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**Public Financial Management and Corruption<sup>1</sup>**

Public Financial Management (PFM) ordinarily covers the management of government revenue, expenditure and cash. Corruption defined as the diversion of public resources for private use can affect any of these operations, at the level of the national and sub-national administrations. This paper focuses on circumstances that are prone to corruptive practices in managing expenditure and cash at the national level. It does not discuss revenue.

The outline of the paper is as follows: Sections I and II provide an overview of PFM and corruption, respectively. They are followed in Section III by a brief analysis of the relationship between corruption and the budget process and the requirements for reducing this malfeasance.

## **I. An overview of PFM**

### **What is PFM?**

**PFM** can be defined as framework of laws, regulations, traditions and practices for managing government finances in order to achieve macro-fiscal stability (real growth with low inflation, no payment arrears, sustainable debt, etc.), an optimal allocation of resources (increased social welfare), efficiency of public spending (more public goods and services at lowest market prices), and good governance (transparency and accountability). PFM regulates procedures that apply in four broad areas: budget, treasury, accounting, and control.

**The budget** is prepared by the executive branch which, in turn, sends it to the legislature for debate and adoption. A good budget is timely, comprehensive and presented using a simple and easily understandable terminology. After approval, it is implemented by the government which is responsible for providing timely budget execution reports. The budget is executed at four key stages: commitment, verification, payment order, and payment.

**Treasury procedures and operations** involve the management of government cash to meet its payment needs. The conduct of treasury operations can be facilitated by the existence of a

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TSA, a framework for managing the government financial assets in order to minimize borrowing requirements and interest charges, the regular reconciliation of government accounts, and the existence of transparent disbursement rules and procedures of money to enable the tracking, compilation and analysis of the government financial transactions.

**The accounting system** is organized to store and compile transactions information for the purpose of producing accounting documents, notably annual and semi-annual ledgers that are needed to report on the execution of government financial operations. Modern accounting uses double as opposed to single entry accounting rules. While most countries operate on a cash accounting basis, some are adopting accrual accounting that better reflects the government's assets and liabilities, and financial position.

Two types of **control** are exercised in connection with the budget and more generally government financial operations: an internal and an external control. The internal control office, tasked mainly with management control and audit reports to the executive branch whereas the external control office (audit and oversight) reports to parliament. Management control (the first and main line of preventive abuse of public trust) is in effect, a set of *ex ante* verifications undertaken during budget execution to ensure that: (i) public resources are committed and expended in accordance with the budget law, other financial laws and regulations, and government priorities; and (ii) the principles of fair market pricing of government purchases and uniform application of rules are observed in the use of public resources. The external oversight is an *ex post* control.

### **How then does one measure the quality of the PFM system?**

In an effort to promote reforms in the PFM, the World Bank and the Fund developed in the early 2000s, a set of 16 indicators to measure the quality of PFM systems of HIPC relief recipients. These indicators, denoted HIPC-AAP, covering budget preparation, execution reporting and procurement, were used to assess the initial state of PFM of 22 countries in 2001-02. Governments were expected to take measures to address the weaknesses identified by the assessment. A reassessment of the PFM systems in 2003-04 indicates that overall, progress has been achieved: total benchmarks met increased by some 10%. Budget reporting showed the largest improvement with 42% of benchmarks met in 2004 compared to 33% in 2002. Budget formulation remained virtually flat at 44% in 2004 against 45% earlier whereas budget execution deteriorated from 39% in 2002 to 35%. In terms of countries, two countries improved very significantly and five countries made noticeable progress. The 15 remaining countries needed substantial upgrading of their PFM. Though the HIPC-AAP framework provided useful signals about the PFM performance of countries, it nevertheless harbored weaknesses: (i) narrow coverage ; (ii) no involvement of donors, the HIPC-AAP being mainly a joint IMF-World Bank undertaking; (iii) persistence of several PFM diagnostic tools; and (iv) application of the HIPC-AAP framework only to HIPC relief recipients.

Consequently, donors agreed to propose a new framework to assess PFM systems, namely PEFA. The new instrument has 28 indicators to measure the quality of the PFM and three indicators to assess the performance of donors. In principle, the evaluation is to be carried out by the PEFA countries themselves with a vetting by donors. However, in practice, with a few exceptions, the PEFA diagnostics have been led by donors. While the HIPC-AAP contains a bare-bone action plan of reforms, the PEFA does not propose a reform program. The completed PEFA diagnostic is expected to serve as a basis for a multi-donor dialogue with the government in order to craft such a program.

### **What are the basic features of a good PFM system for developing countries?**

The management of public finance in developing countries is generally hampered by deep-seated deficiencies in several areas, including budget, treasury and accounting. The focus on budget is important because fiscal policy, a key component of macroeconomic policy, is cast in annual frameworks of revenue and expenses. The treasury manages government cash in order to meet its disbursement needs, whereas accountants report on the actual use of government financial and real assets. Taken together, activities in these three areas enable to assess the impact of government decisions on economic activity and social welfare. Well-managed public financial systems have some good features in common (Box1).

**Budget.** In well-functioning PFM systems, government financial operations are classified according to logical and simple criteria that are consistent with international standards.

Clarity

and simplicity are essential to facilitate understanding of government policy, legislative debate, implementation of the budget and fiscal reporting.

Budget proposals ought to be realistic, reflecting a convergent iteration between aggregate amounts derived from an MTEF and the sums of actual dis-aggregated outturns of execution from previous years. To ensure coherence and comprehensiveness, government budget should cover all government operations (current and capital, quasi-fiscal operations, extra-budgetary operations, all receipts, etc.). All contingent liabilities should be described in the budget. The budget should be prepared and enacted in a timely fashion before the start of the fiscal year, and published in order to provide visibility to the private sector and the general public.

**Treasury.** Government cash is to be managed to provide short-term liquidity and enable the acquisition of long-term assets. Typical weaknesses in cash management in several developing countries are lack of control of the accountant general or treasurer on all government accounts, illegal disbursement practices of cash, failure to reconcile government accounts, and failure to link prospective liquidity with commitment plans, leading to payment arrears.

In a well-functioning treasury system, the treasurer has complete knowledge and authority to manage all government monies. These funds are deposited in a TSA or in a small number of bank accounts, all of which are under the control of the treasurer. This enables the government to know its liquidity position at all times and manage funds to meet payment needs in order to avoid costly borrowings. Governments that are prone to corruption and waste often introduce a variety of exceptional expenditure execution procedures that circumvent financial control and blur the trail of cash disbursement. In good PFM systems, government expenditure is undertaken using transparent standard expenditure procedures that ensure accountability through ex-ante control and facilitate the monitoring of government spending. Moreover, cash is disbursed only to pay for expenditure approved in the budget. Extra budgetary and off-budget operations cannot be undertaken without legislative approval. The treasury keeps track of its inflows and outflows and reconciles these operations regularly internally (i.e. in its own books) and externally (i.e. with bank statements).

In general, the ability of governments to pay their bills when due is a strong indicator of their level of fiscal discipline and the credibility of their policies.

**Accounting.** Accounting, like budget classification, is based on rules and practices. Double entry accounting facilitates the reconciliation of government operations and prepares the ground for tracking of government assets and liabilities. Accounts that are based on this rule are more reliable and accurate. To enable macroeconomic policy-makers to make timely decisions, it is essential to track through proper accounting, the flow of expenditure at each stage of the spending chain, including payments. Vote books, account ledgers, administrative and operating accounts are to be maintained regularly and routinely.

Another common feature of well-managed public finances is availability of manuals that contain the rules and practices for undertaking different government operations. Manuals are important because they eliminate guess-work and instill consistency in managing government finance in time and space. The rules and procedures are to be applied in the same uniform manner over the whole country, thereby enhancing the confidence of the private sector in transacting with the government.

## **II An overview of the notion of corruption**

### **Definition**

The legal and operational definition of corruption varies with countries. Transparency International (TI) defines corruption as “an abuse of entrusted power for private gains.”

Hence, this definition could also cover corruption in the private sector. In this note, corruption in PFM is defined as the use of public office for private gains.<sup>2</sup>

### **Box 1. PFM Fundamentals in Developing Countries**

The PFM systems of developing countries have several weaknesses to be eliminated. Three areas stand out for improvement: budget, treasury and accounting.

#### **Budget**

Classification (administrative, economic and functional)

Preparation

- Comprehensive coverage with no extra-budgetary or off-budget operations;
- Based on medium term expenditure framework;
- Single up-to-date list of government personnel for payroll;
- Integrated (i.e. single ) recurrent and capital expenditure;
- Government-approved price list for preparing budget estimates;
- Upheld universality principle;
- Timely enactment of the budget (i.e. ready to start at beginning of the fiscal year); and
- Basic law and of manuals of procedures.

#### **Treasury**

- Existence of treasury single account (TSA);
- Use of timely and updated commitment plan;
- Use of timely and updated cash flow plan linked with the commitment plan;
- Existence of an effective ex-ante commitment control;
- Monthly reconciliation of government accounts;
- No unregulated expenditure procedures; and
- Basic law and of manuals of procedures.

#### **Accounting**

- Based on double entry accounting;
- Preparation of monthly reliable budget execution reports (treasury general ledgers, flash reports, etc.);
- Publication of budget execution information on the same basis as the original budget;
- No significant deviations of budget outturns from the original budget;
- No significant amount of payment arrears;
- Publication of administrative accounts 6 months after end-FY;
- Publication of operating accounts 6 months after end-FY;
- Transmission of audited accounts to the legislators 6 months from the end of FY; and

<sup>2</sup> The Many Faces of Corruption, Tracking Vulnerability at the Sector Level, Edited by J. Edgardo Campos and Sanjay Pradhan, The World Bank, 2007, p. 6.

- Basic law and of manuals of procedures.

The PFM rules and regulations enacted by the executive branch of government for the conduct of government operations in these three areas should be based on laws. The problem of insufficient human and physical capacity also needs to be addressed.

### **Different types of corruptive practices**

Corruption can be distinguished by the amount involved (petty or grand), the function or responsibilities of the persons involved (politicians, civil servants), or the institutions (executive, parliament, judiciary). The negotiation and implementation of large scale investment projects provide a fertile ground for political corruption whereas administrative corruption takes the form of petty corruption (small bribery, theft of cash, goods and services, etc.); direct abuse of public office (misuse of public financial and real assets, illegal fines, taxes, contract-steering, twisting of rules, cronyism and nepotism, etc.); and indirect abuse of public office (bribe for favorable treatment or ruling). Administrative corruption generally takes place at the tail end of politics where public officials come in contact with the public at large.

### **Why is it important to seek to eliminate corruption in PFM?**

Corruption affects adversely the efficiency and effectiveness of delivering public goods and services. It diverts resources, weakens planning of public goods and services and undermines the confidence in the public sector. It leads to a sub-optimal allocation of resources and a lower level of social welfare.

**Misallocation of resources.** By diverting resources away from public coffers, it forces the delivery of fewer goods and services, of lower quality and in some cases, with delays. Often, resources are allocated away from priority social sectors in favor of sectors that benefit few people.

**Ineffective planning.** The preemption of public goods for private gains causes actual spending to differ significantly from the initial expenditure plans. The planning objectives are therefore not achieved, making budgeting of public goods and services ineffective.

**Public confidence.** Corruption decreases the trust of private sector operators in transacting with the government. In addition, it diminishes people's confidence in the government's ability to deliver quality goods and services, at fair market prices, in sufficient quantity, quality on time. Corruption : (i) leads suppliers to overprice their goods and services; (ii) provokes distortions in PFM procedures, for instance by prompting suppliers to obtain payments before delivering the goods; (iii) discourages private investment and donors

assistance, thereby retarding economic growth, the capacity to reduce poverty and to increase social welfare, and (iv) de-motivates taxpayers.

### **Vulnerability for corruption in PFM systems**

There appears to be a negative correlation between the quality of PFM systems and perceptions of corruption. Reporting on work done by TI and the World Bank, Dorotinsky and Pradhan (2007) consider that “countries with better-performing PFM systems have lower corruption perception indexes (Figure 1).” This is because robust PFM systems raise the risk of detection and the cost for bad behavior.

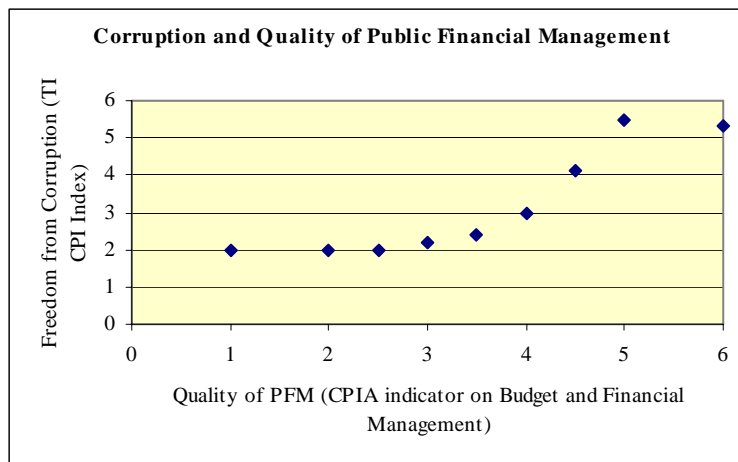
## **III Corruption in the budget process**

### **Corruption in the PFM system**

#### *Legal framework for PFM*

Modern budget processes straddle between two endpoints: a detailed codification of these processes into laws of budgetary procedures and practices (France and continental Europe), and the enactment in the form of law of general principles for managing public funds with the details left to be set by executive rules (UK). Generally, the constitution defines the roles and responsibilities of each state power in the budgetary process. More specific aspects of the

**Figure 1. Correlation Between Corruption and PFM**



Source: Dorotinsky, William and Shilpa Pradhan, 2007, “Exploring Corruption in Public Financial Management” in “The Many Faces of Corruption, Tracking Vulnerabilities at the Sector Level,” Edited by J. Edgardo Campos and Sanjay Pradhan, The World Bank, 2007, p. 269.

budget process are spelled out in budget laws, public finance acts and code of ethics modeled on the IMF Transparency Code (Box 2). Incomplete and fragmented legal frameworks provide opportunities for malfeasance.

### ***Budget***

Core budget stages are planning, preparation, adoption and execution. Vulnerability for corruption is considered to be low at the stages of planning and preparation and high at the adoption and execution stages.

*Budget planning.* Ideally, annual budget should be cast from a multi-year budgetary framework for supplying public goods and services that reflect policies and strategies of the authorities. This plan, prepared by the government, could incorporate inputs from the legislature. In the process, politicians and bureaucrats could tilt the projections of public goods and services toward their geographical constituencies or areas, and/or ethnic groups. The changes to the government's proposed budget could aim at correcting imbalances in order to ensure equity, enhance efficiency or preserve social peace or national unity. However, in neopatrimonial systems of government (see below), powerful politicians could disregard these objectives and make significant a sub-optimal allocation of resources in favor of their constituencies.

*Budget preparation.* In some countries, it has three components: a macroeconomic framework, a policy outline and expenditure ceilings.

The macroeconomic framework lays out, *inter alia*, the revenue and financing expectations from which the aggregate current and capital expenditure targets are derived. The risk of corruption is not significant at this stage because money exchange is not involved. However, favorable conditions could be created for embezzlement, for instance by understating significantly tax revenue or showing favoritism to certain taxpayers in projecting budgetary revenue.

The policy outline articulates policies and strategies underlining the multi-year plan of public activities. It serves as a bridge between the aggregate expenditure targets contained in the multi-year plan and those generated by the macroeconomic framework. A lack of consistency between the two sets of aggregates would normally call for the adjustment of the targets and/or policies to achieve them. The risk of corruption is moderate because only the ministry of finance can influence budget preparation at this stage.

Expenditure ceilings are assigned to spending units at this stage. The total amount of these limits should be equal to the aggregate levels set in the multi-year plan and the macro framework, both of which should be backed by the policy outline. This textbook approach is

far from reality. In practice, allocations are increased or decreased or left unchanged, not only on the basis of policies, but of influences from politicians and bureaucrats in all branches of state power. The initial budget allocations could be altered at any stage of the

clearance process of the expenditure ceilings (budget conference, minister of finance, cabinet, parliament). The deal mentality that prevails at this stage makes setting expenditure ceilings an excellent ground for political corruption.

### **Box 2: Reducing vulnerability to corruption in PFM**

The IMF Transparency Code identifies some factors that would minimize the risks of corruption in public finance. These include:

- The transparent definition of the role and responsibilities of public sector institutions involved in the budget process, the relationships between them, their accounting and reporting systems, etc. Overlaps and omissions in these definitions could open the way for corruptive practices;
- The regular release of budgetary information to the public (original budget and final outturns, annual and semi annual accounts showing also government indebtedness and assets, etc.). In the absence of this information, it would be difficult for the public to hold government accountable;
- The budget should be comprehensive and based on a macroeconomic framework. It should show all revenue, expenditure and financing operations, with spending classified according to international standards to facilitate understanding and comparison. Extra budgetary operations should be reported on the same basis and classified according to the same criteria (administrative, economic and functional). The accounting system should enable to report comprehensively, accurately and in a timely fashion both budgetary and extra budgetary operations. Mid-year reports on budgetary and extra budgetary activities should be published. Government should be required by law to send the final accounts to the Supreme Audit Institutions (SAI) for review and onto parliament within one year from end-of-FY. Deviations from these principles, particularly on comprehensiveness, clarity, timeliness and reporting could mask corruptive practices.

New PFM tools such as performance budgeting are also being experimented to promote, inter alia, good governance. This instrument links budgetary resources to budget outcomes. Budgets are presented in terms of programs to which are attached outcomes that are measured by performance indicators. If the tracking of the output-focus budget shows drops in outputs, ceteris paribus, notably for the same level of inputs, then an investigation can be undertaken to determine if malfeasance has occurred.

*Adoption of the budget.* The risk of corruption during this process depends on several factors: the constitutional regime of the country, the budget schedule, the power of the legislature to amend or veto the budget, etc. In strongly presidential regimes, parliament has limited budgetary power and opportunity to engage in corruption during the adoption process. On the other hand, in countries where legislative authority is strong, parliament can modify the aggregate or individual spending limits, with a high risk of engaging in corruption. It can

change the tax rates or regimes with a view to raising revenue and increasing expenditure commensurately, including its own spending (higher salaries and benefits or travel allowances).

Given the complexity of budget documents, the government can hide corruptive items in the budget or submit it late to parliament, thereby shortening the time for legislative scrutiny and creating conditions for private gains at the public expense.

*Budget execution.* In PFM systems that uphold fiscal discipline, budget execution focuses on the implementation of government expenditure as appropriated in the annual budget approved by parliament. The expenditure chain comprises four stages: commitment, verification, payment order and payments. This chain constitutes a fertile ground for corruption because it provides opportunities to undertake transactions and for money to exchange hands. In several countries, the commitment stage is preceded by a warrant stage.

The minister of finance releases **warrants** (i.e. budget allocations) to spending units, based on needs and the liquidity situation of the treasury. Uncertainties about resources inflows gives room for some discretion in making the allocations that can favor ultimately special private interests. For instance, large warrants could be granted to defense, security or public works in return for kickback to facilitate the signature of procurement contracts.

At **the commitment stage**, spending units can place orders for the delivery of goods and services in amounts not exceeding the budgetary ceilings. Once the expenditure commitment is approved, funds are reserved for the payment of the items ordered and are no longer available for any other payments. Corruption activities can take several forms here: violation of procurement laws and regulations, ordering of unauthorized goods and services, exceeding budget ceilings, bid-riggings, orders addressed to fictitious companies, acceptance of inflated prices, etc. The diversion of public funds can be facilitated by a weak internal control system, manual commitment procedures, and de-motivated and untrained staff. The monetary gains can take the form of cash transfers, free interest loans and/or grants, transfers of objects such as vehicles, household appliances, and free service or travel tickets.

At **the verification stage**, the financial comptroller is to: (i) ascertain that the delivery of the goods and services is effective and conforms to the terms of the contract (quantity, quality, schedule, location, etc.); and (ii) determine that the prices charged to government reflect fair market costs. He also checks for proper respect of rules and regulations at the commitment level. Therefore, in the absence of collusion, the verifier will uncover corruption at the commitment level if it exists (lack of budget cover, excessive cost estimates, lack of proper clearances, fraudulent invoices, etc.). However, the comptroller could be in collusion with the commitment officer, not only by overlooking acts of corruption, at the previous stage of the expenditure chain, but by compounding them with his own, for instance by

recommending payments at inflated prices for substandard products in amounts smaller than ordered or payments for fictitious goods.

Corruption is also common here particularly in the presence of collusion along the expenditure chain. **Payments orders** could be issued knowing that there were serious irregularities during the processing at preceding stages. Even in the absence of such irregularities, the authorizing officer may withhold the issuance of a payment order on account of cash flow shortage while in effect, his real reason is expectation of a bribe.

**At the payment stage**, in addition to checking that laws and regulations have been observed at previous levels, the accountant is to ensure that the claim presented for payment has not been already paid. This stage provides significant risks for corruption because money changes hands. The corruption can take the form of payments to ghost companies or workers, for the delivery of no goods or services, queue jumping, retention of payment in return for quick backs, transfer of less than the stated amounts and pocketing the balance, and favoritism in approving eligibility. The failure to establish clear, transparent and effective rules for setting payment priorities give discretion to payment managers and provide opportunity for corruption. Failure to apply sanctions also encourages the diversion of public money for private use.

### ***Treasury***

The management of government cash is the prime responsibility of the treasury. Cash management seeks to ensure that the treasury has enough money to make payments when they are due. This involves ensuring that government resources are deposited in treasury-controlled accounts and managed efficiently. In particular, loans are contracted on the best possible terms. One of the main weaknesses for many treasury systems is the proliferation of government bank accounts, many of which are managed outside of treasury control and disbursed according to nontransparent rules and with no accountability. In some cases, deposits in government bank accounts serve as basis for making interest free loans to the managers of these accounts. Other fraudulent schemes include the outright transfers of money from government accounts into private bank accounts belonging to the President, the Prime minister and/or cabinet ministers and/or senior government officials. This is often the case in countries where the treasury system is weak and the central bank acts as the cashier and accountant for the state with virtually no framework for cross control.

### ***Accounting and reporting***

Budget accounting and reporting do not provide direct opportunities for corruption because they do not involve cash transactions. However, they can obscure the ability to track corruption. In effect, “accurate, timely and transparent record keeping, accounting and reporting of revenue, expenditure and financial information is essential for enforcing

accountability in the budget process (Dorotinsky and Pradhan, in Edgardo and Pradhan, 2007, p. 275).” Major weaknesses that raise the risk of corruption at this stage include the decentralization of expenditure responsibilities without adequate safeguards for record keeping, lack of communication of information to a central office for consolidation, poor accounting regulation and practices, absence of a modern chart of accounts, unclear institutional definitions of accounting and reporting responsibilities; absence of IFMIS and insufficient human capacity. Inaccurate, incomplete and untimely recording of transactions, complex and fragmented accounting systems, a failure to reconcile regularly government accounts and clearing of suspense accounts can mask fraud and impede audit.

### ***Budget control***

Budget control offers a good opportunity to uncover corruption. However, its effectiveness could be limited by a flawed legal and regulatory framework, and insufficiently competent staff and scarce financial resources. Budget control has two components: internal and external controls.

**Internal control.** Undertaken by the executive branch, it focuses on the enforcement of laws and regulations at the spending stage. With respect to procurement, three types of failures are commonly noted: (i) failure to comply with basic rules and regulations governing commitments (i.e. ceilings, choice of companies, bidding documents, deadlines, delivery periods and payment terms); (ii) poor contract management (i.e. payments for goods not delivered or contrary to specifications, absence of delivery receipts, fraud); and (iii) inaccurate and incomplete supporting documents.

**External audit.** This control is external to the executive branch. Undertaken by an independent judicial or legislative body, it seeks to establish an overall accountability in the use of public money or the effectiveness of government policies. According to INTOSAI, the key hindrances to the effectiveness of Supreme Audit Institutions (SAIs) in uncovering corruption include:

- Long delays in preparing annual reports;
- Failure to audit extra-budgetary funds and donor-financed expenditure and publish the audit reports;
- Lack of independence of the heads of SAIs whom are appointed and dismissed by the President;
- Scanty budgetary allocations and lack of autonomy in their use;
- Limited cooperation with the control offices of the executive branch;
- Inability to undertake in-depth verifications or follow up;
- Poor physical capacity and equipments ; and
- Failure to publish audit repots.

The external audit system is not prone to direct corruption. However, it can impede transparency and accountability by under-reporting corruptive practices or hindering further investigation of misuse of public authority.

Parliament may exercise oversight on government financial policies in the course of the review of SAI audit reports or hearings. However, legislative oversight is often handicapped by : the failure to prepare timely budget execution reports, untrained legislative staff, unsatisfactory legal framework, resistance of the executive to undertake follow up investigations or appear in hearings, partisan collusion between the government and several legislators to frustrate parliamentary investigations, and failure to apply sanctions.

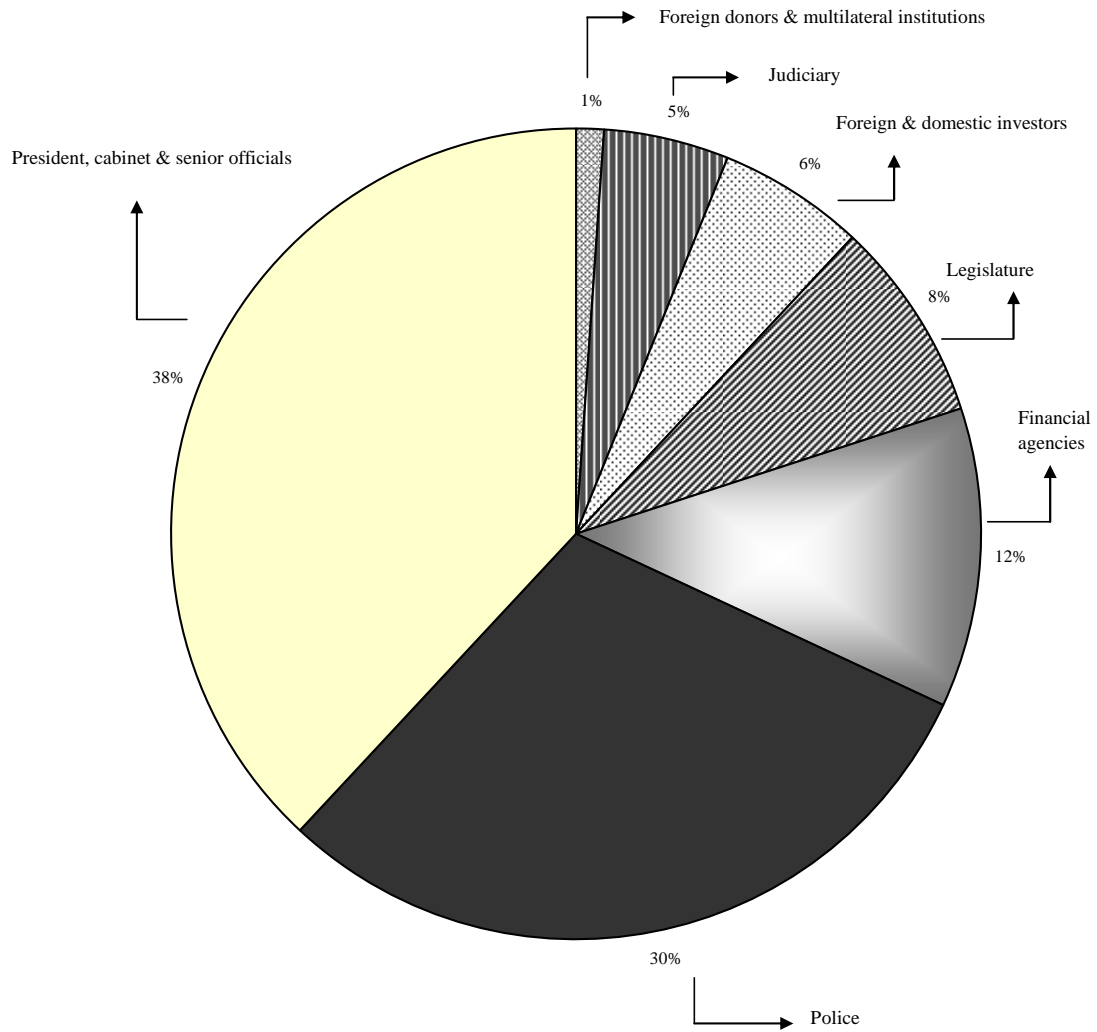
### **Triggers of corruption in the budget process**

Since corruption benefits public officials, it is appropriate to identify the institutions and officials that are the most vulnerable in order to better target the remedies. Isaksen (2005) reports that in response to the question of “what are the most vulnerable institutions to corruption in your country” participants in a conference on the rule of law organized by the World Bank in 2000 considered that: 38% of corruption is attributable the executive (President, Prime minister, ministers, senior officials); 30% to the police; 12% to financial institutions (customs, inland revenue, budget office, treasury, etc.); 8% to the legislature; 6% to foreign and domestic investors; 5% to the judiciary; and 1% to foreign donors (Figure 2).

More recent data are not likely to change significantly this picture. That is the use of public financial and real assets for private purposes is largely undertaken by the government officials (80%). Efforts to reduce corruption should therefore focus on the executive branch. A key official target is the President who engages in grand corruption (Marcos in the Philippines, Mobutu in DRC (former Zaire), Babaginda and Abacha in Nigeria, Pinochet in Chile, and Bongo in Gabon). A few examples are given in Box3. The police thrives in petty corruption and is considered as the most corrupt of all government institutions in several countries (India, Mozambique, etc.). Petty corruption is hard to combat because of the large number of persons involved, the difficult working conditions of most government workers in developing countries and their generally low salaries.

Besides the demand side, the supply side also plays a role in corruption. Public and private companies of industrial and emerging countries engage in corruptive practices in order to secure access to raw materials, and more generally gain advantage over competitors as in the case of Gabon or acquire favors that are detrimental to national or public interests in developing countries.

Corruption is likely to be concentrated where: (i) it is hard to establish (police) and/or punishment is minimal if detected; (ii) officials have great discretionary authority (President,

**Figure 2. Institutional Distribution of Corruption**

Source: Based on a survey participants at a conference organized by the World Bank in 2000.

### Box 3. Illustrative Examples of Grand Corruption

**Chile.** Pinochet is reported to have hidden \$27 million in secret bank accounts, including at Riggs bank in Washington DC. Riggs resisted the investigation of the allegation by the US Office of the Comptroller of the Currency. Subsequently, Riggs pleaded guilty, paid \$16 million in criminal fine and \$8 million to a foundation created to assist victims of the Pinochet regime.

**Gabon.** Elf paid \$20 million annually to President Omar Bongo to obtain guaranteed access to oil and political allegiance to France.

**Georgia.** Under President Shevardnadze, Georgia was considered a failed state, ranking alongside Bangladesh and Nigeria as the most corrupt countries in the world. With the election of President Saakashvili in 2003, Georgia became a case study for the impact of anti-malfeasance-minded President on the socio political life of a country, so much so that the World Bank considered that corruption has been reduced in Georgia more than in any country in Europe or Asia. The reform was comprehensive and affected several institutions. Ministries were cleared of corrupt staff. The police no longer invented driving offenses but rode in new cars and treated drivers with respect and courtesy. Access to universities was merit-based. Companies were paying their taxes.

**Indonesia.** Pertamina is state conglomerate with activities in oil production, tanker fleet, gas station operations, petrochemical, steel, tourism and stadiums. It violated several laws, used six different accounting systems to conceal malfeasance (tax evasion, inflated prices, etc.). Its main beneficiaries were President Suharto, his family members, company executives, friends and political opponents of Suharto (pay offs). After Suharto left power, an investigation revealed that Pertamina paid \$ 1.7 billion in bribes to these recipients.

**Romania.** The privatization of huge state industrial companies created opportunities for large scale corruption. In 2001, the government awarded RAFO, the national oil refinery company to Corneliu Iacobov, one of RAFO executive managers. For three years, the company did not pay taxes estimated at \$600 million. Subsequently, RAFO was sold to a British company owned by associates of Iacobov who were very close to the Romanian President Ion Iliescu and other government officials and legislators, all of whom were on the bribing list of RAFO. The same unscrupulous public officials contributed to the demise of Bancorex, a large state bank that collapsed under the extremely heavy weight of bad loans estimated at about \$4.2 billion granted to politically-connected customers. The government assumed this debt. The former Prime Minister Adrian Nastase is under investigation for buying land from the RAFO-Bancorex group in the center of Bucharest for less than the market value.

Prime Minister, ministers, heads of parliament and judiciary); (iii) only one person has decision-making power; (iv) lines of responsibilities and accountability are blurred; (v) PFM is weak, particularly at the audit level, like in Punjab (India) where 562 employees were responsible for auditing 17,382 institutions; (vi) social traditions for sharing wealth with the least fortunate members of extended families are strong as in African countries; and (vii) government staff are dissatisfied about their working conditions, remunerations and promotions as in most developing countries. Peer pressure and the sentiment that every body else is doing it can also trigger corruptive acts.

Corruption spread through formal and informal channels. Corruption through informal channels prevails in neopatrimonial countries where there is a large scale transfer of public financial and real assets to private interests based on traditions. In such countries, the President or King controls the economic and political life and wealth is amassed through allegiance to him. Modern budget process is only a façade. According to Isaksen (2005), there is a broad view that most African countries are neopatrimonial.

### **Toward reducing corruption in expenditure management**

Reforms in the legal framework and its enforcement, as well as in PFM are essential for promoting transparency and accountability in managing public resources. The international community can also contribute in enhancing governance in the management of government resources in developing countries.

#### ***Laws and their enforcement***

*Legal setting.* Certain features of the legal system can make it easier to prevent, uncover or prosecute corruptive practices. They include laws that: (i) define clearly the fiscal responsibilities of state institutions and officials; (ii) make it a crime to engage in (i.e. offer or accept) corruption; (iii) promote the disclosure of corruptive activities; and (iv) protect persons and organizations (particularly the media) that provide information on corruption. Such laws would require politicians and high-ranking government officials to disclose their personal assets or would call on the government to provide information on all financial operations, including extra budgetary and earmarked funds, special accounts, sale and lease of assets, and quasi-fiscal operations.

*Legislature.* Parliament (notably the public account committee) should be empowered to probe the government's management of state funds. Since corruption affects the legislature also, the law should enable parliament to investigate its own members, including voting patterns and geographical distribution of budgetary allocations. Also, the sources, amounts and control of the funding of political parties should be adequately defined and enforced to reduce the risk of corruptive behavior in the legislature.

*Judiciary.* In general, the main problem in fighting corruption is not a weakness in the legal framework, but the lack of enforcement, starting with the court system. An effective and efficient judiciary transparently applies the law irrespective of the status of the perpetrator. To achieve this objective, there must be a clear separation of authority between the executive and judiciary branches, well-trained magistrates, a fair and efficient management of the judiciary personnel, an appropriate budget, and a police force that upholds high ethical principles, notably integrity.

### ***Budgetary systems and their management***

As mentioned earlier, a strong and robust PFM system reduces the risk of vulnerability to the use of public resources for private gain. The PFM systems of most developing countries have been reviewed by several institutions, using a variety of frameworks in order to identify deficiencies and propose remedies. The effective implementation of the recommendations will contribute to making the PFM rules, procedures and functioning more transparent and predictable, thereby reducing risks of corruption. The success of the reforms require domestic ownership and strong political commitment that are generally absent, particularly in corruption-prone countries. The inverse relationship between the quality of PFM and perceptions of corruption calls for improvements in PFM in order to lessen corruption. The PFM reforms should aim at eliminating the deficiencies identified by the PEFA and other diagnostics in order to put in place the fundamentals of robust and sound PFM systems. These reforms are to be coupled with determined efforts to:

- Identify public activities that are most susceptible to corruption;
- Offer workers compensations (salaries, benefits, etc.) in the public sector that are comparable to those provided in the private sector for the same level of competence and responsibilities (Azerbaijan in Appendix I);
- Undertake regular value-for-money audits of government operations;
- Maintain an up-to-date registry of government assets;
- Create a basis for introducing a program budgeting; and
- Create a culture of professionalism and ethical values.

### ***Role of the civil society***

Active and diversified media and NGOs can play a role in raising awareness of budgetary corruption and promoting accountability and transparency in managing government finance. The framework for achieving this objective could take the form of participatory budgetary discussions as in some Brazilian cities, vigilance committees in Bolivia, citizen's watch-dogs against corruption of tax officials in the Philippines and citizens groups for monitoring oil revenue funds in Chad.

### ***Role of donors***

Donors have developed several tools to detect corruption and encourage accountability and transparency in assisted countries. The direct instruments of the World Bank include Country Financial Accountability Assessment (CFAA) and a Country Procurement Assessment Review (CPAR). The CFAA seeks to enhance awareness and accountability of the PFM system. The CPAR is aimed at the same objective in regard to procurement. The IMF fiscal ROSCs review the effectiveness of countries in their efforts in meeting the IMF Code of Good Practices on Fiscal Transparency. The Country Assessment of Accountability and

Transparency of the UNDP is designed to help governments and consultants in assessing the budget management system in respect to these two criteria. All these tools are useful instruments to instill transparency and accountability in the management of public finance in developing countries.

Using various other diagnostic tools to uncover the structural weaknesses in PFM of developing countries, multilateral institutions and donors are providing assistance to create conditions not only for ameliorating the delivery of public goods and services but for doing so in a more open and efficient way.

### **Conclusion**

Corruption has severe disadvantages. It: (i) undermines public financial management through veils of nontransparent budget execution procedures with no accountability; (ii) reduces the planning capacity of both government and private investors; and (iii) decreases confidence in government's ability to supply quality public goods and services at reasonable price, in the appropriate quantity and in a timely fashion. While it may be difficult to uproot completely, it can be brought under control. To achieve this goal require a strong commitment from the highest level of government as shown by the cases of Georgia and Azerbaijan.

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### **Selected Cases of PFM Malfeasance**

Below are a few cases of nexus between politics, money, influence and private gains. They are intended for illustration purposes. They are all drawn from “Corruption Notebooks 2006,” except for the cases of Sani Abacha, Pinochet, Pertamina and Giffen whose source is “The Many faces of Corruption, 2007.” As indicated above, malfeasance in PFM takes various forms. It can involve very large sums of money as in Romania, very small amount as one dollar to the policeman in Vietnam or cover up of murder in Nicaragua. It is also clear from the experience of Georgia that corruption can be significantly reduced only if the initiative and the commitment come for the highest level of government.

#### **Armenia**

A woman named Sirush had 14 surgical operations and half of her intestine was removed. To go on disability, the health official told her to wait for the remaining intestine to grow back because she was too poor to pay the bribe. For the same reason, the parents of the six-year old Armine who was blind in one eye were told to wait until the boy could not see with the other eye before he is granted disability benefits. The head of the medical social commission set his bribe rate at \$400 while his counterpart in charge of radiology was willing to sign the disability papers for \$200.

#### **Azerbaijan**

Public health is free but to deliver a baby costs between \$300 and \$500. Other illustrative rates were \$25-\$200 to change the grades of university students, \$2000 to shorten a prison sentence, \$2,500-\$4,000 to dismiss a criminal case, and \$50,000 to override major evidence in court. Only four of the 70 universities in the country did not accept bribes. When students threatened to publish the names of the corrupt professors, the latter retaliated by raising the bribe rates. This situation prevailed until a new President took office. Using the large oil revenue of the country, he sharply increased salaries. Consequently, the police stopped demanding bribes after its salary was tripled. Likewise, there was no more bribe at the passport office or at the customs.

#### **Benin**

Rogatien Biaou sold a piece of land owned by the government of Benin in Washington DC without government approval. Alain Adihou was paid by the treasury to computerize the electoral roll but did not finish the work. Cosme Sehlin was found with \$40 million dollars and illegal products stashed in his house. All three, former ministers, are now on trial after a new President assumed office.

### **Cambodia**

The unwritten rule is “no bribes, no official documents, no business.” It is estimated that: (i) 75% of the income tax was lost in 2005 due to corruption; (ii) companies paid \$330 million in bribe in 2005, representing half of total government revenue; and (iii) without bribes, the average salary could be multiplied by six to \$150 per month. About \$12 million were siphoned off from World Bank-financed projects. When the Bank demanded the money back, the government challenged the Bank to produce evidence. Under strong pressure, the government arrested a few low level officials.

### **Egypt**

In 2005, during the legislative elections, voters sold their votes for \$5 in rural areas (equivalent to one kilogram of beef) and \$175 in wealthy neighborhoods. The bribe for inheritance declaration papers could be as low as \$0.88 while that of low-ranking policemen hovered between \$1.75-\$3.50 for traffic arrests. However, it can be steep for other activities. For instance, it can exceed \$17,000 for a permit to build higher than the legal limit.

### **Ethiopia**

This country is known in the business community as the land of 10%, representing the rate of kickbacks. This rate applies not only to the corruption between the private sector and state institutions but between businessmen themselves (i.e. private to private).

### **France**

Elf is an oil company created in 1965 to secure French oil independence by maintaining French influence on oil-producing countries. During the trial of the company's executives, it was found that Elf bribed officials in almost all the countries in which it operated. It paid over \$435 million between 1989-93 to secure business in Africa, South America, Russia, Spain and Germany. In Africa, Elf bribed leaders in Angola, Cameroon, Gabon and the Republic of Congo as well. The company paid over \$7 million annually to political parties in France, notably the Gaullist party.

### **India**

Malfeasance is part and parcel life in India. Cases are countless. For illustration, in a land dispute with the Delhi Development Authority (DDA), the litigator paid \$15,000 to the district court judge who settled the dispute in his favor, only to be faced with the prospects of having to pay a larger bribe because the DDA filed an appeal to the High Court. Concerning petty corruption, a driver hit a cyclist who sustained head injuries and was detained. He was freed after his brother negotiated down the bribe for his release from the asking price of \$200 to \$86. In 2005, 11 legislators were expelled for asking questions in return for bribes. A corruption survey revealed that more than \$4.5 billion of bribes were paid to have access to public services. The most corrupt institutions were the police, the lower judiciary, land administration, government hospitals and schools.

### **Israel**

The last five prime ministers were investigated for unethical behavior: Shimon Peres, Ehud Barak and Ariel Sharon for illegal donations to their election campaigns; Benjamin Netanyahu for accepting expensive gifts and abusing state property; and Ehud Olmert for bribes in real estate deals, and for giving government jobs to cronies. Several former ministers, at least 10 mayors, senior government officials, and members of parliament are under various investigations.

Nir Gilad, a former director general of the Treasury, oversaw a massive privatization of public enterprises, including the sale of the national refinery to Ofer brothers (one the five wealthiest families in Israel). The state lost \$120 million in the course of this transaction. Nir Gilad later became deputy Director General of Ofer brothers and afterwards, Director General.

Petty corruption is required for driver's license, building permits, hearing with tax offices, courts, etc.

### **Kenya**

In 2006, three ministers were forced to resign in connection with investigation by the government of payment of several million dollars to a fictitious company. Two policemen manning the Gilgal weighbridge were caught with \$20,500 in local and foreign currencies. The Mariakani Bridge handles about 2000 vehicles per day, each paying on average \$50. The daily receipt would amount to \$190,000, an attractive source of bribe and embezzlement. The land of game reserves are frequently shaved off while game tourism fees are siphoned off. A 2006 inquiry revealed that the staff of the Tourism Ministry looted over \$2.8 million every year.

### **Lebanon**

The former Prime Minister Rafik Hariri created a private company called Solidere to which he awarded government construction contracts. He dismissed any criticism of conflict of interest. The current Prime Minister Fouad Siniora dismissed criticism for awarding duty-free zone of the Beyrouth airport to one of his close friends almost free of charge. A 2001 UN report revealed that of \$6 billion of projects, only \$143 million worth were awarded through competitive bidding. The remainder was awarded to those who were willing to pay the largest bribe.

### **Mexico**

To win two contracts worth \$5.7 million, Alstom paid \$653,000 to two top executives of the Mexican Light and Power. But influence peddling is also a significant source of corruption. For instance, Frederico Lomeli, the son of a prominent official, killed Maro Hernandez with his BMW and left the scene. Apprehended, he was questioned briefly, released and never charged. Reportedly, the son of former President Fox, collected millions of dollars peddling family connections.

### **Mozambique**

During the ill-managed privatization process of state enterprises, \$400 million disappeared from banks, money that the government had to pay back. In 1992, the government lent \$17 million to a businessman (Antonio Simoes) to modernize the Mozambican Steel Company. The work was not done. The money was not recovered and the government has remained silent. A 2005 survey ranked police as the most corrupt institution in the country, followed by hospital workers, teachers (sexual extortion) judges and prosecutors.

### **Nepal**

The former three-time prime minister, Mr. Deuba, was found guilty for taking bribes in return for awarding government contracts, and buying votes in parliament but escaped sanctions on the basis of technicalities. The King and his family also abused government money. For instance, the King spent \$3.5 million on African safaris whereas his son disbursed \$560,000 to offer two rhinoceros to the Austrian zoo. The King sharply increased his annual salary from \$1.6 million to \$10 million. He spent \$3.2 million holding municipal elections that were boycotted by opposition parties. In 2006, he was forced to relinquish power in favor of an elected parliament.

### **Nicaragua**

On December 11, 2005, an SUV sped at 100 miles per hour crashing into a car that just made a right turn. The two passengers of the car were killed instantly. The driver of the SUV and his companion got out shaken but unscathed. By the time the ambulance and police arrived,

the driver and passenger of the SUV have disappeared. The treasurer of the ruling Sandinista party had the two vehicles removed. Another man was arrested and taken to the police station and presented as the driver of the SUV. Witnesses said that he was not the driver. All the same, he was tried and convicted. Who was the real driver? His name was Rafael Ortega, the son of Daniel Ortega, former and current President of Nicaragua.

### **Nigeria**

To induce Parliament to change the constitution to enable him to remain in power, the former President Obasanjo is alleged to have offered 50 million naira (about \$390,000) to each legislator. The Presidency denied the allegation. Political corruption is rampant at the level of sub-national governments as well. For example, the governor of Bayelsa state was arrested and detained in London for money laundering. He escaped and returned to Nigeria where he is on trial. Malfeasance permeates the entire Nigerian society. The current Speaker of the federal House of Representatives is been asked to resign for spending \$5 million on the renovation of the official residence. In academia, students who buy books or handout written by lecturers are guaranteed as much a 20-point bonus on their final exams.

### **Philippines**

Pineda is the biggest operator of an illegal game called juetend. The annual receipts from this activity is estimated at about \$600 million, of which about \$120 million are paid as bribe to mayors, governors, police chiefs, legislators and journalists and the Catholic Church. President Joseph Estrada was driven out of office by protesters for receiving monthly payoffs from jueteng operators. The current government also is plagued by corruption scandals. For instance, in January 2004, after a dinner given to 27 elections supervisors in President Arroyo's house, a close friend of the presidential family distributed envelopes containing \$500 to the supervisors.

### **Russia**

Corruption has different faces in Russia. In 2001, a young man could avoid the military draft for a fee of about \$ \$2,600 in St Petersburg and \$6,500 in Moscow. The rate is 20 times higher in 2007. The bribe for registration of a child in kindergarten is \$1,000 and for a student at the university, it varies between \$2,000 and \$20,000. Half of all bribes are paid to doctors. It is estimated that the average bribe has risen sharply from about \$23,000 to \$244,000. The annual cost of corruption in Russia is estimated at \$40 billion.

### **Tanzania**

Malfeasance is widespread. It is entrenched in the land sector (notably building permits office). In the health sector, counterfeit drugs abound as their suppliers bribe their way into

pharmacies and hospitals. Permits to import and distribute HIV AIDS kits were awarded on non competitive basis to two companies controlled by the same business group. Corruption has penetrated the court system as well. The failure to pay bribes will translate into misplaced or lost documents, delays in filing case briefs, delays in setting hearings, vague and contradictory court orders, omission to record court proceedings, dismissal of cases on technical grounds, delays in issuing judgments, etc. During elections, votes are bought with cash, cell phones and other enticements. It is estimated that about 20% of the government annual budget is lost to corruption.

### **Uganda**

During his inaugural speech in January 1986, Yoweri Museveni declared: “The problems of Africa and Uganda in particular, are caused by leaders who overstay in power, which breeds impunity, corruption and promotes patronage.” Some 21 years later, he is still in power and corruption is rampant. In 2005, legislators were openly bribed with \$2,800 each to make them change the constitution to enable him to stay in power without term limitation. In 2006, three ministers were dismissed for mismanaging foreign grants to combat HIV-AIDS. Although his brother was dogged by many corruption scandals, President Museveni appointed him minister. Transparency International estimates that about \$950 million are lost annually to corruption.

### **USA**

Giffen, a USA national merchant banker and consultant to the Kazakh government oversaw a tangled web of bribery network created to buy access to Kazakh President and senior officials for Exxon, Mobil, BP, Amoco and Conoco. His lawyers contended that his activities were blessed by senior US government officials. It is believed that this allegation could be correct because the Federal Government refused to release documents that could establish this link for national security reasons.

Besides, the Giffen case, there are numerous instances of bad governance in the US. In June 2007, the House Majority Leader, Tom Delay, was indicted for money laundering and resigned from Congress. In March of the same year, Congressman Randy Cunningham was sentenced to prison for 8 years plus for receiving \$2.4 million bribe from defense contractors in exchange for government business. Vernon Jackson, a businessman was sentenced to seven years plus for paying \$400,000 in bribe to US Representative William Jefferson in exchange for help in securing business deals in Africa. The FBI found \$90,000 hidden in a freezer in Jefferson’s home in Washington. He is awaiting trial. George Ryan, Governor of Illinois, was sentenced to six years plus for receiving money, gifts and free travel tickets in exchange for government contracts.

### **Vietnam**

Petit corruption is widespread. A motorcyclist can pay \$3 dollars and pursue his trip if arrested instead of the legal fees of \$28 plus \$1 per day for storage. With \$20, one can have a driver's license without having ever holding a steering wheel. Flowers are not offered on Teachers' appreciation day, but envelopes of \$5-\$20 per student. It takes: (i) about \$500 to register a child in a good public primary school and \$13 per exam to ensure a good grade; (ii) \$1-\$2 to see a nurse, \$3 to see a doctor, and \$50-\$200 to perform a surgery. Upon graduation from medical school, a doctor may have to pay \$10,000 or more in order to obtain employment in a public hospital.

### **Yemen**

Budget managers regularly pay salaries to made-up workers and order goods and services for fictitious government institutions. Typically, cars are ordered for imaginary soldiers, collected and resold to private individuals and companies and the money is pocketed by government officials. A tax office collects monthly about \$66,000 but only declare \$15,000 to the treasury. Imports can be removed from customs after paying a small fee, no questions asked. An appointment to the Bid and tender Board can propel the nominee from poverty to wealth in few months, including a house worth \$230,000. Some \$10 million could not be accounted for in the Ministry of Information. Likewise, \$1 billion could not be traced in the parliament budget.

### **Zimbabwe**

In October 2005, Leo Mugabe, the nephew of President Mugabe was arrested for smuggling truckloads of four and fertilizer worth \$622,000 to Mozambique. He was briefly detained and released for lack of evidence even though the trucks and goods were impounded.