control facts), and those initiated to promote **financial transparency**. It is especially important to keep up the international momentum on efforts to further lift excessive

professional secrecy, to promote automatic exchange of information on tax matters and transparency of the beneficial ownership of legal entities and arrangements

➢ **Public procurement merits a particular scrutiny**. Whereas a lot of attention has been given recently on the procurement process *stricto sensu* (e-procurement, and other similar initiatives), generally speaking anti-corruption strategies have not really addressed the pre and post procurement phases. More accountability on why certain decisions are taken and on which basis would allow a better control. Open government can be used for that purpose. Very little is also known on what happens after the call for tender has been concluded and the market attributed. Amendments to contract, post delivery service agreements or offset are not subject to the same level of scrutiny than the main contract.

➢ The study demonstrate that **anticorruption measures must therefore be targeted and tailored –** one set of solutions will not work in all contexts, in all sectors or in all countries. Anticorruption strategies should be based on a clear identification of the objectives, of the causal relationship between the policy and its effects.

➢ The G20 should call for the **development of a next generation of corruption data,** better tailored to capture the complexity of corruption risks, and to support the development of more evidence-based policies.

➢ Last but not least there is a real **need of robust evaluation of anti-corruption practices** and measures. We believe that future policies should be accompanied by a solid evaluation component, with an impact assessment of the measures adopted. These assessments could possibly be undertaken through performance assessments of results, with measurement of efficiency and implementation of anticorruption measures and identification of value-for-money solutions.

b. Sector specific recommendations

The impact of corruption and related distortions at the sector level vary according to the sector, the stage of the project cycle and the outcome, as illustrated by the table, '*Consequences of corruption across sectors',* annexed to this cover note. The following section provides proposal and recommendations for action in support of existing sector driven efforts. It also makes proposals for further sector-specific work to inform anticorruption strategies and actions by the G20.

Utilities and infrastructure

➢ **Fighting corruption in the utilities infrastructure sector should target procurement, not only at the tender phase, but the whole acquisition process**. In the early phases, rigorous project identification and appraisal system are critical to reduce the risk of grand corruption. The G20 could take the initiative of developing guidance, or common principles, to provide a rigorous framework for identifying, appraising and prioritizing public infrastructure projects. Anti-corruption strategies should also consider the recourse to a wider set of contractual arrangements, with more integrated forms of contract such as 'design-build' or 'alliancing' where there is a single point of responsibility or where the relationship is based on a common financial interest as the parties share in any costs savings or losses. A significant challenge post tender is the renegotiation of contracts, as evidence shows that they are related to significant corruption risks. Anticorruption efforts should also aim at modernizing procurement practices to reduce the risks of implicit forms of corruption such as collusion and capture.

➢ As corruption in the sector tends to involve decision-making authorities at several levels, anti-corruption responses would benefit significantly from **a strengthening of formal accountability systems across the board, including at the sub-national level**.

➢ Countries could consider requiring independent quality control of final constructions (e.g. group of international experts) on projects conducted on development loans and assistance.

Extractive industries

All areas of government involvement – policy design, licensing, regulation, enforcement, commercial participation, tax administration, and management and spending of revenues – present major corruption risks. G20 countries have considerable experience and expertise in dealing with these issues and the G20 therefore has a special responsibility to lead by example in the fight against corruption in extractive industries to help resource rich countries maximize the sustainable growth that they can generate from this sector.

➢ Political corruption is a significant challenge in addressing corruption in the extractive industries, which also brings most severe consequences. **Given the critical importance of licensing, the role of state-owned enterprises and the tax environment for extractive deals, these three pillars should receive particular attention** in any G20 work and initiative related to extractive industries.

➢ **Enhanced transparency should be a cornerstone of anticorruption measures to fight corruption in the extractive industry**. This should include financial disclosure for companies involved in the extractive value chain, including transparency of beneficial ownership and of financial flows.

➢ **Capacity building of audit agencies and accountability mechanisms** in producing countries is critical to tackle corrupt practices in extractive industries, and improve detection of corrupt activities.

➢ **Building on the growing experience of several G20 countries, the G20 could include steps related to the mandatory reporting of extractive industries fiscal revenues in any extractives related work.** Companies either from G20 countries or listed on their stock markets have a very significant presence in the extractive sector around the world. Based on the G20's public support for disclosure of extractive industry payments to governments, these initiatives could be reinforced by connecting ACWG work into the emerging global transparency standard and ensure a level playing field.

Health

➢ **Anticorruption measures targeting the health sector should address the use of informal payments** which create financial barriers to service use and put citizens at risk for catastrophic payments (defined as payments exceeding 40% of income after subsistence needs are met) and subsequent impoverishment.

➢ G20 Countries should :
   o reduce corruption by **limiting discretion by government actors** (including agency or judicial review of medicines procurement decisions),
   o **securing the rights of citizens** against wrongdoing by government agents (including opportunity seek redress from clinicians who demand bribes for services that should be free)
   o **ensuring adequate exchange of information** between citizens and government (including information about entitlements to health services, official prices, and citizen input to the development of waiting list policies, insurance benefit packages, etc.)

> Anticorruption strategies in the health sector could support the creation of citizen advocacy offices, ombudsman, and grievance redress mechanisms, including strengthening of civil society participation in these functions.

Education

Education is one of the major public sectors and it is a key component of any sustainable growth. Distortions of the sector due to corruption may have a long lasting effect even though the sums may not be so important.

> **Initiatives in the education sector should address corrupt practices that come about during policy decisions** (corresponding to general policy and long-term orientations); **management decisions** (whose scope is less broad and whose effects require less time); and **operational decisions and service delivery** (which can be defined as common daily decisions, limited in scope).

> Policy decisions are affected by corruption in different ways, including allocation of resources to certain schools, construction work, allocation of important positions, and sector regulation more generally. Management decisions affected by corruption could be related to the collection of illegal fees for school admission or exams; favouritism and nepotism in the recruitment of teachers Examples of corruption in service delivery and operational decisions will typically include inflated enrolment figures to augment resources for the school; recruitment of teachers on the basis of fake credentials and diplomas; teachers not teaching the whole curriculum to impose paid private tutoring; unauthorized deductions from teacher salary by education officials; bribing of accrediting agencies to obtain a license.

> **Tracking expenditures is particularly useful in this sector to detect and fight corruption** and appropriate mechanisms could be put in place, such as Public Expenditure Tracking Surveys and Quantitative Service Delivery Surveys (QSDS).

Next Steps

The conclusions reached in this paper provide G20 Leaders with a solid basis for immediate action to better integrate anti-corruption priorities into the G20 growth agenda. Principally, the G20 AWG could consider incorporating into its next action plan the key findings and related recommendations from the cross-sectoral analysis. Moreover, given the specificity of certain recommendations already coming out of this paper, concrete anticorruption actions could be undertaken by countries with minimal delay. The policy conclusions, including both the general policy considerations and sector specific recommendations, could provide a launching pad for the development of a set of high-level policy recommendations to be adopted by G20 Leaders at the Brisbane summit. Input from business and civil society in the development of these high-level policy recommendations could be asked for, and priority sectors could be identified and further developed.

Moreover, the OECD and the WBG recommend that this cover note and the underlying analytical report be shared with other streams of the G20, in particular the investment and infrastructure working group. Increasing understanding of how corruption inhibits economic growth and creating synergies between different strands of the G20 can only help in designing G20 actions that have a lasting effect on corruption, that promote growth and tackle the impact of corruption on inequalities. Such approach would also assist in further integrating anticorruption in G20 countries' strategies for sustainable growth and development at the country level. For instance, the development of G20 national anticorruption strategies, for which progress could be measurable, need to be tailored to specific country circumstances and economies so that anticorruption efforts would achieve best results for economic growth and value-for-money.