

STATEMENT

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Before

THE COMMITTEE ON FOREIGN RELATIONS OF THE UNITED STATES SENATE:

CORRUPTION AND MULTILATERAL DEVELOPMENT BANKS

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Thank you for giving me this opportunity to address this important issue. As Chief Counsel to the Subcommittee on Multinational Corporations of this Committee (1972-1977, General Counsel of the Inter-American Development Bank (1977-1989), and, more recently, as a Democratic appointee to the INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION of the Congress, popularly known as the Meltzer Commission, I have had some experience in dealing with the multiple facets of corruption in international financial transactions and the issues faced by the MFIs.

As I see it, there are three aspects to the problem. First, in projects and programs directly financed by the institutions, how do the institutions assure that the decisions with respect to the awarding of contracts are made on the basis of transparency and the merits of the proposals, free of any taint of corruption? Second, where the institutions have conditioned their financing upon certain reforms being enacted and implemented by the government but the MFI financing is not directly connected to the reforms, how does the MFI ensure that the funds disbursed are properly used? What responsibility do the institutions have to ensure that the reforms that they have publicly endorsed are implemented in a transparent manner free of corrupt practices? Finally, what responsibility, if any, do the MFIs have for assessing the level of corrupt practices in a particular country and calling attention to such practices as an obstacle to development?

A. DIRECT FINANCING

How do the institutions ensure that their own officials are not bought off by contractors or recipient governments in decisions such as the approval of projects and the award of contracts? I believe that this is a minimal risk. The internal project approval process is surrounded by checks and balances that virtually guarantee that such wrongdoing cannot take place. First, a project team is formed to evaluate the economic, financial and technical feasibility of a proposed project. In the IDB, with which I am most familiar, that team will have as a minimum, a lawyer, and, depending upon the nature of the project being financed, such additional technical staff as is necessary.

Before the formation of a project team, the proposal in preliminary form must be approved by an upper management committee, which is chaired by the President of the Bank, and includes senior operational members of the IDB staff. The most senior members of the staff of the IDB. The final analysis by the Project Committee of the feasibility of the project in all of its facets must be submitted for, at the staff level, final approval to a Loan Committee, chaired by the Executive Vice-President of the IDB. Each project must be approved Final by the Board of Executive Directors. A similar process, although different in some details, is followed in the World Bank.

At each stage of the process of analysis and approval there are so many individuals involved and checks and balances built into the system, that no one individual can control the decision. Hence, I think that the risk of individuals within the institutions making corrupt decisions which determine the project approval is minimal. However, in particular where there is purchase of goods and services, there are almost invariably disputes over the award of

contracts. Where the purchase of such goods and services is being financed with MFI resources, except in extraordinary and specified circumstances, all contracts are awarded by a process of competitive bidding. That process administered by the borrower following agreed MFI procurement guidelines. In larger contracts where international competitive bidding is used, a two-envelope system is used. At the first stage, the bidders must submit technical qualifications in which price does not figure. Only after the first stage of technical pre-qualification has been approved, does the second envelope of price come into play. All bids must be opened in a public session. The process and the final award must receive the non-objection of MFI officials.

Ideally, the process if properly administered, should be open and transparent and thus insulated from the possibility of corruption in the award of the contracts. Inevitably, though, there will be challenges to the process and the final result. The losing bidders will complain that they lost by virtue of a flawed process, corruption in the award, or any number of other reasons. Very often, they will seek the intervention of their governments which will direct their Executive Directors in the institution to seek redress for their complaints.

The venue in the IDB for hearing appeals is the Procurement Committee, which is chaired by the Manager for the Regional Operations Department of the particular country where procurement is taking place and other senior managers of the Bank. The Procurement Committee makes its own investigation of the validity of the complaints and reports in writing its conclusion to the Executive Vice-President of the IDB, who can endorse or overturn the report. The World Bank internal appeal process traditionally has been more informal. (Procurement issues are not within the purview of the World Bank's Inspection Panels). On that

part of a project directly financed by an MFI , I think that the award of contracts is fairly transparent and insulated from corruption.

The problems arise, I believe, on that part of a huge construction project where the financing is independent of the MFIs. There may be an issue with the borrower country and entity in charge of the project about whether the MFI procurement guidelines ought to apply to the entire project, including that part not being financed and supervised by the MFI. This is particularly sensitive where supplier credits are a part of the financing. What role, if any does the MFI have in approval of the process and final award of such credits? Can it really insulate itself from possible abuses where its financing is not directly involved? I think not.

American companies may be at a particular disadvantage. They are subject to the Foreign Corrupt Practices Act, which makes it a felony for the company through its officials or agents to make corrupt payments to foreign government officials in connection with procurement decisions by that government. Many European governments have traditionally treated such corrupt payments as ordinary business expenses, deductible for tax purposes. The OECD Convention on Bribery urges member governments to end such tax treatment, but it is dependent upon the action of individual governments, many of which have been slow to act. American companies are consequently particularly dependent upon the MFIs to effectively assure the integrity of the project.

A recent project in Lesotho, Africa illustrates the issue. The Director of the Lesotho Highland Water Authority was convicted in the courts of that country of corruption in the award of contracts in connection with the project. Part of the project was financed by the World Bank. There is no allegation of corruption in the award of contracts on that part of the project financed

by the World Bank. The Lesotho authorities then convicted as well two international contractors who had paid the bribes. The World Bank, potentially, has an effective, if draconian, remedy. It could place the international contractors on a proscribed list barring them from bidding on any future World Bank financed projects anywhere in the world. Usually, the project is financed or administered through a subsidiary of the parent company organized for the individual project; once the project is completed, the subsidiary is dissolved. In order to be effective the sanction must pass through the subsidiary to the parent company, usually an internationally recognized company.

A more difficult case is the huge multipurpose dam project, Yacyreta, a tripartite project among Argentina/Brazil/Paraguay, which has been financed in part by both the World Bank and the IDB. I should note that at the time of the original loans from the World Bank and IDB, I was the General Counsel of the IDB. From its inception, the project was complicated if for no other reason than three countries were involved but the most controversial issue involved the relocation of thousands of Paraguayan families, for which the government of Paraguay had neither the financial resources, nor the administrative competence or the political willingness to effectively follow-through on the relocation plan which was an integral part of the project.

The international institutions can provide the financial resources but not the administrative competence or political will. The Paraguayans were masters at playing off the two larger neighboring countries to maximize the financial benefits for a small clique surrounding the then Paraguayan strong-man Stroessner. The form this financial extortion took was ensuring that Paraguayan companies controlled by Stroessner's cronies were included in the

larger country construction consortia. Yet, it was also difficult to oppose the inclusion of such companies which were justified in the interest of technical capacity-building in Paraguay.

In fairness, I should note that at the time (1979-80), Argentina and Brazil were determined to proceed with the project and were willing to pay whatever the price demanded by the Paraguayans. Both countries were oil-import dependent and had been highly traumatized by the oil price revolution of 1973/74. Deep water oil discoveries in Brazil and Argentine on-land oil discoveries had not yet been proved. Hydro power was an attractive alternative for both of the larger countries. The MFIs, it was thought at the time, could ensure the integrity of the bidding process for very large international contracts and an adequate relocation program. On the first part, the integrity of the bidding process, I think they were relatively successful. On the second part, the relocation issue, they were less successful. And, as a recent report by the World Bank Inspection Panel notes, the relocation issue continues to plague the project.

The Lesotho case may be the easy one. One has a local court proceeding and finding of criminal conduct by the local project manager and consulting companies. If the World Bank placed the offending companies on the proscribed list, it is difficult to see how the regional development banks could sanction awarding contracts to the same companies on projects financed by them. The potential sanction is thus truly draconian. The World Bank and the Asian Development Bank have sanctions proceedings in place which provide for investigation, and a hearing for any company proposed to be subject to the sanctions. The IDB has a similar process now under consideration.

How many other countries are as zealous as that of Lesotho in pursuing the matter within their own judicial systems? And if they don't do so, what is the responsibility of the MFIs? It is

unlikely that they can pursue such an investigation where the government shows no disposition on its own to investigate allegations of corruption on that part of a project not financed by an MFI and which is not subject to the procurement guidelines of the MFI. If we are serious about addressing the cancer of corruption in projects even partially financed with public international funding, I think that it is reasonable to insist upon the entire project being subject to procurement guidelines that assure transparency in the award of international contracts and thus minimize the risk of corrupt payments in connection with such contracts.

More recently, attention has focused on getting the national export credit financing agencies of the creditor countries to address the issue of padding the supplier credits with corrupt payments in the award of the contracts. Given the intense competition in this segment of the international economy, I am not optimistic that any time soon this issue will be effectively addressed.

B. STRUCTURAL REFORM CONDITIONALITY

In the late 1980s and during the decade of the 90s, increasingly, the MFIs conditioned a substantial part of their lending upon borrowing countries undertaking major structural reforms such as privatization of state owned enterprises. The major vehicle of financing for these reforms were structural adjustment or sector adjustment loans. What distinguishes these loans from more conventional project financing is that the use of funds is not necessarily related to the structural reforms upon which the loans are conditioned. Typically, a loan is authorized conditioned upon the country, for example, privatizing the banking sector or the state owned electricity companies. Loan funds go to the Central Bank and need not be expended for purposes related to the privatization which is the condition for the loan. The funds can be used for purposes that are not

specifically prohibited: paying creditors, held in the currency reserves of the country, or for general imports. A first “tranche” of the funds is usually disbursed to the Central Bank upon signing of the loan contract. After six months, a review is conducted to determine whether the country has implemented the agreed reforms. If performance by the borrower in implementing the agreed reforms is satisfactory, the remainder of the loan is disbursed to the borrower.

The MFIs must also ensure that disbursed funds for non-specific purposes are not used for corrupt purposes. This is usually accomplished by a post-audit of the use of the disbursed funds. Realistically, however, this is the weakest link in the system. Money is fungible. It is extremely difficult, if not impossible to trace the MFI disbursed funds. You basically are relying on the probity of the Central bank officials.

As the importance of the structural adjustment lending has over the years grown in importance and magnitude for the MFIs another equally important issue arises: what responsibility do the MFIs have to assure that the reform process they are endorsing, particularly where privatization of state-owned assets is involved, is transparent and free from corruption? By endorsing the privatization reforms, the MFIs, particularly the World Bank, place the imprimatur of international approval upon the process.

Yet, in many instances, that process is so flawed and marred by corruption that it discredits the agreed reform. No country has been more acclaimed for its structural reforms than Mexico. This is the way that Andres Oppenheimer, the chief Latin American correspondent for the **Miami Herald**, in his book, **BORDERING ON CHAOS**, described privatization in that country: “In his bid to increase capital inflows, Salinas had put state banks on the block at three times their book value and often more...But in exchange for high prices, Salinas offered their

buyers sweet regulatory deals and long term promises of fabulous riches through NAFTA, which would soon allow some of the new private owners to sell their monopolies to multinational corporations at record profits...Through a policy of “directed” deregulation or selective liberalization, Salinas paved the way for the formation of more than a dozen monopolies that would control industries such as copper mining and telecommunications.”

After the Mexican devaluation of December 1994, the World Bank and the IDB poured billions of dollars into the Mexican banking industry to “bail out” the banks from their profligate lending, designed to recuperate the exaggerated prices they had paid for the state owned banking assets that were privatized. Mexico is not an isolated case. The same pattern has been noted in Russia and Argentina, both countries, which were at the time acclaimed for their reforms, particularly the privatization of state owned assets. Subsequently, the process, the lack of transparency, the massive corruption that accompanied the process, became in both countries major political issues.

I think it is unreasonable to expect that the World Bank, and or the regional development bank, can by themselves ensure the integrity of the process. The political and financial interests, and the stake of the government in the policy are too great. The process will be driven by domestic considerations and the domestic balance of power. What I think is reasonable however is to expect that where the corruption that has accompanied the process is as notorious as it was in Mexico, Argentina and Russia, the international financial community, through the MFIs, not give its stamp of approval, as was done in all three cases, to such a flawed process by extravagant praise of the “reforms.”

What then is the remedy? Political democracy. Argentina is the country which best illustrates the point. The government of President Carlos Saul Menem by the end of the decade of the 90s was thoroughly discredited. Menem failed in his initiatives to amend the constitution to permit him to succeed himself as President and then to mount a political comeback. The reasons are complex, rooted in part in the failure of the government's economic plan and the rivalries within his own political party. But all informed observers agree that the perception and the reality of massive corruption in the government, and particularly the privatization of state owned enterprises, played a major role in the demise of Menem's political career.

A competitive political party system, an aggressive free press, and a previously discredited judiciary all played crucial roles in ensuring that the corruption issue was a central part of the Argentine political decision-making. The system worked the way we should hope it would. And that is why I remain skeptical of the role of outside entities in addressing corruption in any particular society. The best and most effective remedy is the existence of the institutions of political democracy—a competitive political party system, a free press, free trade unions, an independent judicial system.

Too often, that objective has been sacrificed to an excessively technocratic economic outlook within the MFIs. The most egregious example is that of Indonesia under the government of Suharto. Indonesia was acclaimed by the World Bank as a “star” of the system because of its economic performance and alleged reduction in absolute poverty. And there were gains, both in economic management and in the reduction of those living in abject poverty. But in a remarkably detailed report the **Wall Street Journal** (Brauchili, 6/14/98), observed that “World Bank officials knew corruption in bank-funded projects was common” and “went along with

government estimates that showed epic improvements in living standards, despite indications the numbers were inflated.” The **Journal** notes that the World Bank lent Indonesia more than \$25 billion over three decades and quotes James Wolfensohn, the President of the World Bank, explaining that “We were caught up in the enthusiasm of Indonesia.” Hopefully, we are now beyond the excessively economic technocratic thinking that led World Bank officials to overlook and justify the seamier side of development in the Suharto era.