Promoting Economic Growth in a New Era:

A USAID Workshop

June 28–July 2, 2004

Washington, D.C.

USAID
BUREAU FOR ECONOMIC GROWTH, AGRICULTURE AND TRADE
OFFICE OF ECONOMIC GROWTH

ASSISTANCE INSTRUMENTS

SEGIR INDEFINITE QUANTITY CONTRACTS (IQCS)

Support for Economic Growth and Institutional Reform (SEGIR) – The SEGIR IQCs offer missions and bureaus quick, easy access to 28 consortia representing 250 contractors specializing in five technical areas: **General Business, Trade, and Investment (GBTI); Commercial, Legal and Institutional Reform (LIR); Macroeconomic Policy; Privatization; and Financial Sector**. The first generation of contracts have an aggregate authorized ceiling of almost $2.2 billion (please see Annex A for a breakdown). Follow-on IQCs are complete and awarded for Privatization, and about to be awarded for LIR and Macroeconomic Policy. These follow-on IQCs will be authorized at an aggregate level of at least $4 billion. The follow-on Financial Sector and GBTI contracts may be completed in time for the FY2004 procurements.[1] Missions use their own funds for task orders under the various SEGIR components. For more information on how to access SEGIR, check the USAID website (http://inside.usaid.gov/eg/segir_genl/segir.htm). Also contact the CTO and Component Manager of the appropriate SEGIR component.

Component	CTO	Manager
Privatization	Yoon Lee (ylee@usaid.gov)	Mark Karns (mkarns@usaid.gov)
Commercial, Legal & Institutional Reform	Yoon Lee (ylee@usaid.gov)	Nick Klissas (nklissas@usaid.gov)
Macroeconomic Policy	Jim Elliott (jelliott@usaid.gov)	Jim Elliott
Financial Sector	John Crihfield (jcrihfield@usaid.gov)	John Crihfield
GBTI	Yoon Lee (ylee@usaid.gov)	Mark Karns (mkarns@usaid.gov)

INTERAGENCY AGREEMENTS

U.S. Securities and Exchange Commission:
This program consists of SEC-led activities to facilitate the development of securities and capital markets, corporate governance, and securities regulatory functions within USAID cooperating countries, using the expertise of the world's premier securities regulatory body. Activities are short-term in duration, and typically include country and market assessments; review and commentary on proposed securities, and corporate laws and regulations; technical support for on-site USAID contractors; and annual training opportunities through SEC's International Institute for Securities Market Development, and International Institute for Enforcement and Market Oversight. Missions and bureaus may access the technical services of SEC through an Interagency Agreement between the EGAT Bureau and SEC. EGAT funding support may be available for cost-sharing in some cases. Contact: Georgia A. Sambunaris (gsambunaris@usaid.gov).

[1] The follow-on Financial Sector and GBTI awards will be made through another federal government organization (the General Services Administration) and will be called Blanket Purchase Agreements (BPAs). The BPAs will closely resemble IQCs, and from a user's perspective function in the same way.

U.S. Federal Trade Commission (Summer 2004):
This program will consist of FTC- and U.S. Department of Justice-led activities to assist institutional capacity building among competition policy authorities in USAID cooperating countries. Activities would largely consist of conducting assessments and in providing short term technical assistance. Longer term activities are possible, but would require a separate funding vehicle. Contact: Nicholas Klissas (nklissas@usaid.gov).

Federal Deposit Insurance Corporation:
This Interagency agreement facilitates the transition of emerging market banking and financial sector institutions into accommodation of functioning and transparent deposit insurance networks, and prudential oversight and corporate governance of bank deposits by investors. The FDIC will provide technical assistance and training in support of USAID financial sector reform activities. The program will assist USAID cooperating countries in developing deposit insurance within a host country banking structure, and will offer advisory services in the development of bank risk assessment. The new EGAT financial sector strategy envisions a growing role in the conduct of corporate governance practices in the banking sector aimed at addressing risks and providing for fair treatment of all depositors/investors. The new FDIC IAA will be implemented worldwide among USAID countries. This agreement will run through 2007 as a 632(a) transfer to the FDIC. Contact: Georgia A. Sambunaris (gsambunaris@usaid.gov).

GRANT AGREEMENTS

Financial Services Volunteer Corps (FSVC):
FSVC's mission is to build the sound financial infrastructure required by countries seeking to develop transparent, market-oriented economies. FSVC's core competencies include the following: commercial banking; central banking; capital markets; banking and financial legislation; anti-money laundering; payment systems; pension systems; and corporate governance. Through FSVC, missions have access to active professionals in the U.S. financial community for short-term, volunteer consulting services overseas. Volunteers are typically leaders in their field, and often establish professional relationships with their counterparts that last well beyond any particular assignment. Missions and bureaus may access the technical services of FSVC through a Cooperative Agreement between the EGAT Bureau and FSVC. USAID missions and bureaus pay for travel and lodging for the volunteers, including indirect costs. FSVC provides financial sector experts, who volunteer their time at no cost to the program. Contact: John Crihfield (jcrihfield@usaid.gov).

Public-Private Infrastructure Advisory Facility:
Through EGAT, USAID participates as a board member and donor, in the Public-Private Infrastructure Advisory Facility (PPIAF) a multi-donor facility designed to help developing countries improve the quality of their infrastructure through private sector involvement. The PPIAF is widely recognized as the focus of state-of-the-art thinking in this area. It identifies, disseminates, and promotes best practices on matters related to private involvement in infrastructure. Limited USAID funding can have a larger impact when leveraged with PPIAF funding and/or PPIAF expertise in ports, railways, electricity, sewerage, water, solid waste, and others. USAID Contact: Mark Karns (mkarns@usaid.gov). Website: www.ppiaf.org

New Access to Volunteer Organizations VEGA:
Volunteers for Economic Growth Alliance (VEGA) is a Leader with Associate (LWA) Cooperative Agreement providing access to an Alliance of sixteen economic growth volunteer organizations.
VEGA is designed to provide Missions with a broad range of volunteers in a variety of economic growth specializations. Missions can initiate a collaborative design process for an Associate Agreement with

VEGA by sending a description of the envisaged program to the CTO. VEGA will also be engaged, through the Leader Agreement, in defining best practices of utilizing volunteers to achieve impact in economic growth areas. This will include: defining best practices in the design of programs whose goal is to achieve sustainability through host-country private sector suppliers of business services; creating a monitoring and evaluation system to quantitatively and qualitatively capture impacts of volunteer programs; and using the information gained through these exercises to improve activity designs in the field. For more information on VEGA contact Kristin Randall (krrandall@usaid.gov) or visit www.vegaalliance.us .

Emerging Markets Development Advisors Program:
EMDAP places first year U.S. Master of Business Administration (MBA) students and students in international business/development programs in host-country businesses for 10 months to provide general management technical assistance. While in country, Advisors work in mid-level management positions, keep contact with their U.S. university mentors (professors/department heads within their graduate school), and write case studies on issues of the Advisers' choosing on the challenges of conducting business in a developing country. The case studies are published, together with a compendium of "lessons learned" which can be utilized by U.S. and host-country universities. The EMDAP is implemented through a Cooperative Agreement with the Institute of International Education (IIE). Mission funding is provided though transfers to EGAD/EG for the EMDAP CA or through incremental funding via a MAARD. Contact: Kristin Randall (Krrandall@usaid.gov).

The Center for International Private Enterprise (CIPE: www.cipe.org):
The ***Transitional Economies Corporate Governance Initiative*** is a grant program focusing on non-governmental organization (NGO), and private sector enforcement of corporate governance in the financial sector. This activity also promotes business association development and SME training, and addresses issues related to the informal sector. The program aims to apply technical assistance and training initiatives that implement the recently revised OECD Principles of Corporate Governance, and transparent financial sector monitoring of corporate transactions. As an affiliate of the U.S. Chamber of Commerce, CIPE has a unique network of regional and host country business groups and policy organizations that serve as counterparts for this program. The program operates in harmony with the efforts of the OECD, the IFC/World Bank's Global Corporate Governance Forum in implementing an internationally recognized program of corporate governance practices through encouragement of:

- Corporate governance institutes and codes of conduct advocated by the OECD
- Board of director training and fair treatment of shareholder rights
- Financial reporting, auditing and enforcement training
- Media training
- Small grant pilot programs
- Shareholder rights for annual meetings for publicly listed companies
- Joint donor roundtable and white paper development

This activity provides for USAID/Mission buy-ins as well as regional funding for the E&E and LAC regions. Contact: Georgia A. Sambunaris (gsambunaris@usaid.gov)

Strategies and Analyses for Growth and Access (SAGA):
The SAGA program is currently Africa specific and has a cooperative agreement with Cornell University to implement a research program on micro level constraints to growth in Africa. Cornell is focusing their research efforts in Ghana, Uganda, Kenya, Madagascar, and S. Africa, as well as coordinating with WARP to work on regional activities in W. Africa. Other African missions interested in accessing Cornell University for analytical work that fits into their general research framework can buy-in to the

program. More information about the Cornell program can be found at www.saga.cornell.edu. SAGA also supports strengthening of national economic research institutes (think tanks) to formulate, disseminate and advocate economic policy analysis in support of economic reform. The project does this through a grant to The Secretariat for Institutional Support for Economic Research in Africa (SISERA), a regional organization based in Senegal. African missions interested in buy-in possibilities to support national economic research/policy institutes in their countries can find out more about SISERA through www.idrc.ca/sisera or contact Rita Aggarwal (raggarwal@usaid.gov).

TRADE CAPACITY BUILDING (TCB) SUPPORT PROJECTS

Under the SEGIR contracts EGAT has entered into a number of task orders that Missions may utilize by adding additional funds. In some cases EGAT may share the cost of new activities with Missions. Because these are pre-competed, the paperwork and delay required is minimal. New requests for specialized technical assistance can be addressed in as little as three weeks.

SPS – Trade Capacity Assistance in Agricultural Standards (CAAS) – CAAS is a 3-year Task Order with Development Alternatives, Inc. (DAI) to address TCB needs related to the development and application of Sanitary and PhytoSanitary (SPS) measures and other agricultural and agribusiness standards. This includes both public and private sector needs, including strengthening public sector regulatory regimes and helping agricultural and food producers meet standards and regulations in key international markets. Other activities include: technical research, development of related training resources, surveys and analysis of critical SPS issues, in-depth evaluation of previous or existing SPS-related projects, and assistance with the design of SPS projects. This project has core funding from EGAT, with buy-in from the field. Contact: David Soroko (dsoroko@usaid.gov).

Customs, Trade Facilitation, & Transportation Security – The "Facilitating Streamlined Trade" (FASTrade) initiative responds to a growing awareness that cumbersome and often corrupt customs and other border clearance systems can be one of the greatest obstacles to effective integration into the global economy. FASTrade also can help missions address the increasingly complex and costly security requirements imposed on international shipments as part of the war against terrorism. EGAT has awarded the contract for this mechanism to a consortium consisting of Booz Allen Hamilton, Louis Berger, and George Mason University's Mercatus Center. Please check the project website at http://tcb-fastrade.com/ for a more detailed description of the different technical dimensions of the project, including a list of field activity concepts, an explanation of how to access FASTrade expertise, and further background information. Contact: John Ellis (jellis@usaid.gov)

Fiscal Reform in Support of Trade– Fiscal Reform is designed to help USAID provide technical leadership in addressing fiscal issues—those relating to trade liberalization and more broadly to tax policy and administration, budgeting and expenditure control, inter-governmental transfers, local taxes and so on. The services of the project are available to help missions identify, design, or evaluate fiscal activities, carry out fiscal research and analysis, or provide training in the fiscal area. This multi-year task order started in July 2003 is implemented by Development Alternatives Inc. (DAI) and Georgia State University. Fiscal Reform requires roughly a month for short-term taskings. Missions may buy-in to this activity. Contact: David Dod (ddod@usaid.gov). Project website: www.fiscalreform.net .

Services – Trade Enhancement for the Services Sector (TESS) – Trade Enhancement for the Services Sector (TESS) is a new USAID program that supports service sector liberalization and advancement. TESS is designed to support USAID missions in formulating and implementing service sector related elements of their trade strategies, through a variety of tools including training, trade capacity building, diagnostics, and other technical assistance. This three year initiative, implemented by CARANA

Corporation, involves the development of a website, training, and short-term assignments related to the design, implementation, and evaluation of service sector liberalization. Missions can access TESS services through core funding, co-financing, or Mission buy-ins. There is a three-week turnaround on taskings. Contact: (asimmons-benton@usaid.gov). Website: www.tessproject.com .

Commercial Law – The Seldon Project – Seldon mobilizes assistance to assess commercial law regimes, including laws concerning contract, commercial dispute resolution, property rights (IPR, land, and movables), bankruptcy, company law, trade law, and foreign direct investment. Seldon does commercial law assessments, trade law assessments, short-term consultative work, and assessments to help Missions design strategies and commercial law activities. Seldon, a 3-year Task Order implemented by Booz Allen Hamilton, expires in FY 2005. EGAT provides core funding and Missions can buy-in from the field. Seldon requires a one-month notice for short-term taskings. Contact: Nick Klissas (nklissas@usaid.gov).

WTO Accession and Compliance – The Doha Project – The Doha Project provides WTO accession support and short-term, trade-related consultative services. The short-term services in the WTO disciplines include IPR, services, sanitary and phytosanitary standards (SPS), customs, technical barriers to trade, and others. The Doha Project is a 3-year Task Order, expiring in FY 2005, implemented by Booz Allen Hamilton. EGAT provides core funding, and Missions can buy-in from the field. A one-month notice is needed for short-term taskings. Contact: Nick Klissas (nklissas@usaid.gov) or Anne Simmons-Benton (asimmons-benton@usaid.gov).

General Support for Trade Capacity Building (STCB) – STCB is a 3-year Task Order with Nathan Associates to respond to Missions' requests to provide trade-related technical assistance. Missions are expected to use their funds to access this mechanism. STCB has been used to design country-specific "trade mainstreaming" projects to integrate pro-trade policy and capacity building into national economic growth and poverty reduction strategies. Missions also use it for design support for TCB projects, technical research and workshops on global trade issues, and trade training courses for USAID staff and senior officials. Contact: John Ellis (jellis@usaid.gov).

SAGA/TRADE---This is a trade capacity building activity specific to Africa. The grantee is a regional organization in Africa called the African Economic Research Consortium (AERC). AERC commissions analytical work and organizes workshops on trade related issues of concern to African countries. National expertise is utilized to the extent possible in each of the African countries that AERC works. Missions can buy-in to this activity. Contact: Rita Aggarwal (raggarwal@usaid.gov).

OTHER TCB ASSISTANCE

TradeMap – The TradeMap database is a proprietary, web-based database of the International Trade Center (ITC) in Geneva. TradeMap provides very up-to-date and comprehensive world trade and trade barrier data in a user-friendly format. EGAT and the ITC negotiated an agreement under which ITC will provide access and some training to all users USAID may identify, including host country government officials, academics, private sector counterparts, contractors and grantees. Though the database is considered particularly useful for businesses in exploring export markets, it can also be useful to trade policymakers. Access TradeMap at: www.trademap-usaid.org. Contact: Anne Simmons-Benton (asimmons-benton@usaid.gov).

IQCs PROVIDING COMPLEMENTARY SERVICES FROM OTHER EGAT OFFICES:

Rural and Agricultural Incomes with a Sustainable Environment (RAISE) – RAISE is a partnership between EGAT's Agriculture and Environment offices to help Missions design and implement strategies to stimulate lasting and broad-based job creation by strengthening natural resource-based industries and community-based natural resource management. RAISE consists of three consortia with over 30 partners including environmental NGOs, private sector businesses, consulting firms, and universities. These consortia can take on Task Orders lasting up to four years. Each consortium can undertake up to $66.7 million in business. Task orders must be negotiated by November 23, 2003, with a Project Activity Completion Date of November 23, 2006 or before. The three RAISE consortia are led by Associates in Rural Development; Chemonics International: and Development Alternatives, Inc. For further information, click on www.raise.org or http://www.genv.org/iqc/RAISE/index.asp (for USAID website). For general inquiries regarding RAISE or submitting draft scope of work for initial review, contact raise@usaid.gov. Once a scope of work is approved, the Mission contracting officer sends it directly to the appropriate RAISE consortia. Contact: David Soroko (dsoroko@usaid.gov).

Partnerships for Food Industry Development (PFID) – PFID promotes science-based legal, regulatory and policy frameworks for international trade in food products, and adapts and applies food processing and marketing technologies to create value-added products and/or to improve their safety and quality. PFID is a Leader-with Associate grant mechanism for Mission buy-in and supports linkages between universities and food industries. It is being expanded in FY 2003 to include the full range of high-value seafood, meat and produce export products. Contact: Carol Wilson (cwilson@usaid.gov)

Global Workforce in Transition (GWIT): GWIT is a 5-year, $35 million multi-task order IQC that provides Missions with easy access to workforce development, competitiveness, trade and SME development experts who can help countries raise workforce skills in ways that increase productivity and competitiveness, thereby fostering economic and employment growth. Activities include short-term workforce assessments and longer-term projects that strengthen connections between the private sector and education to improve workforce skills, sharpen their relevance and timeliness, and create more flexible labor markets. Workforce assessments help identify strategies for addressing challenges related to the current and future supply and demand for labor and skills resulting from liberalized trade policies, privatization, cluster-based competitiveness and SME development initiatives. More information on how to access GWIT and its activities and capabilities is available on the GWIT website, WWW.GWIT.US or by contacting: Robert McClusky (rmcclusky@usaid.gov).

Annex A

Support for Economic Growth and Institutional Reform (SEGIR)

SEGIR I:

Component	**Deadline – TOs**	**Deadline Work**
Privatization	September 30, 2003	Dec. 19, 2005
LIR	September 30, 2003	Feb. 7, 2006
Macroeconomic Policy	June 19, 2005	June 19, 2006
Financial Services	May 19, 2004	Jan. 19, 2007
GBTI	Aug. 13, 2004	Aug. 12, 2007

* Reflects the ceiling amount minus obligated funding. This may not be the amount available to for buy-ins.

SEGIR II: (all contracts can accept task orders for 5 years)

Component	**Ceiling**	**Notes:**
Privatization	$ 500 million	obligated September, 2003
CLIR	$ 600 million	planned for obligation FY 2004
Macroeconomic Policy	$ 600 million	planned for obligation July 2004
Financial Sector	unlimited	planned for obligation late FY2004
GBTI	unlimited	planned for obligation 9/30/04

Office of Economic Growth EGAT/EG Pending

Steve Hadley
Director

Bettie Burgess
Mitzi Likar
John Gunning
Skip Kissinger

Trade & Investment

Dan Rathbun, Team Leader
John Ellis
Anne Simmons-Benton
Jennifer Chase-Solomon
Nick Klissas
Tom Katen
(ex-Joe Lessard Trade Advisor)
(E&E Trade & Investment?)

Enterprise Development Financial Markets

Brad Wallach, Team Leader
Georgia Sambunaris
John Crihfield
Mark Karns
Kristin Randall
Chris Barltrop
Aneera Dobbins
Amy Cogan
(E&E Competitiveness Advisor)
(E&E SME Advisor)

Economic Policy & Governance

Paul Deuster, Team Leader
Mark Gellerson
Rita Aggarwal
Fred Witthans
Jim Elliott
Yoon Lee
David Dod
(Vacant)

6/10/04

MOZAMBIQUE
"Control of Corruption" Indicator 2002
Point Estimate (-2.5 to + 2.5): -1.01
Percentile Rank: 14.9
Standard Deviation: 0.21
List of 5 Sources

	Source	Publication	Type
1.	Columbia University	State Capacity Project	Poll
2.	World Bank	Country Policy and Institutional Assessments	Poll
3.	Political Risk Services	International Country Risk Guide	Poll
4.	Business Environment Risk Intelligence	Qualitative Risk Measure in Foreign Lending	Poll
5.	World Markets Research Center	World Markets Online	Poll

TANZANIA
"Control of Corruption" Indicator 2002
Point Estimate (-2.5 to + 2.5): -1.00
Percentile Rank: 15.5
Standard Deviation: 0.16
List of 8 Sources

	Source	Publication	Type
1.	Afrobarometer	Afrobarometer Survey	Survey
2.	Columbia University	State Capacity Project	Poll
3.	World Bank	Country Policy and Institutional Assessments	Poll
4.	Global Insight's DRI McGraw-Hill	Country Risk Review	Poll
5.	Economist Intelligence Unit	Country Risk Service	Poll
6.	Political Risk Services	International Country Risk Guide	Poll
7.	Business Environment Risk Intelligence	Qualitative Risk Measure in Foreign Lending	Poll
8.	World Markets Research Center	World Markets Online	Poll

Source of Data: D. Kaufmann, A. Kraay, and M. Mastruzzi 2003: Governance Matters III: Governance Indicators for 1996-2002.

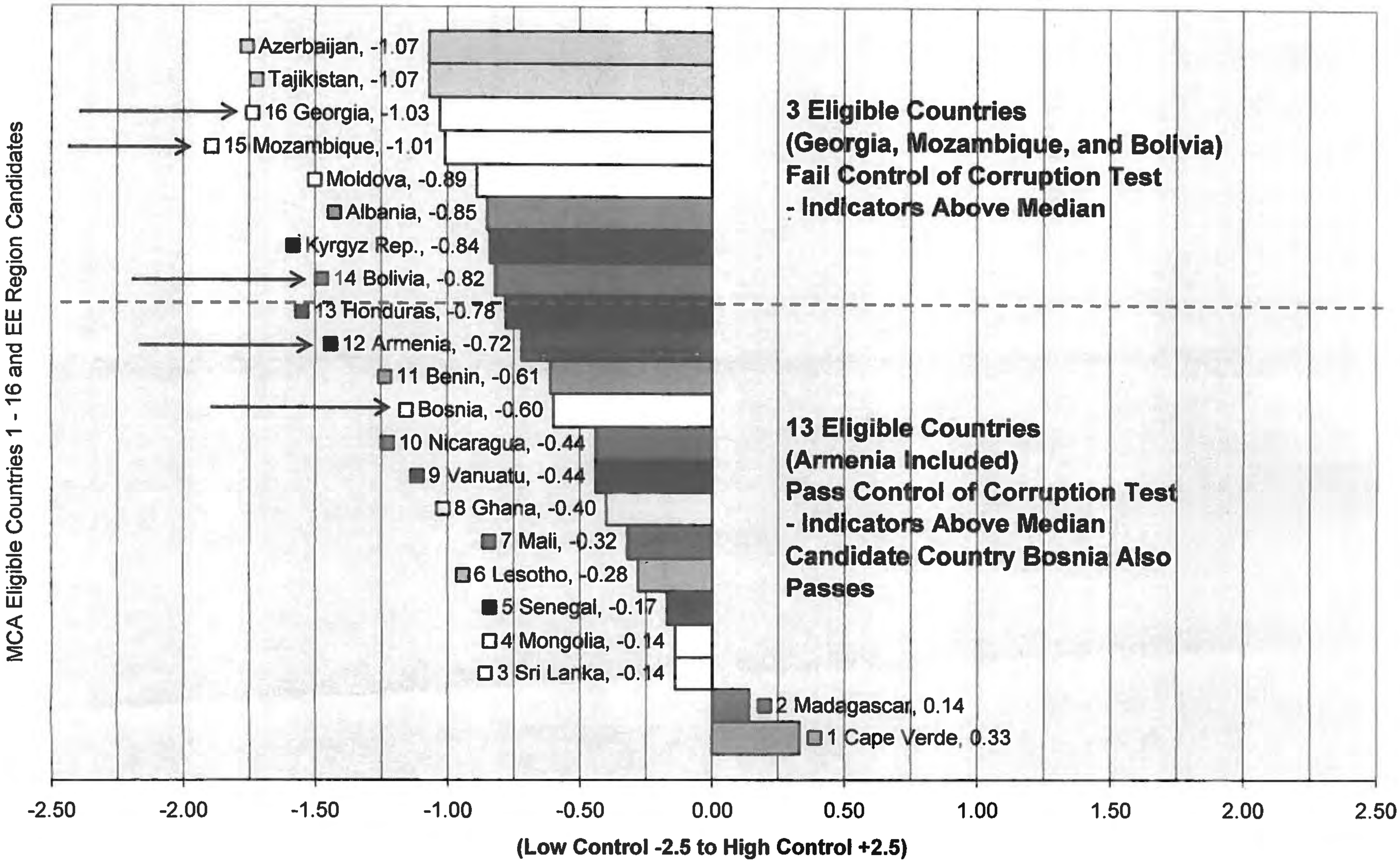
Table 2.9

16 MCA Eligible Countries for FY 2004
Europe and Europe Region Candidate Countries
Control of Corruption Indicators for 2002
Point Estimate and Percentile Rank
Source: World Bank Institute

			Point Estimate (-2.5 to +2.5) Percentile Rank (0 to 100)			Control of Corruption	
MCA Eligible Country	EE Region Candidate Country		Point Estimate	Percentile Rank	Standard Deviation	Above Median Pass	Below Median Fail
1		Cape Verde	0.33	66.0	0.30	√	
2		Madagascar	0.14	61.9	0.27	√	
3		Sri Lanka	-0.14	54.6	0.16	√	
4		Mongolia	-0.14	54.1	0.25	√	
5		Senegal	-0.17	53.1	0.18	√	
6		Lesotho	-0.28	48.5	0.24	√	
7		Mali	-0.32	46.4	0.24	√	
8		Ghana	-0.40	42.8	0.16	√	
9		Vanuatu	-0.44	40.2	0.44	√	
10		Nicaragua	-0.44	39.7	0.18	√	
No	1	Bosnia	-0.60	34.5	0.17	√	
11		Benin	-0.61	34.0	0.27	√	
12	2	Armenia	-0.72	30.4	0.16	√	
13		Honduras	-0.78	27.3	0.16	√	
14		Bolivia	-0.82	25.3	0.16		x
No	3	Kyrgyz Rep.	-0.84	23.7	0.16		x
No	4	Albania	-0.85	23.2	0.18		x
No	5	Moldova	-0.89	21.6	0.14		x
15		Mozambique	-1.01	14.9	0.21		x
16	6	Georgia	-1.03	12.4	0.16		x
No	7	Tajikistan	-1.07	10.3	0.17		x
No	8	Azerbaijan	-1.07	9.8	0.14		x

Using the median as the basis for a rigid "in-or-out" rule for MCA purposes runs the not insubstantial risk of misclassifying some countries because margins of error are not trivial. As the World Bank Institute researchers explain in more detail than can be included here, for a large intermediate range of countries which fall neither in the group of the very best or worst, there is a non-trivial possibility that they belong in either the top half or the bottom half of the sample. In the opinion of several experts, using a range is far more appropriate than using the median as a bright line test for MCA purposes. These margins of error may explain in part why it is appropriate for the MCC Board to exercise sound discretion in evaluating candidate countries with scores relatively close to the median.

Figure 2.8 FY 2004 MCA Eligible Countries (16) and SEED and FSA Candidate Countries Control of Corruption Indicators 2002 Point Estimates



Promoting Economic Growth in a New Era: A USAID Workshop
June 28-July 2, 2004
Assessing and Controlling Corruption
A. David Meyer, Moderator dmeyer@usaid.gov

Corruption Numerology

Dr. Samuel Johnson (1709-1784):

"Round numbers are always false."

Meyer's Variation on a Theme of Johnson:

"Indicators with decimal points lack precision."

Mark Twain:

"In the space of one hundred and seventy-six years the Lower Mississippi has shortened itself two hundred and forty-two miles. That is an average of a trifle over one mile and a third per year. Therefore, any calm person, who is not blind or idiotic, can see that . . . just a million years ago next November, the Lower Mississippi River was upward of one million three hundred thousand miles long, and stuck out over the Gulf of Mexico like a fishing rod. And by the same token any person can see that seven hundred and forty-two years from now the Lower Mississippi will be only a mile and three-quarters long, and Cairo and New Orleans will have joined their streets together, and be plodding comfortably along under a single mayor and a mutual board of alderman. ***There is something fascinating about science. One gets such wholesale returns of conjecture out of such a trifling investment of fact."***

— from "Life on the Mississippi" (1874) as quoted in "How to Lie with Statistics" by Darrell Huff (1954)

A New Era

Monday, June 28, 2004
9:00-10:45

Plenary Session

Welcome: Steve Hadley, Paul Deuster

Overview on Global Trends, Growth Determinants and Aid Effectiveness

Steve Radelet, Presenter
Joy Ryan, Presenter
Michael Crosswell, Moderator

Monday, June 28, 2004
11:00-12:30

Plenary Session

Dealing with Fragile States and the Agency's Anti-Corruption Strategy

Fragile states have posed a growing problem since the end of the Cold War and are now recognized as a source of our nation's most pressing security threats. Corruption is widely recognized as a major constraint to development as well as a driver of fragility. This session will feature presentations on two new Agency strategies (currently in draft) that aim to address these central issues, and offer opportunities for comment and discussion on relevance to EG programs and policy recommendations.

Presenters:

Melissa Brown, Senior Policy Advisor for Democracy and Governance, USAID/PPC
Neil Levine, Senior Advisor for Governance, USAID/DCHA/DG

Monday, June 28, 2004
1:30 – 3:00

Breakout Session

Presentations on Geographic Regions: Trends, Experiences and Aid Results

Africa

Bruce Bolnick Presenter
Rita Aggarwal Moderator

Monday, June 28, 2004
1:30 – 3:00

Breakout Session

Presentations on Geographic Regions: -- Trends, Experiences and Aid Results

Asia

Rebecca Black, Presenter
Robert Wuertz, Presenter
Steve Parker, Presenter

USAID Support for Vietnam's Implementation of the U.S.-Vietnam Bilateral Trade Agreement and WTO Accession

Steve Parker
Project Director, STAR-Vietnam

Overview

- Highlights: How USAID's STAR-Vietnam Project is Making a Difference
- Vietnam Development Context
- Economic Impact of the BTA
- Remaining Challenges

STAR VIETNAM

Highlights: BTA Context

- The BTA comes into effect on December 10, 2001
- A comprehensive set of requirements on:
  - market access,
  - commercial law,
  - economic governance affecting trade in goods and services,
  - intellectual property right protection,
  - investment,
  - business facilitation
  - transparency and the right to appeal
- U.S. extends NTR/MFN treatment to Vietnam,→ lowers tariffs for Vietnamese exports from an average of 40% to 4% – Vietnamese exports to the U.S. boom
- Vietnam, a developing economy, has extensive requirements due upon entry into force of the BTA, but a number of other requirements can be phased in (up to ten years) – Vietnam makes steady progress toward implementing the BTA over time

STAR VIETNAM

Highlights: USAID Creates STAR

- USAID, in coordination with USTR, expedites mobilization of the *STAR-Vietnam* Project in October 2001 to support Vietnam's implementation of the BTA and accession to the WTO
- The Vietnamese Government provides *STAR* with unprecedented access to all stages of the legal reform process (working with 46 state agencies)
- Vietnamese counterparts ask for STAR to provide technical assistance to reform almost every (non-tax) law affecting commercial activity in Vietnam
- USAID increases funding to STAR to augment resources available to meet the unexpectedly large demand for STAR assistance
- In just two and one-half years, STAR provides training and seminars, publishes reference materials, supports websites and organizes study tours to enhance understanding of BTA/WTO requirements for more than 4,000 key government officials and business leaders
- **STAR becomes a major legal reform and development project**

STAR VIETNAM

Highlights: Making a Difference

- **Completed Legal Reforms:**

1) Improving access for legal services (Decree on Foreign Lawyers)
2) Improving transparency of laws and regulations (revisions to "Law on Laws" and Decree on Official Gazette and other implementing regulations
3) Improving court procedures, especially for IPR and commercial disputes (a new Civil Procedure Code)
4) Strengthening the commercial banking system (revisions to the Law on Credit Institutions)
5) Liberalizing commercial arbitration procedures (a new Ordinance on Commercial Arbitration and implementing regulations)
6) Bringing Customs procedures into conformance with WTO requirements, especially the Customs Valuations Agreement (key Customs circulars)
7) Establishing the basis for the right to appeal administrative actions with due process and court review (revisions to the Law on Complaints and Denunciations)
8) Others with less direct BTA implications (Bankruptcy Law and Ordinance on Anti-Dumping)

STAR VIETNAM

Highlights: Making a Difference (2)

- **Legal Reforms 2004-05:**

1) A complete overhaul of investment law (developing a Common Investment Law and Unified Enterprise Law)
2) A full revision of contract law (revising key commercial elements of the Civil Code and Commercial Law)
3) Strengthening IPR laws and regulations (revising Part 6 of the Civil Code, developing a new Law on IPR, adjusting law and regulations to accede to international IPR conventions, enhancing Customs border measures, increasing penalties for infringement)
4) Enhancing a much more effective system for enforcing court decisions (a new Code on Judgment Enforcement)
5) Developing a set of independent administrative tribunals with due process and judicial review (a new Law on Complaints to meet right to appeal requirements, still in development)
6) Even stronger transparency (elimination of the use of opaque official letters, publication of court decisions, enhanced reporting on National Assembly activities, development of an electronic Official Gazette, the use of web pages to encourage public comments on drafts laws and regulations)

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Legal Reforms 2004-05 (cont):

7) Developing a legal framework for E-commerce and E-customs (developing a new Electronics Transactions Law)
8) Improving implementation of International treaties (like the BTA and WTO, developing a new Law on International Treaties)
9) Enhancing competition (developing a new Competition Law)
10) Developing securities markets to mobilize capital more effectively (developing a new Securities Law)
11) Implementing banking law reforms and developing 100% subsidiaries (guidelines for revisions to Law on Credit Institutions)
12) Greater conformance with WTO requirements for telecommunications (implementing regulations for Ordinance on Telecommunications)
13) Opening wholesale and trade distribution networks (circulars on trade and distribution)
14) Revising the Customs Law to support WTO compliance and a large Customs Modernization Program (funded by the World Bank)

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Highlights: Making a Difference (3)

- **Supporting Effective Implementation of New Laws:**

1) Systematic training programs for judges, lawyers and enforcement agents on IPR and commercial dispute resolution procedures
2) Support for improving coordination of IPR enforcement efforts at local levels
3) Training and technical workshops for key National Assembly members and staff
4) Training and technical workshops for local government officials in larger provinces
5) Development, publication and wide distribution of regular Economic Reports on BTA Implementation

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Vietnam Development Context

- **The Demographic Bubble:** 1.5 million new entrants a year and existing underemployment in rural areas
- **Early Stage of Industrialization**
- **Abnormal Trade Structure Before the BTA**
- **Political Legitimacy:** social stability requires broad-based, rising standards of living

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Vietnam Development Context (2)

- **Broad-Based Economic and Legal Reforms – Accelerating in 2000**
  - Building on Steady 7 Percent Growth
  - Still, the Need to Create 2 Million New Jobs Each Year
  - New Policy Focus in 2000 on Building the Private Sector and Advancing International Integration – the Enterprise Law and the BTA

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Vietnam Development Context (3)

- **The U.S.-Vietnam Bilateral Trade Agreement (BTA) as Part of a Larger Reform Effort**
  - The Enterprise Law: more than 60,000 new private firms created in 3 years
  - The ASEAN Free-Trade Agreement: major tariff reductions for goods trade
  - Commitment to WTO Accession
  - The Legal Needs Assessment and Public Administration Reform (UNDP)

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Key BTA Characteristics: The US Side

- The U.S. extends NTR/MFN treatment, opening the U.S. market for Vietnamese exports by reducing tariffs from an average of 40 percent to 4 percent
- The U.S. reserves right to apply textile quotas and to conduct antidumping and countervailing duty investigations

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Key BTA Characteristics: The VN Side

- The BTA, built upon a WTO foundation, requires major legal reforms and substantial improvements in market access for service sectors, investment, intellectual property protection
- Limited tariff reductions, and thus limited affect on market access for goods
- BTA acknowledges Vietnam as a developing economy: some major commitments due upon entry into force; the phase in of other commitments (up to 10 years)
- BTA is a stepping stone to WTO accession

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Economic Impact

- The Spectacular Trade Response to the BTA:
  - Vietnam increases exports to the U.S. over 400% from $1.0 to $4.5 billion in just two years
  - Mostly export creation – leading to increased job opportunities
  - Major increases in manufacturing exports, largely clothing, in line with comparative advantage
  - U.S. becomes largest market for Vietnamese exports and manufactured exports become largest export sector
  - U.S. exports to Vietnam doubles in two years, spurred by sale of aircraft

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2002 – Boom Year for Bilateral Trade Between Vietnam and the United States

Vietnam's Exports to the U.S. in 2002 and 2003 by Commodity Category

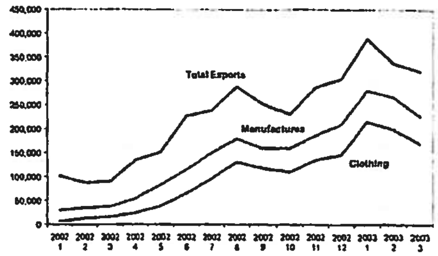
	2002 Exports (US$ '000)	2002 Rate of Growth (%)	2003 Exports (US$ '000)	2003 Rate of Growth %
VN Exports to US	2,394,745	128	4,554,845	90
Primary Products	914,284	31	1,374,971	23
Fish & seafood	614,028	79	712,111	19
Vegetables & fruit	76,003	32	106,003	39
Coffee	13,061	-35	28,100	44
Crude rubber	21,311	346	13,281	11
Petroleum	181,122	1	277,341	53
Other primary	16,843	97	65,811	21
Manufactures	1,480,460	501	3,180,934	125
Non-mineral products	19,192	115	27,915	45
Metal manufactures	3,183	317	[illegible]	[illegible]
Electrical appliances	4,9[illegible]	330	4,101	[illegible]
Furniture	18,041	696	111,771	111
Travel goods	49,311	3,432	33,911	94
Clothing	406,371	1,724	2,458,744	164
Footwear	324,834	3	327,101	46
Other manufactures	28,239	843	48,561	72
[illegible] goods	84,524	709	[illegible]	154
[illegible] Manufactures*	690,992	163	910,601	61
[illegible] Manufactures**	771,4[illegible]	836	48[illegible],281	791

U.S. Exports to Vietnam in 2002 and 2003 by Commodity Category

	2002 Exports (US$ '000)	2002 Rate of Growth (%)	2003 Exports (US$ '000)	2003 Rate of Growth (%)
Total	580,155	26	1,324,440	128
Primary products	121,029	16	144,653	19
Food	49,310	0	48,231	-2
Textile fibers	10,311	0	39,660	[illegible]
Other primary	61,546	36	56,312	37
Manufactures	459,062	29	1,179,784	157
Leather	26,024	34	24,2[illegible]	-7
Plastics & products	23,615	25	33,216	41
Paper products	16,779	[illegible]	21,111	26
Machinery	183,015	47	183,763	1
Transport equipment	61,248	5	719,134	[illegible]
Electronic parts	17,634	-4	22,4[illegible]	27
Scientific equipment	11,442	-4	12,74[illegible]	[illegible]
Other manufactures	14,697	1	22,237	[illegible]
Excluding Transportation Equipment				
Total Exports	420,357	23	525,[illegible]1	25
Manufactured Exports	367,[illegible]	25	440,[illegible]	18

Source: USITC

Economic Impact (3)
Vietnam's Exports to the U.S. in 2002 ('000 USD)



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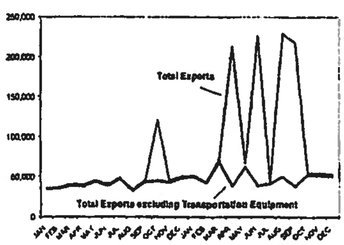
Economic Impact (4) - **Monthly Exports to Vietnam: 2002 and 2003 ('000 USD)**



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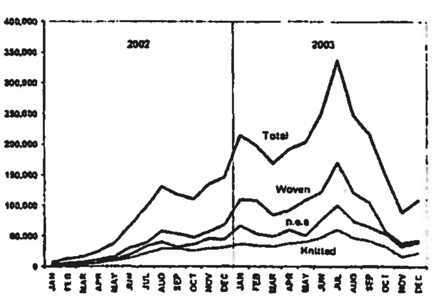
Economic Impact (5) - **Vietnam's Monthly Exports of Clothing Made of Woven Fabric (SITC 841&842), Knitted Fabric (SITC 843&844) and Articles of Apparel, n.e.s (SITC 845) ('000 USD)**



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Remaining Challenges

A. Far more requests for TA support on major reforms than current Project resource levels can handle

B. Building capacity for effective implementation of legal reforms

C. Linking BTA implementation to WTO accession

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Thank you for your attention

Any questions?

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USAID in Mindanao

Trade Facilitation/Risk Management of BOC Strengthened

- Objectives
  - To increase trade facilitation at the Bureau of Customs without sacrificing adequate revenues from and control of imported products
- Key Outputs...
  - Draft customs valuation legislation
  - Proposed risk management system for post-entry audit
  - Proposed customs processing facility (Super Green Lane)
- Outcomes...
  - Invoices replace reference prices as base for duty
  - Post-entry audit group in BOC
  - Post-entry audit conducted
  - Selected importers use SGL

MILESTONES

- 1996: Law Passed
- 2000:
  - Pre-Shipment Inspections
  - Use of Transactions Values Required
  - Super Green Lane Starts

Problems...

- Corruption
- Under Invoicing

And Solutions...

- Donor Steering Committee
- Local ownership
- Post Entry Audits
- Super Green Lane

Donor Steering Committee

- JICA
- CIDA
- APEC
- US Customs
- USAID

Local Ownership

- Head of Customs
- Subordinate Customs officials
- Project Steering Committee
- Business Support Organizations
- Interagency Committees
- Importers
- Customs Brokers

Post Entry Audit

- Customs Officials Have Less Discretion
- Start-Up Operation

Super Green Lane

Enhancing Competitiveness through Trade Facilitation

Bureau of Customs

SGL Importation

Year	Value (US$)	Value (Peso)	Duties & Taxes	Volume (Kgs)
2000 May 16-Dec 31	123,108,390	5,799,147,239	1,002,558,269	42,002,622
2001	507 661,239	20,026,634,140	4,556,261,397	275,764,272
2002	799,492,093	41,273,285,756	6,423,640,036	642,019,477
2003 Jan-Nov27	934,892,702	48,120,856,779	7,155,173,450	681,475,718
Total	2,365,154,426	121,220,123,914	19,137,633,173	1,641,262,089

Top 10 SGL Importers -
Based on Duties, Taxes Paid

	PhP B
1. Fortune Tobacco	P 2.147
2. Honda Cars	P 2.052
3. Procter & Gamble	P 1.877
4. Universal Robina	P 1.177
5. Sony Philippines	P 1.148
6. Matsushita Electric	P 1.069
7. Kodak Philippines	P 0.724
8. Abbott Laboratories	P 0.708
9. Asian Car Makers	P 0.697
10. Pfizer	P 0.686
Total	P12.285

SGL as of 2003

- Target membership - 100
- Actual total members - 80
- Approved in 2003 - 11

Reasons for Slow SGL Accreditation

- High SGL Fee: PhP2,500 per entry
- Policy on Regulated Import Items
- Coordination problems with brokers
- Insufficient information campaign

New Super Green Lane

Enhancing Competitiveness through Trade Facilitation

Bureau of Customs

The New SGL Program

CAO 6-2003

CMO 28-2003

Key Provisions of CAO 6-2003

- **Expanded Program coverage:** any importer with a one-year track record of regular imports may apply for accreditation, provided he is willing to undergo post entry audit (previously limited to top 1,000 importers in terms of duties and taxes paid)
- **New accreditation process:** Importer provides Customs with advance information on his import operations to achieve an acceptable confidence level re: compliance with trade regulations.
- **SGL entry fee :** restructured from a fixed PhP2,500 per entry to a graduated schedule based on value of import shipment, from a minimum of PhP500 to a maximum of PhP2,500.

Key Provisions of CMO 28-2003

- Procedures for accreditation and import compliance monitoring
  - New accreditation forms to facilitate submission of information to BOC
  - Redefined the roles of BOC organizational units, support measures, and coordination with private sector players.

SGL Fee Structure

- From Flat Fee : P2,500 per entry
- To a Graduated Fee

Value of shipment	SGL Fee
Below US$5,000	: P 500.00
US$5,001 -100,000	: P1,000.00
US$100,001-200,000	: P1,500.00
US$200,001-500,000	: P2,000.00
Over US$500,000	: P2,500.00

Results

- WTO Compliant
- Post-Entry Audit Institutionalized
- SGL Revitalized
- New Risk Management System

SGL Results

- Increased Revenue
  - +2.6%, 2000-2001
- Increased GDP
  - +$0.4 Billion

(http://dfat.gov.au/publications/trade_facilitation.pdf)

Thanks!

Growth with Equity in Mindanao-2 (GEM-2) Program

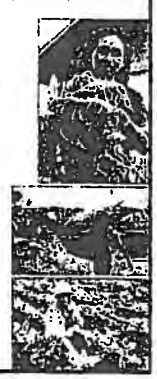
Principal Activities

- Business Support Organization (BSO) Development
- Targeted Commodity Expansion Program (TCEP)
- Community and Mid-Scale Infrastructure Programs (CIP and MSIP)
- ARMM Governance Improvement
- ARMM Education Improvement
- Policy Modification Assistance
- "Targets of Opportunity"

Targeted Commodity Expansion Program (TCEP)

- expand production and marketing of lucrative, non-traditional commodities in the conflict-affected areas of Mindanao;
- put in place all elements of the "cold chains" and "cool chains" needed to expand shipment of vegetables and fruits from Mindanao
- help assure a major expansion of exports of fish, fruit, and vegetables to the large and growing China market.

Major Issue (s)
Generation of adequate private sector investment in cold/cool chains and related infrastructure



Business Support Organization Development

- Strengthen BSOs - make them financially self-sufficient and able to effectively service the sectors they represent
- All BSOs to have substantial levels of activity in the conflict-affected areas.

Major Issue (s):
BSOs attaining financial sustainability

Policy Analysis, Advocacy, and Coalition-building to accelerate reform focused on the following areas:

- Ports and shipping (in collaboration with GEM)
- Customs
- Bio-technology
- Anti-corruption (including procurement reform)
- Intellectual Property Rights (IPR)
- Governance

Recap of Project Information, Objectives and Timeline

- To support the government in its efforts to put in place reforms that will:
  - Stabilize and deepen financial institutions
  - Make trade and investment more competitive and dynamic
  - Improve economic governance
- Implementation period: June 1998 - June 2004, two extensions
- Operating budget (obligated and spent): $35.3 million US
- Agencies & public-private bodies as counterparts/partners: > 40
- Number of Filipino consultants hired: 252
- Number of foreign consultants hired: 74
- Research assistants and support staff hired: 169
- Number of Republic Acts worked on: 18
- Number of Executive Orders supported: 16
- AOs, Circulars and Memorandum Orders: 39

List of Republic Acts EGTA Worked On

1999: (2)
- RA 8751, Countervailing Duties
- RA 8752, Anti-Dumping Act

2000: (6)
- RA 8762, Retail Trade Liberalization Act
- RA 8791, General Banking Law
- RA 8792, E-commerce Act
- RA 8794, Motor Vehicle User's Charge
- RA 8799, Securities Regulation Code
- RA 8800, Safeguard Measures Act

2001: (2)
- RA 9160, Anti-Money Laundering Act
- RA 9135, Customs Valuation Act

2002: (1)
- RA 9168, Plant Variety Protection Act

2003: (4)
- RA 9182, Special Purpose Asset Vehicle
- RA 9184, Government Procurement Reform Act
- RA 9194, Amendment to AMLA
- RA 9227, Judiciary Salary Standardization Act

2004: (3)
- RA 9239, Optical Media Act
- RA 9243, Documentary Stamp Tax
- RA 9267, Securitization Act

Interaction of Conflict and Policy

- Business Support Organizations
- Developing supply of vegetables
- Interesting dealers
- Establishing a cold chain
- Making transport efficient

Increased Competition in Maritime Shipping

- Objectives
  - To reduce costs of port charges and inter-island shipping through increased inter- and intra-port competition
- Key Outputs...
  - Draft EO on Roll-on-roll-off shipping and ports system
  - RORO Investment Prospectus
  - Report on Unified Contractor for Manila North Harbor
  - Draft Shipping Modernization legislation
- Outcomes...
  - Strong Republic Nautical Highway Launched (EO 170/170a)
  - DBP providing loans for RORO operators

Biotech Success

- Long gestation
- Private sector partner
- Authorized commercial planting of Bt corn
  - 100 ha in 2002
  - 11,000 ha in 2003
  - 40,000 ha in 2004
  - 80,000 ha in 2005

Main Points

Microlending can be profitable
Livelihood is key in conflict areas
Contract out policy projects?
Policy projects pay off

Questions?

Highlights in Competition and Productivity-Enhancing Initiatives

- RA 8762 Retail Trade Law, enacted March 2000
- DA Admin Order #8 on Biotechnology, signed August 2000
- NTC Memorandum Circular 14-07-2000, "Rules for Interconnection" issued August 2000
- EO 170 Promoting "Roll-On-Roll-Off" ports and shipping system signed January 2003
- EO 253 for Cargo Open Skies into Clark Special Economic Zone signed December 2003

Life-of-Project Highlights in Public Sector Governance Objectives

- RA 8799, Securities Regulation Code, enacted July 2000
- RA 9135, Customs Valuation Law, enacted April 2001
- RA 9184, Government Procurement Reform Act, enacted January 2003
- RAs 9160/9194, Anti-Money Laundering Act (and amendment), enacted September 2001, March 2003
- RA 9239, Optical Media Act, enacted February 2004

Capital Markets Better Regulated

- Objectives
  - To strengthen capital markets governance, improve investor protection and thereby increase investments in securities
- Key Outputs
  - Proposed Securities Legislation
  - Fixed income exchange registration documents
  - Draft rules of SRC
  - Econometric model on DST
- Outcomes
  - RA 8799, Securities Reg Code
  - Fixed Income Exchange
  - Demutualized PSE
  - RA 9243, Doc Stamp Tax

Improved Adjudication of Commercial Law

- Objectives
  - To improve the developmental impact of court decisions in commercial cases
- Key Outputs...
  - Rules of Procedure on Corporate Recovery
  - Benchbooks on Corporate Recovery and Liquidation
  - Draft legislation for Corp Recov
  - Caseflow management system
- Outcomes...
  - Court handling of Corp Recovery
  - CA Mediation launched
  - Pasay Courts start CFM

BIR More Transparent and Efficient

- Objectives
  - To improve the efficiency and effectiveness of tax administration through legislative and administrative reforms
- Key Outputs
  - Blueprint for Tax Administration Reform
  - Tax Authority Study Tour
  - Draft tax authority legislation
  - "The BIR Towards 2010"
  - Industry benchmarks for VAT
- Outcomes
  - No-contact aud t
  - Voluntary Assessment and Abatement Program Monitoring

Trade Facilitation/Risk Management of BOC Strengthened

- Objectives
  - To increase trade facilitation at the Bureau of Customs without sacrificing adequate revenues from and control of imported products
- Key Outputs...
  - Draft customs valuation legislation
  - Proposed risk management system for post-entry audit
  - Proposed customs processing facility (Super Green Lane)
- Outcomes...
  - Invoices replace reference prices as base for duty
  - Post-entry audit group in BOC
  - Post-entry audit conducted
  - Selected importers use SGL

Fiscal Policy More Efficient and Equitable

- Objectives
  - To improve fiscal policy in particular with respect to local government finance and project finance for infrastructure
- Key Outputs...
  - Analysis of Contingent Liabilities of BOT/GOCC
  - Proposals for
    - LGU Program Lending Program
    - Promoting municipal bonds
    - LGU financial reporting/SIEs
- Outcomes...
  - CL tracking/monitoring system
  - Statements of Income/Expend.
  - Reduced risk weight for LGU bonds

Government Procurement More Efficient and Transparent

- Objectives
  - To improve efficiency, effectiveness and transparency of government procurement by providing a standardized procurement law
- Key Outputs...
  - Public procurement diagnostic
  - Draft IRRs of EO 262 & PD 1594
  - Draft procurement legislation
  - GPRA implementation manual
- Outcomes...
  - RA 9184, GPRA (Jan 2003)
  - Formalization of NGO oversight
  - Creation of Proc. Watch, Inc
  - Recorded savings in procurement

Money Laundering Reduced

- Objectives
  - To reduce possibilities that banks and other targeted institutions can be used to launder illegally acquired money
- Key Outputs...
  - Study visit to Thai AMLO
  - Draft provisions of AMLA
  - Draft of Info System Plan
  - Draft Transactions Reports
- Outcomes...
  - RA 9160, Anti-Money Laundering Act and RA 9194
  - AMLC accesses P100m for information system
  - Money laundering cases prosecuted

Financial Intermediation of Banks Improved

- Objectives
  - To improve financial intermediation of banks and reduce systemic risk through improved central bank supervision
- Key Outputs...
  - BankExec International BSP Training
  - Draft supervision manuals
    - risk-focused supervision; thrift/rural banks; trust and fiduciary; treasury risk mgmt
- Outcomes...
  - RA 8791, General Banking Law
  - BSP Circular 280 on risk-based capital adequacy framework
  - Risk-focused bank examinations

Reduced Corruption Opportunities in High-Risk Agencies

- Objectives
  - To increase the cost (and reduce opportunities) of engaging in corrupt behavior in public service and thereby reduce corruption
- Key Outputs...
  - BOC Integrity Action Planning workshop
  - DepEd, Omb Integrity Development Reviews
  - Strategic Planning and training for DOF/Rev Integ Protect.Srvc.
- Outcomes...
  - BOC, DepEd, Omb Integrity Action Plans
  - EO creating RIPS

Anti-Corruption Agencies More Effective

- Objectives
  - To strengthen Anti-Corruption and Accountability Agencies of the government for improved effectiveness
- Key Outputs...
  - Extensive training of Ombudsman and other anti-corruption staff
  - Anti-Corruption Summit Workshop
  - Draft Joint Anti-Corruption Plan
- Outcomes...
  - More effective OMB prosecution
  - Joint Anti-Corruption Plan for OMB, CSC, COA "Solana Covenant"
  - CSC/OMB MOA on administrative cases signed

Increased Competition in Air Transport

- Objectives
  - To enshrine users of air services as the primary stakeholders in air transport policy, and increase competition for the user's benefit
- Key Outputs...
  - Draft Cargo Open Skies EO for Clark SEZ
  - Extensive air transport research
  - Draft IRRs for EO 219 (Air Lib.)
- Outcomes...
  - EO 253 Clark/Subic Cargo Open Skies signed
  - Multiple air carriers given "flag carrier" status increasing comp.
  - Flights to key destinations increase, fares decline (eg CP to Hong Kong)

Increased Competition in Maritime Shipping

- Objectives
  - To reduce costs of port charges and inter-island shipping through increased inter- and intra-port competition
- Key Outputs...
  - Draft EO on Roll-on-roll-off shipping and ports system
  - RORO Investment Prospectus
  - Report on Unified Contractor for Manila North Harbor
  - Draft Shipping Modernization legislation
- Outcomes...
  - Strong Republic Nautical Highway Launched (EO 170/170a)
  - DBP providing loans for RORO operators

Increased Competition in Telecommunications

- Objectives
  - To increase competitiveness of domestic enterprises by improving competition in the provision of telephone services
- Key Outputs...
  - Draft interconnection IRRs/MC
  - Draft uniform system of accounts
  - Proposed principles for wholesale pricing of telephone services.
  - Draft MC on Universal Service Prgrm.
  - Draft VOIP rules
- Outcomes...
  - Interconnection rules issued, improved interconnection
  - Retail price rules allow greater flexibility/unbundling of services
  - Rapid growth in teleco-dependent BPO

E-Commerce & ICT Developed

- Objectives
  - To promote government policies that will support private sector development of e-commerce and the ICT sector for improved competitiveness
- Key Outputs...
  - Draft ICT Strategic Plan
  - Draft E-Commerce law
  - Draft EO for Commission on ICT
  - Training on CMM certification
- Outcomes...
  - "E-Philippines Strategic Plan" to guide support to ICT industry
  - RA 8292, E-Commerce Act
  - EO 269 created Commission on Information and Communication Technology (CICT)

Agriculture Markets More Efficient and Equitable

- Objectives
  - To help create a private sector-led, productive agriculture sector especially in the grains subsectors
- Key Outputs...
  - NFA Reorganization Study with Financial valuations
  - Draft rice tariffication bill
  - Prototype SPS information system
  - Draft rice subsidy plan for DSWD
- Outcomes...
  - Rice imports allowed by farmer groups
  - SPS database and website established

Trade Policy is More Competitive and WTO-Consistent

- Objectives
  - To help continue the process of trade liberalization by ensuring that trade remedies are consistent with WTO requirements
- Key Outputs...
  - Draft safeguards legislation
  - Draft countervailing duty legislation
  - Draft anti-dumping legislation
  - Draft EO to reduce ag input tariffs
- Outcomes...
  - RA 8751, CVD law, passed
  - RA 8752, Anti-dumping, passed
  - RA 8800, Safeguards law, passed
  - EO 133 reducing ag input tariffs

Biotechnology Exploited Safely

- Objectives
  - To increase production, productivity and incomes of farmers through modern agricultural biotechnology
- Key Outputs...
  - Proposed policy framework for commercialization of GMOs
  - Seminar on international best practices in biotech regulation
  - Technical study on cost of GM labeling
  - Proposed guidelines on processed biotech products
- Outcomes...
  - DA AO 8 issued on GMO commerc
  - Bt Corn hectarage at 80-100 K
  - Corn farmer incomes increasing

Intellectual Property Rights Protected

- Objectives
  - To protect intellectual property and thereby increase the returns from intellectual, artistic and creative endeavors
- Key Outputs...
  - Draft optical media legislation
  - Draft IRRs for Intellectual Property Code
  - Proposed information systems plan for BOC IP Unit
  - Model IP anti-piracy ordinances
- Outcomes...
  - IRRs for IPCode (Copyrights and Safeguards Reg) issued
  - RA 9239, Optical Media Board
  - BOC CAO 6-2002 creates IPUnit
  - LGU Anti-piracy ordinances passed

Plant Variety Protection Institutionalized

- Objectives
  - To improve protection for investments in varietal improvements in agriculture, thereby increasing productivity
- Key Outputs...
  - Draft PVProtection legislation
  - PVP study tour for GOP officials
  - Draft IRRs for PVP law
  - Draft PVP DUS test guidelines
  - PVP office and enforcement manual
- Outcomes...
  - RA 9168, PVP Act
  - Plant Variety Protection Office
  - 17 applications received from seed companies for protection under law

USAID India
Economic Growth Program

Rebecca Black
Director, Economic Growth Office
June 2004

India's Performance

- Population: 1 + billion
- GDP: $510 billion, grew over 7% in 2003
- Inflation: down to 4.5%
- Capital Markets: Settlement cycle for security trades down from 30 days to T+2
- Banking sector: non-performing assets less than 5%

Why USAID's EG support?

There is continued need

- India's GDP is half that of China, both starting from the same point in 1950; growth is insufficient to employ growing population
- 300 million people or more live below poverty line
- Fiscal deficit of central and state governments is 10% of GDP
- Financing gap for infrastructure is $600-$800 million/year, while $100 million alone is available from public funds

- Only 2% of India's population participates in the securities market; only 10% of India's population that *can afford* insurance has some sort of health insurance
- Current population is 70% rural but rural economy is 28% of GDP. In 2030, half the population will live in cities.
- Only 28% of households are connected to sanitation systems
- Agriculture productivity in basic crops dropped to 1-2% of GDP

Need
and Opportunity

- India is a major power in South Asia and beyond
- US-India Economic Dialogue
- GOI demand for targeted USAID assistance
- Recent election: Analysis from Professor Pratap Bhanu Mehta: "It is an expression of the fact that the reform of the state has not gone far enough"

EG Program

Increased Transparency and Efficiency in the Allocation and Mobilization of Resources (in selected states)

Meaning...

Mobilize domestic and international capital for productive investments in people, infrastructure and job/income generation

Through..

- ⌘Improved **financial governance**, private and public, to increase productive investment (and reduce wastage)
- ⌘Greater **capacity to create partnerships** among private, public, academic, and community sectors, and through use of technology.

I. Increasing long term capital for investment and broadened access
through enabling policy and regulatory environment

- ⌘ **Effective capacity to regulate and develop financial markets:**
  - **Securities** (strengthening of Securities Exchange Board of India, 5 year TA contract)
  - **Insurance** (5 year TA contract to assist Insurance Regulatory and Development Agency in regulating and developing industry)
  - **Commodities futures** (exploratory TA task order to expand and stabilize Futures Market)

- ⌘ **Municipal bond market development** (Financial Institution Reform and Expansion, Debt project, FIRE D, capacity building of municipal sector, with DCA to support pooled financing for infrastructure investment)
- ⌘ **Enterprise finance:** use of DCA to leverage wholesale capital for MFI's; TA for BDS and finance for growth-oriented microenterprise (new task order); Venture Capital Fund for small business (SEAF).

II. Increased investment in physical and human capital through better allocation of public funds and expansion of resources

- **State Fiscal Reform:** Build capacity of three-four Indian states to make good fiscal policy, including productive and accountable decisions on public expenditures and tax/non-tax revenue mobilization, based on more accurate data and sound analysis (5 year/$11.6 million TA contract)
- **Urban/Municipal reform and infrastructure investment:** Build capacity of local government institutions in financial and service management to increase investment in basic infrastructure and improve service delivery, focused on water and sanitation (new 5 year TA contract for capacity building and transaction structuring)

Fiscal reform cont.

- **Increased resources:** reduction of ineffective public subsidies, and increased tariff and tax collection in water, energy, fertilizers, wheat/rice crops (TA contracts for analysis and system development.)

- State and local reform incentive funds:
  - **The State Facility**: incentive fund for state reduction in deficits and improved fiscal management (short term TA contract providing international comparative analysis)
  - **Urban incentive funds**: Incentive funds for policy and regulatory reform at the state level guiding local procedures, restructuring grants, private sector participation incentives (TA on policy and systems)

III. Partnerships and Technology: Building Capacity and Utilization

- **US-Asian Environmental Partnership (US-AEP):** Improve water and sanitation, air quality, and environmental governance through tech transfer and development of partnerships for funding and technical support (Staff and limited program funds for partnership development)
- **Agriculture Bio-Tech:** development and commercialization of new crop technologies within well regulated research and development processes (grants and coop agreements for research and development)
- **Agriculture market development:** more efficient markets for expanded and diversified production utilizing new technologies
- **Private participation in service delivery:** focus on water and sanitation (FIRE D TA contract)
- **E-Governance** providing greater accountability and efficiency in state and local government, and civil society (grants and TA)

Program Example:

Improved regulation of securities market, FIRE R (Financial Institution Reform and Expansion)

- First phase (1995-98) of the FIRE-R program helped:
  - establish securities depository;
  - robust clearing and settlement systems and practices;
  - strengthen Securities and Exchange Board of India (SEBI)'s oversight capacity;
  - develop legal, regulatory and institutional frameworks for exchange traded financial futures and options; and
  - improve disclosure and market conduct practices in the mutual fund industry.

Current phase of the program

- Assisting SEBI and the Ministry of Finance in
  - implementation of a comprehensive surveillance system for cash and derivatives markets;
  - on-site and off-site supervision and enforcement;
  - a regulatory framework for licensing, testing and certification of market intermediaries that interface with investors; and
  - the development of curriculum for law school professors to introduce teaching of securities laws and regulations in Indian law schools.

Program basics:

- Five year $9 + million technical assistance contract
- Five year Agreement with the U.S. Securities and Exchange Commission (SEC) to help build SEBI's capacity.

Results

- Reduction in systemic Risk; reduced settlement cycle from three weeks to T+2 system;
- Legal, Regulatory and Institutional Framework for Derivatives Markets established;
- Restructuring and empowerment of SEBI;
- Institutionalization of Securities Law Education;
- Risk management of mutual funds brought to international standards.
- Framework developed for licensing, testing and certification of Market Intermediaries

Program example:
Municipal Infrastructure finance with DCA

Leveraging market-oriented discipline and private sector funds in water and sanitation projects and service delivery: FIRE D technical assistance supporting municipal credit-worthiness and project preparation for financing with DCA guarantee; private funds leveraged through pooled municipal bonds

- Tamil Nadu: pooled bond issued to finance 14 municipalities in water and sanitation improvements
  - Cost to USAID: $ 392,960 subsidy
  - Guarantee leveraged: $ 3.2 million
  - Total project cost: $ 6.4 million

DCA #2

- Karnataka: project preparation and institutional support to Karnataka Urban Infrastructure Development Finance Corporation (KUIDFC) in issuing a bond-financed water investment for 8 municipalities in greater Bangalore. DCA guarantee leveraged private funds with matched funding from user fees (1/3) and state funds (1/3)
  - Cost to USAID: $779,030 subsidy
  - Guarantee funds: $10.85 million
  - Bond Issue: $ 21.7 million
  - JBIC likely to fund: $30 million for sanitation
  - Total project: $ 120 million

Results

- Tamil Nadu: 900,000 people with better water and sanitation services
- Karnataka: 1.2 million people to get better water and sanitation services
- Market standards utilized in project preparation and finance
- Pooled bond finance tested and proved;
- Private funds leveraged; user funds leveraged
- Partnership among users, state, municipal, private sector, and other donors developed.

New programs

1. **State fiscal reform, reducing deficits and increasing productive expenditures (REFORM program):** support to three state governments in..
   - establishing fiscal planning/analysis cells & debt/investment management
   - promoting treasury reform
   - developing databases, MIS, budget/accounting systems
   - improving procurement policies and systems
   - strengthening investment project appraisal and selection
   - improving socio-economic data collection methodology
   - building capacity of states' training institutions in fiscal management
   - building national level data base on fiscal transfers

2. **Growth oriented micro-enterprise: building a bridge from micro to small enterprise (new contract in procurement):**
   Expanding capacity of existing finance and business service institutions to support growing microenterprises. Focus on agro-business and urban services (cluster approach) and enhancement of SME policy.
3. **Agriculture partnerships:** US/India university linkages to promote research, product and market development, and policy analysis.
4. Development of a safe and vibrant **insurance market** (new contract).

Key Factors in EG Strategy

- ⌘ GOI interest in using perceived US comparative advantage in: capital market development, technical assistance capacity building in state and local reform; bio-tech development; partnership structuring
- ⌘ Long term investments: 5-15 year TA commitments for institutional development, with supporting policy reform
- ⌘ Quality staff, quality partners

Issues

- ⌘ Management of EG Office: consolidation of multiple units and programs; development of "team" vision
- ⌘ $, DA and ESF
- ⌘ Fluidity of movement among counterparts in GOI.
- ⌘ New government?

Monday, June 28, 2004
1:30 – 3:00

Breakout Session

Presentations on Geographic Regions: -- Trends, Experiences and Aid Results

Middle East Session: Egypt and Jordan EG Issues and Reform Programs

Middle East economic performance has been characterized by relatively slow growth, weak export performance, continuing low labor productivity and high unemployment, low levels of human capital investment, relatively closed trade regimes, burdensome governmental regulations, widespread corruption, and a relatively weak state-dominated financial sector. This session will feature the experience of two of the region's most comprehensive economic reform programs mounted by USAID/Egypt and USAID/Jordan. Joe Ryan and Jim Barnhart will present the Egypt and Jordan EG issues and reform programs, Richard Sines will be the discussant, and Jim Walker will serve as session moderator.

Jim Barnhart, Presenter
Joe Ryan, Presenter
Richard H. Sines, Discussant
James L. Walker, Moderator

USAID/EGYPT

Economic Growth

From Aid to Trade

June 28, 2004

Egypt: A Middle-Income Country

	PPP GNI 2001	$1-a-Day Rate 2000
Guatemala	4,380	16.0%
Philippines	4,070	14.6%
Jordan	3,880	<2.0%
EGYPT	3,560	3.1%
Morocco	3,500	<2.0%

Egypt: Economic Structure

- State-owned firms produce about 25% of GDP.
- Trade barriers relatively high.
- Growth in the 1990s averaged 4.9%

Egypt: Economic Events of 2003

- Above average FX receipts: tourism, Suez Canal, remittances.
- Float tested in January 2003: Dollar rises to 5.40 from 4.60 in 24 hours, rises further to 6.15 by mid-year. (Was 3.40 for years in the late 1990s.)
- Budget deficit rising from 6% toward 7%.
- FDI still very limited.

USAID/Egypt

- Established 1975 after diplomatic relations were resumed.
- Annual budget $815 million from 1979-1998
- Ten-year glide 1999-2009 will halve the budget.
- Program Review 2002-2003 aligned projects with MEPI.

MEPI Mandate and Economic Growth

- Grass-Roots Impact
- Financial Sector Modernization
- Trade Capacity Building & Progress Towards FTA
- Commercial Law Initiative

MEPI Mandate and Economic Growth

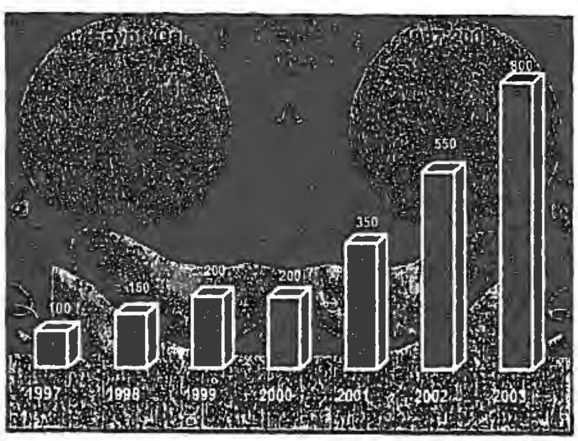
- Grass-Roots Impact
  - Agriculture
  - Microfinance
- Financial Sector Modernization
- Trade Capacity Building & Progress Towards FTA
- Commercial Law Initiative

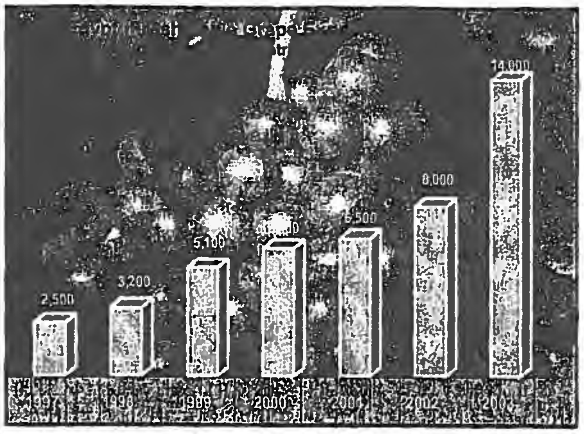
Paving the Road

Policy
- Policy Advocacy to Support Agribusiness and Trade

Enterprise Development
- Strengthening Private Agribusiness and Producer Associations
- Global Positioning

Technology
- Global Quality Standards
- New Technologies
- Information Technology

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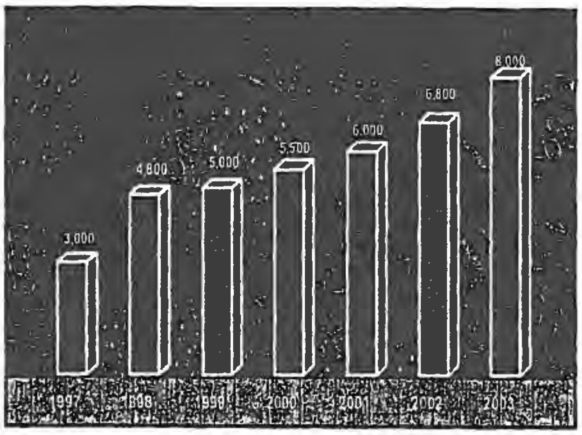
2002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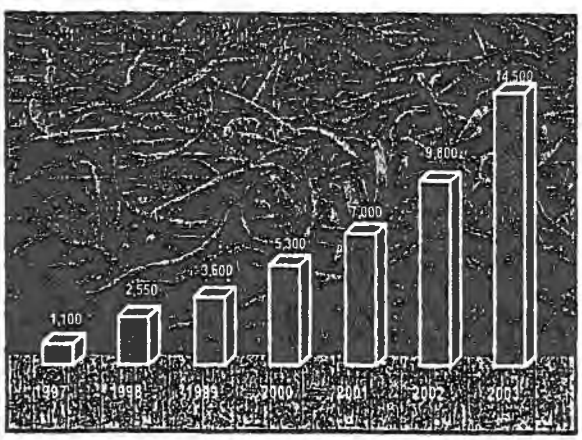
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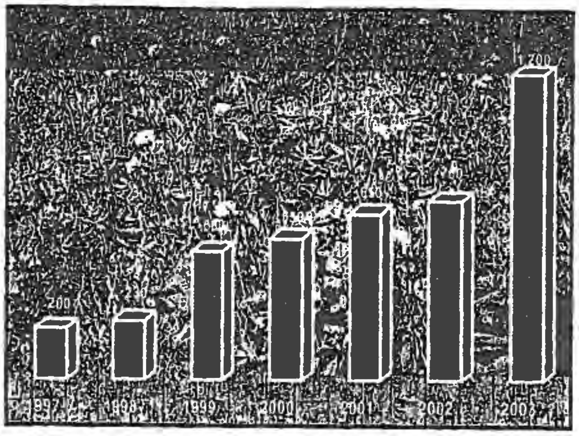
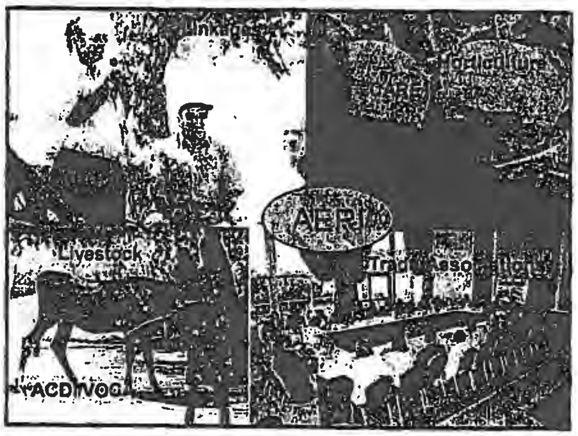


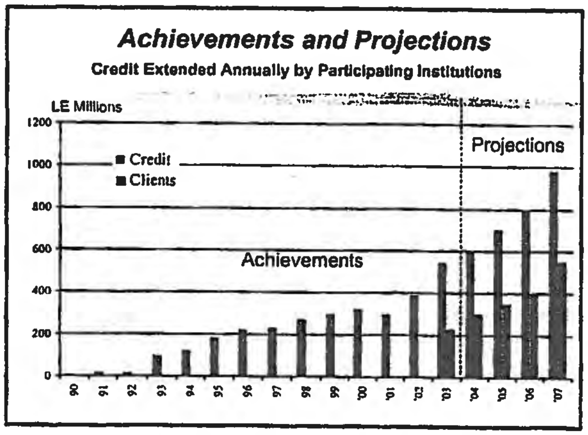


Grass-Roots Impact

✓ Agriculture
• Microfinance

Microfinance

- Democratic, Decentralized Economic Activity
- Women's Role In The Economy
- Private Sector Sustainability



MEPI Mandate and Economic Growth

✓ Grass-Roots Impact
- Financial Sector Modernization
- Trade Capacity Building & Progress Towards FTA
- Commercial Law Initiative

Financial Sector Modernization

- Results of Program Review
  - Within Framework of Partnership for Financial Excellence
  - Financial Services Volunteer Corps (FSVC) is participating
- Ongoing Negotiations on a Financial Sector Memorandum

Banking Sector

- Non-Performing Loans
- Privatization
- Cash Flow Lending; Portfolio Management
- Credit Information
- Mortgage Lending
- New Products – Leasing, Home Improvement Loans, Inventory Credit

Real Estate

- Legal and Regulatory Constraints
- Professional Development (Real Estate and Mortgage Brokers, Valuation, Survey)
- Bonds and Securitization
- Loan Processing Standardization
- Property Information Database

Central Bank of Egypt

- TA Needs Assessment (with IMF)
- Egyptian Experts in Foreign Exchange, Investment, Risk Management
- FSVC Advisor Axilrod to Design Monetary Policy Unit
- Training through the Egyptian Banking Institute

Insurance

- 1998 reforms opened competition: Entry of more firms, foreign ownership, more insurance products
- Complete the transformation of the Egyptian Insurance Supervisory Authority (EISA) to a well-functioning regulatory body

MEPI Mandate and Economic Growth

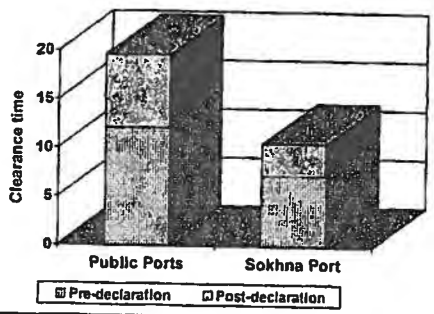
✓Grass-Roots Impact
✓Financial Sector Modernization
- Trade Capacity Building & Progress Towards FTA
- Commercial Law Initiative

Trade Capacity Building

- US-Egypt Business Council Road Map
- USAID Contributions
  - Customs Reform
  - WTO Compliance
  - Information & Communications Technology
  - US-Egypt Import Business Linkages

Import Clearance Times

Ship Arrival to Final Release



Progress in Customs Reform

- Clearance times reduced from 22 days to 3 days at the public-sector port of Damietta
- Selective vs. 100% inspection
- New procedures drafted: fewer steps in the clearance process
- National roll-out starting now

WTO Compliance

- Compliance with WTO agreements: e.g., Technical Barriers to Trade, reformed textile duties
- Trade facilitation by simplifying testing, sampling, and inspection
- Institutionalize trade policy making process

Information & Communications Technology

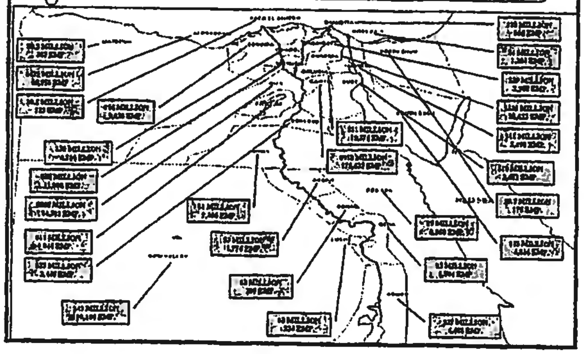
- Promote business competitiveness and trade
- Telecommunications Regulatory Authority implements WTO agreements
- Trade Liaison Office (Chantilly, VA) facilitating US-Egypt ICT partnerships
- Government trade portal established
- SME Development

U.S.-Egypt Private Trade Financing

1986 - 2003

Transactions	10,966
Egyptian Importers	1,743
U.S. Suppliers	2,199
Egyptian Banks	31
U.S. Banks	7
Transactions	$3.1 billion
Women Ownership (1999-2003)	43%

482,337 Workers
All 27 Governorates



MEPI Mandate and Economic Growth

- ✓Grass-Roots Impact
- ✓Financial Sector Modernization
- ✓Trade Capacity Building & Progress Towards FTA
- Commercial Law Initiative

Commercial Law Initiative

- CLI is one of MEPI's Economic Reform Pillars
- USAID Contributions
  - Law Commission
  - Commercial Code
  - Legal Education
  - Intellectual Property Rights
  - Property Registry

Commercial Law

- GOE Law Commission to draft amendments of commercial laws and monitor implementation
- Assist Cairo and Alex Law Schools to upgrade curricula
- Promote licensing and continuing legal education
- Implementation of the IPR law
- Real Estate legal infrastructure

Thank You

USAID/Jordan and Economic Reform
"A Top-Five Presentation"

Economic Growth Officers Workshop

June 28, 2004

Jordan: A Quick Overview

- Small in Size (90,000 square kilometers, comparable to Austria, Portugal or Scotland)
- Small in Population (5.1 million, roughly equal to Norway or Nicaragua)
- Small in GDP (JD 8.0 billion or $11 billion in 2003)
- Per Capita GNP in 2003 was approximate $1,825 ("lower Middle Income")

Our Goal

How to transform a small, resource-poor country into a dynamic, regional economic player that is competitive and efficient in the global economy...

Building Economic Growth

1. More Transparent, Efficient, and Responsive Public Sector

2. More Effective Legal and Regulatory Reform

3. Increased Depth of Private Sector Growth

Number 5: Trade Facilitation

At the legal/regul.
- WTO Accession (16 laws and regulations.)
- FTA (PCT, Madrid Protocol, Copyright)
- GPA

[illegible]

At the Private Sector level
- ✓Firm Level Assistance
- ✓TIJARA Coalition

TCB Results:

JORDAN - UNITED STATES BUSINESS PARTNERSHIP

- **Leveraged tough reform initiatives**
- **Increased advocacy of private sector**
- **Improved border management efficiency**
- **Jordan is a favorable home for innovation**
- **From 10/02 to 6/04: 3,256 Export Transactions ($120 Million)**
  - **Europe and US Markets**

Number 4: Financial/Capital Markets

At the legal/regul.
- Securities Law
- Credit Bureau Law
- Electronic Trans.
- JSC, SDC, ASE Bylaws

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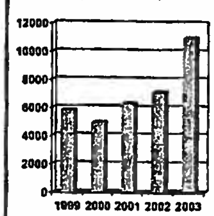
At the Private Sector level:
- Brokers/CFA Training
- Commercial Banking/Corporate Gov.

Financial/Capital Markets Results:

Market Capitalization (USD million)



- Full modernization of capital markets
- CALPERs "invest" list
- CBJ Early Warning System
- PCA developed
- First 5-year mortgage bond

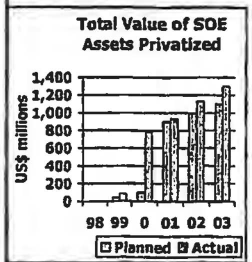
Number 3: Privatization

At the legal/regul.
- Privatization Law
- Bankruptcy Law
- Labor Law
- Financial Leasing Law
- Companies Law

[illegible]

At the Private Sector level:
- First IPO on the ASE
- Developing legal/financial expertise

Privatization Results:

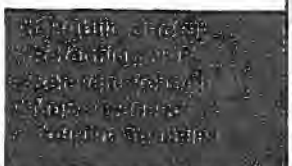


- •Over $1.3 Billion privatized since 1999
- •Net job increase
- •Increased efficiencies
- •Momentum generated for further privatization
- •Built a credible agency

Number 2: Reform that touches all..

At the legal/regul.

- ↗ Microfinance Law
- ↗ National Poverty Alleviation Strategy
- ↗ Environmental Law
- ↗ Tourism Strategy



At the Private Sector level

- ✓ Established 4 MFI's
- ✓ Private investment in tourism projects
- ✓ Business Development expanded
- ✓ Student-level entrepreneurs

Results:

- Active MFI Clients: 16,000/125,000 cumul.
- 80% of clients are women
- MFI's are financially sustainable
- $175 million GoJ for tourism
- Vocational training w/private sector needs
- Eco-tourism highlighted nationally
- 16,000 students graduating fro INJAZ

Number 1: Technology: A Reform Tool

At the legal/regul.

- Telecom Law and regulations
- Ministry of ICT regs.
- ERfKE strategy

At the Private Sector level...

- First IT Association established
- NGO for volunteer ICT training begun
- Community ICT centers targeted

Technology Results

- National PMO for e-gov
- 6 gov ministries on SGN
- Portal for G2G, G2C, G2B
- Three Mobile licenses
- End of fixed line monopoly
- Netcorps extended nationally
- Linking HE to community ICT centers
- INTAJ strongest BA in nation

Aqaba: Test Case for Reform

AQABA SPECIAL ECONOMIC ZONE AUTHORITY

- 2001: Aqaba Special Economic Zone
  - Establishing the legal/regulatory system
  - Building institutional capacity of the new ASEZA
  - Promotion, Investment, Customs
- Aqaba International Industrial Estate
  - Parsons Brinkerhoff International

Using Cash Transfers for Reform

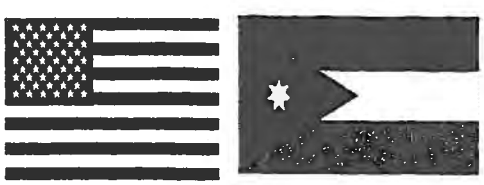
- **Transfer based upon Conditions Precedent**
- **Economic Growth, Water, Health**
- **Link CPs with TA**
- **Local Currency Equivalent Co-Programmed with the GoJ**

The Tough Task: Foreign Direct Investment Promotion

- **Roadmap exercises have worked well**
- **Municipal-level BPR**
- **National laws and institutional changes meet resistance—delay**
- **Aqaba: the model that works**

Thank you

- ***USAID/Jordan: Investing in Jordan's Future***



Monday, June 28, 2004
1:30 – 3:00

Breakout Session

Presentations on Geographic Regions: -- Trends, Experiences and Aid Results

E&E

David Jessee, Moderator
Sprout, Moderator

Monday, June 28, 2004
1:30 – 3:00

Breakout Session

Presentations on Geographic Regions: -- Trends, Experiences and Aid Results

LAC

Charles Mohan, Moderator

Monday, June 28, 2004
3:30 – 4:30

Plenary Session

USAID Priorities, Including for Economic Growth

USAID Administrator Andrew S. Natsios, Presenter

Challenges

Tuesday, June 29, 2004
9:00 – 10:30

Plenary Sessions

Challenge of HIV/AIDS

Ambassador Randall L. Tobias, Presenter
Malcom McPherson, Presenter
Bruce Bolnick, Presenter
Richard Cornelius, Presenter
Nelson, Moderator
Paul R. Deuster, Moderator

HIV/AIDS and Economic Growth: Consequences and Remedies

Malcolm McPherson
EGAT/ED and Harvard University
June 29th, 2004

Overview

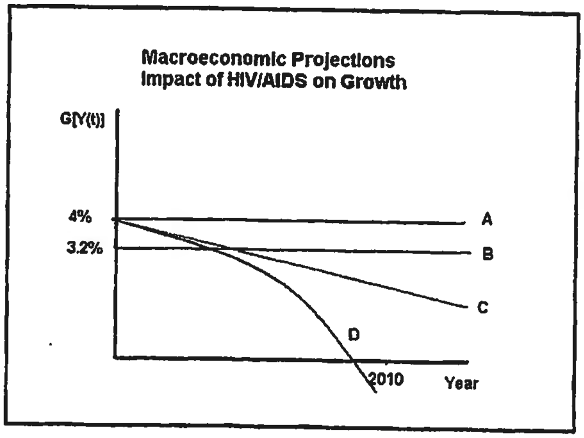
- The Macroeconomic Impact of HIV/AIDS: A Framework
- Non-Linear Effects
- Remedies and Pitfalls [Scaling up]
- Promoting Economic Growth: Private-Public Partnerships to Boost Public Sector Capacity.
- Concluding Observations

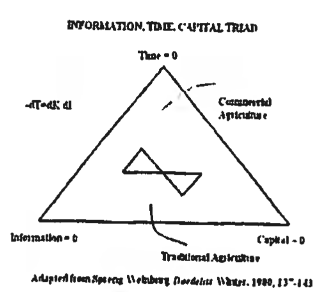
Sources of Economic Growth

- Growth results from accumulation of productive factors; improvements in productivity; re-organization that fosters accumulation and raises productivity
- [Dallas Fed "A Better Way"] micro/macro
- Micro: investment, innovation, education & training; competition
- Macro: reorganization [special role of trade]

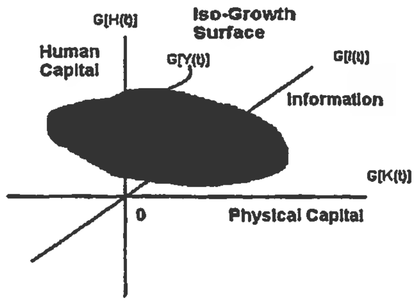
Impact of HIV/AIDS

- Unravels all sources of growth
- Strips time and human capacity out of society and the economic system
- Changes behavior -- individual and organizational -- in fundamental ways.
- Immediate effect is to reduce investment and productivity.
- Falling investment reinforced by a decline in income and savings [typically non-linear]





Growth Framework



Non-Linear Growth Effects

- Economic: cumulative decline in savings and investment
- Organizational: hollowing out of ministries/department/firms
- Networks: fragment as key members fall sick and die.
- Institutions: degrade as incentives to comply with and/or enforce rules-of-game shift

Economic Impact

- Behavior change as decision horizons shorten
- [Recall: economics -- forward looking comparisons of expected benefits and costs over time]
- Investment – current outlays with expectation of a future payoff.
- Examples: education, plant & equipment, social cooperation, reciprocation, financial assets/obligations, economic reform

Organizations

- Formal structures often have limited flexibility
- Loss of staff and staff time leads to "hollowing out" ==> cannot deliver services or meet performance goals.
- Examples: Malawi ministry of agriculture; KZN school system (teachers); Botswana civil service (DPSM)

Networks

- Basis of all modern economies and societies
- Hayek - relevant information is shared; Kremer -- progress by adding connections
- Endogenous growth models: highlight the cumulative effects of information and knowledge through "agglomeration" and spillover effects [Bangalore, Route 128]
- HIV/AIDS -- loss of information and connections

Institutions

- Rules of the game? What are they? How are they sustained?
- Governance issues; combating opportunism
- Example: who is treated under PEPFAR or 3 by 5? Who determines?
- What is role of equity, efficiency, and effectiveness in combating HIV/AIDS?
- What about the majority who are HIV negative?

Non-Linear Effects

- Impact of HIV/AIDS is path-dependent ➔ effects are asymmetric
- Human capital, skills, organizations, and institutions needed to repair the damage are being undermined.
- The longer HIV/AIDS proceeds the more difficult it is to reverse the damage.

Remedies/Pitfalls

- Counteract HIV/AIDS -- need actions & activities that restore a sense of futurity
- Examples: improve macro management to raise growth rate; recombine productive factors [effective use of information]; reorganize workflow and routines; leadership to support/strengthen institutions

Policy Issue – Scaling Up

- World Bank: *Intensifying Action Against HIV/AIDS in Africa Responding to a Development Crisis* (World Bank 2000) [now MAP initiative]
- Steps: Declare HIV/AIDS a national crisis – appoint a high level national task force
- Gather relevant data to forecast impact
- Grant power to agencies to organize an appropriate multi-sector response
- Identify and mobilize critical partners

Scaling Up -- II

- Appoint skilled/dedicated leaders to guide programs
- Mobilize the needed public/private resources
- Build capacity throughout country to respond
- Mobilize communities to design programs
- Continually monitor and evaluate the activities
- Join sub-regional and regional efforts to increase effectiveness

Implementation?

- How can a country scale-up if HIV/AIDS is eroding human capital, disrupting organizations, fragmenting networks, and degrading institutions.
- Where is the capacity to create the capacity needed to maintain scaled-up programs?
- What will be scaled down so that HIV/AIDS activities can be scaled up?
- World Bank MAP has unspent funds. This is seen as an implementation failure, not as over-reach.

Improving Economic Performance

- Individual businesses take macro conditions as given; but, all cannot do that.
- What can businesses do to improve macroeconomic performance?
- One approach: encouraging public private partnerships, especially in high HIV prevalence countries, to boost public sector capacity

Some Context

- A primary focus is Africa -- long history of slow growth, debt, food insecurity, and "marginalization" in world trade and exchange
- Continuous emphasis on raising economic growth – theme from Lagos Plan of Action to NEPAD
- Reminder: over 2001-2015 NEPAD committed to halving poverty, expand education, and mitigate the effects of HIV/AIDS.

NEPAD

- NEPAD is a growth program: 7 percent average growth -- an investment rate of 35 percent of GDP and capital/output ratio of 5
- Performance (so far) well below this.
- Key issue: How will investment rise and efficiency improve with HIV/AIDS undercutting key capacities?

Investment and Productivity

- Only sustained source is local business
- Governments over-stretched [debt, deficits]
- Donors -- net aid already high; problems of effectiveness and ownership.
- Foreign investors – in strategic areas, but rest requires lead of local investors.
- Challenge: How can local businesses be engaged to foster rapid economic growth?

PPP to Boost Public Sector Capacity

- Barrier to economic growth is weak public sector capacity.
- Governing poorly: too many activities; not focused on activities that matter for growth.
- One remedy: business support to strengthen public sector capacity in areas that promote rapid growth.

What Kind of Business Support for the Public Sector?

Macro Level
- Scale back the development agenda
- Improve macroeconomic management

Sector Level
- Improve management
- Increase efficiency
- Reduce transaction costs
- Training, technical support

Engaging the Government?

- Business leaders pressure government – dialogue, growth forum, national debate
- Form working groups, task forces, special commissions, international experience
- Work with individual ministries, departments, or public agencies
- Improve personnel management, operations, organization, information systems, inventory control, tender procedures….

Engaging the Government II

- Training – management, auditing, computer literacy, budgeting, …
- Encourage open, transparent business-government interaction focused on economic growth [Mauritius]
- Publish performance data; audit results
- Build on emerging HIV/AIDS partnerships

Challenges to PPP

- Why should businesses bother? Options -- exploit captive market, or leave country.
- Limited trust; weak cooperation with government, and with other businesses.
- Business leaders have few skills in government, and vice versa.
- Gamesmanship, first mover problem; government backsliding

Benefits of Partnership

- Bleak future without cooperation -- every one loses
- Socially responsible: helps public sector to manage and govern effectively.
- Profitable: improved governance is the foundation for rapid economic growth.
- Regenerate a "capable state," i.e., matches agenda to capacity

Concluding Comments

- Growth framework to understand impacts of HIV/AIDS
- Non-linear effects -- human capital, organizations, networks, institutions
- Remedies -- regenerate a sense of futurity
- Pitfalls of over-reach [scaling up]
- PPP to boost public sector capacity
- Reinforces the case for economic growth

A Final Ditty...

- Even if growth is too slow,
- And the way ahead is foggy,
- Keep your spirits aglow,
- Just remember the froggie..

Don't EVER give up!

USAID Workshop: Promoting Economic Growth in a New Era
June 29, 2004

The Challenge of HIV/AIDS: Focus on Poverty

Bruce R. Bolnick
Nathan Associates, Inc.

NATHAN

Yet another vicious circle for poor developing countries

HIV/AIDS

Poverty

Programmatic Implications?

HIV/AIDS → Poverty

HIV/AIDS

Poverty

- Adverse effect on growth – *the main engine for poverty reduction*
- Devastating economic impact on poor households
  - —Loss of income, production
  - —Cost of care and funerals
  - —Sale of assets, increase in debt
  - —Less education for children
  - —Hunger and malnutrition
  - —Short-circuit knowledge transmission
  - —Erode public and community services

Estimates for Mozambique

HIV/AIDS
Poverty

- Based on 2001 demographic analysis using 2000 prevalence estimates
  - —Adult incidence: 12.2% (latest: 14.9%)
  - —Rising to 17% plateau
  - —1 in 8 adults to die by 2010
  - —1 in 11 households will suffer major economic shock

→Per capita growth reduced by 0.7 % points,

→Poverty incidence 4.3 % points higher

→***830,000 additional people living in absolute poverty in 2010***

N

Poverty → HIV/AIDS

HIV/AIDS
Poverty

- Malnutrition
- Less education
- Less access to prevention measures (STD treatment, condoms)
- Economic and social pressure on women

N

Where do the numbers come from?

Economic models as "simulation laboratories"

- Econometric analysis
- General equilibrium modeling
- Poverty analysis using household survey data
- Microeconomic and sectoral studies

N

Programmatic implications

- Prevention, treatment, care
  - → PEPFAR
  - → Multi-sectoral approaches

- Economic and social programs
  - → Weaken the transmission link to help "turn the tide against AIDS"
  - →Poverty as the "mosquito"

N

Conclusion

- Economic and social impact studies
  - —Design of cost-effective policy response
  - —Design of mitigation measures
  - —Catalyst for multisectoral responses
- Implications for foreign assistance?

N

EGAT BRIEFING PAPER

Economics of HIV/AIDS: Multisectoral Impacts and Programmatic Implications

NATHAN
ASSOCIATES INC.
www.nathaninc.com

SUBMITTED TO
USAID/EGAT

SUBMITTED BY
Nathan Associates Inc.
TCB Project

UNDER CONTRACT NO.
PCE-I-00-98-00016, Task Order 13

June 18, 2002

EGAT BRIEFING PAPER

Economics of HIV/AIDS: Multisectoral Impacts and Programmatic Implications

SUBMITTED TO
USAID/EGAT

SUBMITTED BY
Nathan Associates Inc.
Support for Trade
Capacity-Building Activities
Arlington, Virginia

PREPARED FOR
USAID Workshop: Promoting
Economic Growth in a New Era

UNDER CONTRACT NO.
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June 18, 2002

Sponsored by USAID's Bureau of Economic Growth, Agriculture and Trade (EGAT) and implemented by Nathan Associates Inc., the Trade Capacity Building (TCB) Project, 2001–2004, helps developing countries assess their trade constraints and prioritize their trade-related technical assistance needs. The project provides trade experts for short-term technical assistance in developing countries and assists USAID Missions in designing, implementing, monitoring, and evaluating technical assistance that will stimulate economic growth and reduce poverty. Electronic copies of reports and materials related to trade needs assessments, resource guides, and trade training workshops are available at www.tcb-project.com. USAID Missions and Bureaus may seek assistance and funding for activities under this project by contacting John Ellis, USAID/EGAT, TCB Project Task Manager at jellis@usaid.gov.

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Contents

1. Introduction

HIV/AIDS is a global health calamity. It is also a profound human tragedy for the victims, their families, and their communities. At the end of 2003, the disease had already killed an estimated 30 million people, and 40 million more were living with the virus, principally in sub-Saharan Africa.[1] Last year alone, AIDS or AIDS-related illnesses killed 3 million people, and 5 million were newly infected. Most victims are adults in the prime of productivity and family life; over half are women. In addition, 2.5 million young children are presently infected with the virus, and more than 10 million have been orphaned by the disease.[2]

Responding to this crisis, President Bush announced in his 2003 State of the Union Address the President's Emergency Plan for AIDS Relief (PEPFAR) to provide $15 billion over five years "to turn the tide against AIDS in the most afflicted nations of Africa and the Caribbean."[3] PEPFAR focuses on *prevention* of HIV/AIDS, *treatment* of AIDS and related conditions (including procurement and delivery of anti-retroviral therapies), and *care* for those suffering from HIV/AIDS as well as orphans and vulnerable children.

Even with a successful campaign to slow the epidemic, extend the lifespan of AIDS victims, and provide care for those affected, HIV/AIDS will still have a serious and prolonged impact on economic development in high-prevalence countries. As Administrator Natsios has stated, "HIV/AIDS is one of the biggest challenges to development that we have ever faced."[4] The fight against the disease itself is unquestionably the top priority. But it should not be the only response. In high-prevalence countries, HIV/AIDS threatens to undermine the achievement of Agency goals for security, democracy, and prosperity. The fight against HIV/AIDS *as a development challenge* requires complementary programs to mitigate the most serious economic effects.

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[1] The figures on infections and deaths are from UNAIDS and WHO (2003). Approximately 95 percent of those living with the virus are in developing countries, including 70 percent in sub-Saharan Africa. Additional estimates are located in Appendix B.

[2] UNICEF, *Africa's Orphaned Generations* (2003), estimates that there are more than 11 million AIDS orphans in Africa alone.

[3] President Bush's State of the Union 2003 Address to Congress, January 28, 2003. Congress authorized funding for the full $15 billion through Public Law 108-25, May 27, 2003.

[4] STATE Cable 097109 (2001)

2. Basics of HIV/AIDS Epidemiology

The human immunodeficiency virus (HIV) attacks the immune system. If untreated, the virus leads to death from the acquired immunodeficiency syndrome (AIDS). The virus is contracted through heterosexual intercourse; sexual contact between men; childbirth and breastfeeding (mother to child transmission); sharing of needles or syringes; transfusions of infected blood products; medical accidents, and unsafe medical practices. [5] The disease is asymptomatic for several years. Once the immune system is sufficiently compromised, the victim begins to suffer co-infections or malignancies, such as tuberculosis, herpes, pneumonia, or Karposi's Sarcoma.[6] The last stage of progression—AIDS itself—is characterized by one or multiple co-infections with severe complications and physical wasting leading to death.

Chart 1 shows that 24 countries in sub-Saharan Africa and one country in the Caribbean face high-prevalence generalized epidemics, which are characterized by a prevalence rate of 5 percent or more among adults aged 15–49.[7] (Appendix A provides more detailed information on these 24 countries.) According to UNAIDS estimates for end-2001, nine African countries had a prevalence rate of 15 percent or higher. In four of them—Botswana, Lesotho, Swaziland and Zimbabwe—more than one in four adults have HIV/AIDS. Infection rates are especially high among commercial sex workers, mobile groups such as truckers, and workers who are separated for long periods of time from their families, such as miners, soldiers, and construction workers.

In Africa, most victims die within 8–10 years after contracting the virus, unless they receive anti-retroviral (ARV) combination drug therapy. With ARV therapy, the prognosis is 3–5 years of additional life. Besides adding extra quality years for work and in child-rearing, ARV

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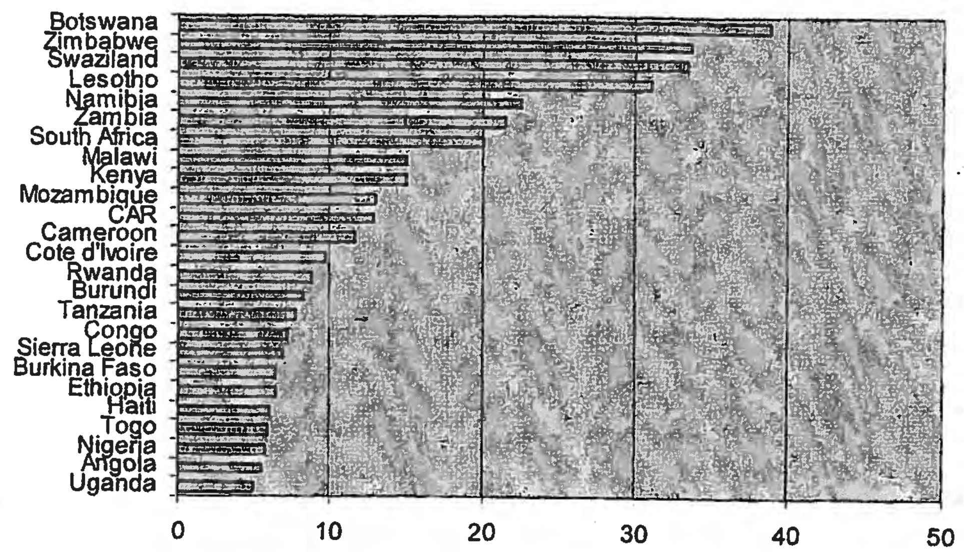
[5] A recent study in the *Lancet* (February 7, 2004) reports that 90 percent of HIV transmission in sub-Saharan Africa is through unsafe heterosexual sex.

[6] A sarcoma is a cancer that develops in connective tissues such as cartilage, bone, fat, muscle, blood vessels, or fibrous tissues (related to tendons or ligaments). Karposi's sarcoma exhibits disfiguring and painful tumors and lesions

[7] Official UNAIDS epidemiological estimates for end-2001. The next revision of country estimates is due to be released in July, 2004

Chart 1. HIV in high prevalence countries, end-2001
% of adults age 15-49 infected with HIV



treatment is widely viewed as a vehicle for HIV prevention because it creates an incentive for individuals to seek testing and counseling and reduces the social stigma of the disease.[8]

The cost of ARV medication has declined sharply to less than $300 per person per year for generic combination therapy. The total cost of providing treatment in a low-income country is about $500 per client per year.[9] This cost is a heavy burden in countries like Zambia, Malawi, Tanzania, or Mozambique, where per capita income is well below $300 per year, and government health expenditures are no more than $10 per person per year. Moreover, the cost per life-year saved by ARV therapy is far higher than the corresponding cost for HIV prevention programs, or other health programs such as tuberculosis treatment or child vaccination.

According to WHO (2003), only 2 percent of those in need in Africa had access to ARV therapy in 2003. This figure should rise rapidly due to the PEPFAR initiative, the WHO/UNAIDS Global 3 by 5 Initiative, programs of the Global Fund to fight AIDS, Tuberculosis and Malaria, and many other local and international efforts.[10]

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[8] There is concern, however, that the availability of ARV treatment can also lull individuals into being less careful about risky behavior such as unsafe sex

[9] Source Kombe and Smith (2003). A similar figure is reported for India by Over, *et al* (2003) Over estimates that ARV therapy could have a net negative impact if it were to lead to even a 10 percentage point reduction in the use of condoms among commercial sex workers

[10] The 3 by 5 program target is to provide ARV treatment to 3 million people by 2005 These figures are inclusive of PEPFAR and the efforts by other organizations See WHO (2003)

3. Multisectoral Approaches to HIV/AIDS

The response of USAID and its development partners is focused on the health emergency through an integrated approach that includes prevention activities such as public education programs that reduce risk behaviors by promoting abstinence, fidelity, and condom use; the distribution of condoms; diagnosis, testing, and counseling services; palliative health care to treat AIDS-related illnesses; the provision of pharmaceuticals to prevent mother–to-child transmission; and (most recently) the provision of anti-retroviral drugs to slow the progression of AIDS and prolong the healthy life of victims. This set of inter-related activities can be called the Medical Model.

The Medical Model operates not only through the formal health care system, but also through organizations in other sectors of society. Thus, HIV/AIDS education programs are run schools, community groups, work groups, NGOs, and even traditional healers, as well as by clinics and hospitals. Many organizations distribute condoms at truck stops, border crossings, and places of work. Some businesses offer their employees HIV testing, counseling, and ARV treatment. These are examples of a *multisectoral approach* within the Medical Model, as pioneered by the government of Uganda.[11]

To address the areas of direct concern to EGAT, it is desirable to pursue an *expanded multisectoral approach* that includes mitigation of the economic impacts of HIV/AIDS in high-prevalence countries. Targeting the adverse social and economic impacts is important not only in its own right, but also complements the Medical Model by ameliorating conditions that contribute to the spread of the disease, such as poverty, malnutrition, lack of education, gender inequality, and weak public organizations.

In adopting an expanded multisectoral approach, there is also a need to explore innovative mechanisms for *cross-sectoral* coordination (including private–public and public–public

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[11] See USAID, Bureau for Global Health, *Country Profile HIV/AIDS: Uganda* at www.usaid.gov . The widely cited cable 097109 (2001) from the Administrator emphasizes that "The HIV/AIDS pandemic is not just a health sector issue; it is the business of every officer in every sector of the Agency." However, the cable links this endorsement of a multisectoral approach specifically to "HIV-prevention programming in all sectors." This is what we term the Medical Model in the text.

partnerships), to facilitate the sharing of knowledge and experience across diverse program components.

The expanded multisectoral approach has been widely discussed within the Agency,[12] and some programs are already addressing economic aspects of the crisis, notably in South Africa, Zambia, and RCSA. (These are discussed later in the paper.) However, these cases are still the exception rather than the rule. On balance, USAID programs are not providing support for activities involving evaluation of the economic impact of HIV/AIDS, analysis of alternative economic policy options, and implementation of operations to ameliorate the most serious adverse effects of HIV/AIDS on economic development.[13]

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[12] See the USAID website on Mulitsectoral Programs at www.usaid.gov/our_work/global_health/aids/. Also, USAID (June 2002), USAID (March 2002) and USAID (November 2002)

[13] As an example, the legislation authorizing PEPFAR cites the need for "multisector strategies that address the impact of HIV/AIDS on the individual family, community, and nation," yet there is no provision for funding programs to address the economic impacts. The appropriation is fully earmarked for treatment (55 percent), palliative care (15 percent), prevention (20 percent), and support for orphans and vulnerable children (10 percent)

4. The Economic Impact of HIV/AIDS

The economic effect of HIV/AIDS at all levels of society stems from three fundamental factors: mortality, morbidity, and uncertainty. First, the disease robs the nation of people in the prime of life. For example, recent demographic projections for South Africa indicate that without an effective ARV program more than 40 percent of the black population now at age 15 will die by age 35. More than 80 percent of the premature deaths would be due to AIDS-related causes.[14] Second, most victims face prolonged illness and disability prior to death; this period can last several years and create high demand for care and treatment. Third, in countries with high rates of premature death, individuals who are at risk face uncertainty about their survival, which diminishes incentives to save for the future or to invest in education and training. Where prevalence rates are high and resources are few, the pandemic poses enormous difficulties for households, businesses, NGOs, and government alike.

Based on existing research and knowledge, it is evident that high HIV prevalence in a developing country creates serious challenges for nearly every economic sector. Prevention and treatment programs will lessen the adverse impacts only gradually because the disease has a long gestation period. Poor countries and poor households cannot afford to wait.

Let us see how HIV/AIDS affects seven areas of special concern to the EGAT Bureau: trade and investment, growth, poverty, agriculture, education, economic opportunities for women, and the environment and natural resource management.[15]

The Impact on Investment and Trade

In a low-income country, a high rate of HIV/AIDS infection reduces the returns on investment by increasing costs and reducing revenues. Costs rise due to lower labor productivity, higher labor turnover, increased absenteeism, opportunistic theft, lower morale, and additional expenses for medical insurance, death benefits, and workplace programs for

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[14] Based on calculations from life tables compiled by the Actuarial Society of South Africa, furnished by Nathan Associates, SEGA Project office, Pretoria, December 2002

[15] This section draws on numerous sources cited in the reference list.

HIV/AIDS prevention, treatment, and care. The disease also causes the premature death of experienced workers and managers whose skills are critical to business operations and sales, and who are expensive to replace. For small companies the loss of key employees can be devastating.[16]

In markets where prices depend on external conditions, higher costs lead to a loss of competitiveness and lower returns on investment. In sectors that serve the domestic market without competition from imports, a widespread cost shock leads to a price adjustment that cushions the impact on profits. But higher relative prices still reduce demand for the product, and therefore revenue. For some industries (such as furniture produced for the mass market), AIDS can also affect revenue through its impact on market demographics and incomes of afflicted households.

In high-prevalence countries, the risk of doing business increases because of the microeconomic uncertainties noted above and further uncertainty about how the disease will affect the investment climate more broadly. For example, increased government expenditure to cope with the health emergency may reduce spending on infrastructure and public services, or create pressure for higher taxes. The quality of market-supporting institutions may be impaired by high infection rates in the civil service and the judiciary. Where the disease greatly expands the number of homeless orphans and destitute adults who lack hope for the future, it can lead to higher crime rates and accentuate the risk of political instability.

Finally, HIV/AIDS reduces investment through its effect on domestic saving. In the household sector, the disease demonstrably causes families to reduce saving, sell off assets, and incur debt. Government saving[17] can also diminish as part of the fiscal response to the heightened demand for medical services.

Through its effects on investment, productivity, and competitiveness, HIV/AIDS acts as an impediment (equivalent to a tax) to the growth of trade. The adverse consequences are most pronounced for labor-intensive production activities, the very sectors that should be leading the expansion of exports in low-income countries. These include labor-intensive manufacturing, labor-intensive cash crops, and tourism.

HIV/AIDS can also have an adverse effect on trade through its impact on the quality of transportation, port, and border services. Transportation networks are major corridors for transmission of HIV. Consequently, transport workers are among the groups at highest risk for infection. In poor countries, a high incidence of the disease can also weaken the infrastructure supporting domestic and international trade by drawing government expenditure into health programs and away from directly productive public investment.

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[16] The added cost is mitigated, but not eliminated, by endogenous responses of the employers. For example, some companies adjust to higher labor costs by switching to less labor-intensive processes, or by using contract labor in place of regular employees (who qualify for benefits)

[17] Government saving is the extent to which current revenue exceeds current (that is, non-capital) expenditure.

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The Impact on Growth

Estimates of the impact of HIV/AIDS on economic growth vary widely depending on the methodology, the assumptions, and the country context. Most studies find that the disease will have a large adverse effect on total GDP in the medium-term, and a substantial effect on per capita income (after taking into account the impact on population growth). A fairly typical result is that of Arndt and Lewis (2000), who calculate that by 2010, HIV/AIDS in South Africa will reduce GDP by nearly 20 percent, and per capita income by 8 percent, relative to the levels that could have been achieved in the absence of the pandemic. The impact is likely to worsen as incidence rates rise. As stated by Bloom (2000), "the full fury of the epidemic has yet to be felt."[18]

Even if the magnitude of the growth impact is controversial, the direction is unambiguous. HIV/AIDS undermines economic growth by reducing the quantity and productivity of labor throughout the economy, impairing incentives for capital investment, reducing saving rates, devaluing education and training, and eroding the quality of market-supporting institutions, to list only the most obvious channels of impact.

To the extent that HIV/AIDS impairs economic growth, it also weakens the dynamics of trade. This is because trade and growth tend to be mutually reinforcing. The expansion of trade stimulates economic growth, and strong growth supports the expansion of trade. Economic growth directly increases the demand for imports. It also facilitates the expansion of exports by fostering investment, finance, entrepreneurship, and competition. Economic setbacks from the pandemic can disrupt this positive dynamic.

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The Impact on Poverty

HIV/AIDS has a triply devastating effect on poverty reduction in heavily affected countries. First, at the national level, the adverse impact on economic growth short-circuits the most powerful engine for sustainable poverty reduction: rising national income. For example, in the model used for poverty projections in the Poverty Reduction Strategy Paper for Mozambique (2001) estimates showed that each 1 percentage point loss in the growth rate of per capita income leads to an increase of 5 percentage points in the poverty head count over a ten-year period.[19] For a population of 20 million, this means that 1 million additional people would be living in poverty at the end of the decade because of less favorable macroeconomic trends alone.

[18] A widely cited recent study by Bell, Devarajan and Gersbach (2003) uses a stylized theoretical model to show that the long-term impact of HIV/AIDS in South Africa could be calamitous over a period of three generations because of a cumulative loss of access to education and parental guidance.

[19] Bolnick (2003). These projections are based on 1996-1997 household survey data

Second, at the individual level, the poor are far more vulnerable to the disease than the rich. They also have far fewer mechanisms for coping with the AIDS-related loss of income and the added burden of first caring for and then burying the victims. For families living in or near poverty, the onset of AIDS and associated illness in even one parent can be tragic. The sequence of adjustments often includes reducing household saving, pulling children out of school or sending them to live with relatives, cutting back on the consumption of necessities (including health services for other family members), selling family assets, and, ultimately, incurring debt. Where the virus is widespread, traditional social networks cannot cope with the consequences.

Third, intensified poverty heightens the risk of further transmission of the disease as a result of malnutrition, lack of education, inability to afford condoms, and economic pressure on women to turn to transactional sex to augment family income.

The Impact on Agriculture and Food Security

In Africa, HIV/AIDS is causing prolonged illness and premature death for millions of small-scale farmers and agricultural workers. This directly affects production capacity by reducing the supply of labor, particularly among the most productive members of the rural economy. Agricultural households are also affected by the death of family members who have jobs in the city, the mines, or commercial farms, because of the loss of remittance income that is often used for the purchase of seeds, fertilizer, and pesticides. As a consequence, HIV/AIDS is now considered to be a major factor contributing to acute food insecurity in countries like Malawi, Zimbabwe, and Zambia.

The loss of productive family labor leads poor households to cultivate less land and take labor-saving shortcuts that reduce productivity, such as less careful mounding, weeding and mulching, and less use of fertilizer and pesticides. To avoid risk, many afflicted households reduce the cultivation of cash crops in favor of subsistence crops. The premature loss of parents and elders also diminishes the inter-generational transmission of knowledge about cultivation, animal husbandry, and risk management. In addition, recent evidence in the literature on "new variant famines" suggests that the disease also weakens the ability of poor households in Africa to recover from lean seasons caused by droughts or floods. Commercial farmers are also affected, though less dramatically, by lower productivity among their workers.

The impact of HIV/AIDS on agriculture and food security creates a vicious circle: hunger and malnutrition heighten the risk of contracting the disease and its associated illnesses, which in turn contribute to hunger and malnutrition. Programs to maintain food production and food supplies can complement direct health interventions in breaking the chain of disease transmission.

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The Impact on Education

HIV/AIDS has a serious impact on the education system through both the demand and supply sides. On the demand side, the disease has a sharp demographic effect on the school-age population because so many women die before completing their reproductive years, and because children born with the infection usually die before going to school. Many children of parents with HIV/AIDS leave school because they must care for parents who are suffering from associated illnesses, because their families can no longer afford the fees, or because they have to work to compensate for the loss of family income. Similarly, many single-parent orphans drop out of school to work at home or join the labor force. Double-parent orphans from poor families are even less likely to continue their schooling because surrogate parents tend to favor their own children, and those who are left homeless face a daily struggle to survive in the village or on the streets.

The risk of HIV/AIDS affects incentives for children and young adults to stay in school. A 15-year-old who sees many others dying by age 30 may well conclude that there is not much point in pursuing further education. This shortening of time horizons due to the decline in life expectancy—more specifically the period of productive work—eliminates much of the expected payoff from such an investment.[20]

On the supply side, the most direct effect is that HIV/AIDS kills teachers. The numbers can be startling. For example, a 1998 World Bank study estimated that the disease will kill one quarter to one half of the teachers in Malawi by 2005.[21] The impact goes well beyond the supply of teachers to include those who train teachers and those who administer the education system. Also (as a recurring theme), the additional demand for health programs threatens to cut funding for education, which is generally one of the largest components of the government budget. Finally, widespread HIV/AIDS can also disrupt the quality of the learning environment for those who remain in school because teachers are frequently absent, and it is hard for anyone to concentrate on lessons when parents, teachers, kin, and friends are falling ill and dying.

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The Impact on Opportunities for Women

Women comprise a majority of AIDS victims in Africa—even though evidence suggests that women engage in casual sex far less frequently than do men.[22] Women are disproportionately

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[20] In Botswana, the most extreme case, the US Census Bureau estimates that HIV/AIDS has reduced the average life expectancy to 39 years, when it would have reached 72 years by now in the absence of HIV/AIDS. By 2010, the figure could be below 30 years, unless effective programs for prevention and treatment are implemented and sustained. Source: Stanecki (2002).

[21] Cited in Bollinger *et al* (July 2000), p 9.

[22] UNAIDS (2002). Annex on "HIV/AIDS country specific estimates for end-2001." The estimate is that 58 percent of those living with HIV/AIDS in Africa are women, and 42 percent are men. Also, the data on

vulnerable to infection for biological reasons. Moreover, the lack of social and economic empowerment for women and the high incidence of violence against women in many countries make it more difficult for women and girls to reject unwanted advances or to insist on safe sex practices.[23] This includes a high incidence of sexual predation in school and in the workplace.

In addition to being the main victims, women and girls also bear the main burden of providing home-based care for other family members with AIDS. Female family members are most likely to drop out of school or forego opportunities to earn income. If a wife is suspected of being HIV positive after her husband dies, she faces powerful emotional abuse in many traditional societies from social stigma and discrimination. Accentuating these burdens, inheritance laws and traditional practices in many African countries deny women the right to family assets when the male head of household dies. As a result, women are often left destitute and without marketable skills. Recourse to transactional sex only increases their vulnerability.

Reflecting this problem, the Act authorizing the PEPFAR initiative specifically calls for the development of strategies "to increase women's access to employment opportunities, income, productive resources, and microfinance programs."[24]

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The Impact on the Environment and Natural Resources

A major consequence of HIV/AIDS is to slow the rate of population growth, and possibly bring it to a halt.[25] Though one might infer that the impact on the environment and natural resources is therefore positive, demographic effects are just part of the story. Offsetting this is the effect of the pandemic on poverty and the quality of natural resource management.

The link between HIV/AIDS and poverty has already been discussed. Here the key point is that poverty is a principal cause of environmental degradation in low-income countries. As the disease intensifies poverty or holds more people to a subsistence livelihood, it can increase pressure on resources through charcoal burning, deforestation, poaching, over-fishing, and wildcat mining. Furthermore, poor rural households that lose primary workers may have less capacity to adhere to traditional soil-conservation practices, and to use fertilizers to restore soil quality.[26]

"reported higher risk sex" show far higher rates for men than for women in every reporting country. Data from www.unaids.org.

23 Little attention has been devoted to sexual vulnerability of young boys, especially homeless orphans.

24 Section 101(b)(3)(G) of Public Law 108-25—May 27, 2003. This mandate is not consistent with the funding earmarks listed in Section 402 of the legislation.

25 Stanecki (2002) reported U.S. Census bureau estimates that the population growth rate could be negative by 2010 in Botswana, Mozambique, Lesotho, Swaziland, and South Africa, and close to zero in Zimbabwe and Namibia. These estimates do not necessarily accord with projections made by local experts.

26 References: Mauambeta (2003), FAO (2003).

At the local level, community-based natural resource management is difficult enough in normal circumstances. The task is much harder when a pandemic leads to the premature death of village leaders, destitution for many households, large numbers of orphans, severe strains on the traditional social fabric of the community, and shortened decision horizons. At the national level, fiscal pressures from slower growth and demand for health services are likely to reduce funding for environment programs (which rarely have a top priority). In addition, the disease will cause the loss of experienced environmental managers, while reducing the supply of freshly trained professionals.

Regardless of the population growth rate, measures to offset the adverse effect of HIV/AIDS on the environment can improve sustainable natural resource management.

5. Programmatic Implications

These brief impact summaries demonstrate the importance of HIV/AIDS as an economic development crisis in high-prevalence countries. The list of AIDS-related problems can easily be extended to other areas of concern to EGAT. For example, HIV/AIDS can have a serious effect on microenterprise development and microfinance organizations. It poses difficulties for the design of social safety nets. It also impairs economic development by eroding the quality of governance, the strength of democratic institutions, the effectiveness of legal and judicial systems, the stability of the national security apparatus, and increasing the severity of crime and corruption.

The primary programmatic implication of this analysis is that a broad multi- and cross-sectoral approach is essential for effective use of foreign assistance resources. There are three reasons. First, promoting economic growth is a fundamental and long-standing strategic goal of the Agency. In view of the pervasive *economic* consequences of HIV/AIDS, virtually all of USAID's economic development assistance to high-prevalence countries need to take into account the effects of the pandemic. This linkage should be systematic and coordinated across sectors.

Second, many of the economic effects of HIV/AIDS are first-order problems for economic development that require resources and support now. These include the impacts on agriculture and food security, poverty, education, and opportunities for women. For trade, investment, and growth of the private sector, the impact of the pandemic may be less dramatic, but is still substantial. These areas of central concern to the Agency's economic growth strategy must also be covered in the expanded multisectoral strategy.

Third, our discussion of impacts highlighted multiple feedbacks between the health crisis and the economic crisis. Thus, programs to mitigate the economic effects will reinforce efforts through the Medical Model to "turn the tide against AIDS in the most afflicted nations."[27]

One problem in pursuing a broad multisectoral approach is that the scope and magnitude of the economic impacts are not well understood. This is not a justification for inaction. Instead, it is a strong reason to include careful studies of the impact of HIV/AIDS in every major

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[27] State of the Union Address

program on Economic Growth and Trade. This will enable the Agency to identify critical areas for intervention and develop programs to make the best possible use of resources to deal with the economic implications of the disease.

This approach has been adopted by USAID missions in Zambia and South Africa, as well as the Regional Center for Southern Africa (RCSA). The Zambia mission's *Multisectoral HIV/AIDS Strategy 2004-2010* includes sectoral impact studies to document the effects of HIV/AIDS, and activities to mitigate the effects in each major sector. These include measures dealing with food security and nutrition for vulnerable households, training in agriculture for female heads of household, and comprehensive plans to address the impact on the education sector, among other things. In South Africa, the mission has funded empirical studies on the economics of HIV/AIDS, including the effects on and responses of households, businesses, sectors, and macroeconomic performance.[28] The studies have been important in shaping the national debate on HIV/AIDS policy. As a deliberate by-product, the program also contributed to developing national capacity for research on the economics of HIV/AIDS. As for the RCSA, its *Regional Strategic Plan 2004-2010* states that all RFPs and RFAs should require bidders to propose effective approaches to mitigating the impacts of HIV/AIDS, and that the Performance Monitoring Plans should include indicators to track the results. The EGAT bureau should seriously be considering how best to build on these efforts.

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[28] A collection of the research has been published as a special issue of the *South African Journal of Economics*, edited by Booysen and Dike (2002). See also the website for the Health Economics and AIDS Research Division, University of Natal (http://www.nu.ac.za/heard)

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Appendix A. Selected Indicators for High-prevalence Countries

Selected Indicators for High-prevalence Countries , end-2001
(prevalence rate of 5% or higher, adults age 15-49)

	A	B	C	D	F	G	H	I	J
		People living with HIV/AIDS, end-2001							
Country	Prevalence rate adults (15-49) (%)	Total	Adults (15-49)	Adult women (15-49)	Children (0-14)	AIDS orphans (0-14)	Life expectancy at birth (years)	Per capita govt expenditure on health (US$)	Per capita income (US$)
Sub-Saharan Africa									
Angola	6	350,000	320,000	190,000	37,000	100,000	40	19	660
Botswana	39	330,000	300,000	170,000	28,000	69,000	40	126	2,980
Burkina Faso	7	440,000	380,000	220,000	61,000	270,000	42	4	220
Burundi	8	390,000	330,000	19,000	55,000	240,000	41	2	100
Cameroon	12	920,000	860,000	500,000	69,000	210,000	48	8	560
Central African Republic	13	250,000	220,000	130,000	25,000	110,000	43	6	260
Congo	7	110,000	99,000	59,000	15,000	78,000	53	12	700
Cote d Ivoire	10	770,000	690,000	400,000	84,000	420,000	45	7	610
Ethiopia	6	2,100,000	1,900,000	1,100,000	230,000	990,000	48	1	100
Kenya	15	250,000	230,000	140,000	220,000	890,000	51	6	360
Lesotho	31	360,000	330,000	180,000	27,000	73,000	36	18	470
Malawi	15	850,000	780,000	440,000	65,000	470,000	40	4	160
Mozambique	13	1,100,000	1,000,000	630,000	80,000	420,000	43	8	210
Namibia	23	230,000	200,000	110,000	30,000	47,000	49	76	1,780
Nigeria	6	3,500,000	3,200,000	1,700,000	270,000	1,000,000	49	3	290
Rwanda	9	500,000	430,000	250,000	6,500	260,000	44	6	230
Sierra Leone	7	170,000	150,000	90,000	16,000	42,000	34	4	140
South Africa	20	500,000	4,700,000	2,700,000	250,000	660,000	51	92	2,600
Swaziland	33	170,000	150,000	89,000	14,000	35,000	39	28	1,180
Tanzania	8	1,500,000	1,300,000	750,000	170,000	810,000	47	5	280
Togo	6	150,000	130,000	76,000	1,500	63,000	52	4	270
Uganda	5	600,000	510,000	280,000	110,000	880,000	49	8	250
Zambia	22	1,200,000	1,000,000	590,000	150,000	570,000	40	10	330
Zimbabwe	34	2,300,000	2,000,000	1,200,000	240,000	780,000	38	20	...
Caribbean									
Haiti	6.1	250,000	240,000	120,000	12,000	200,000	50	12	440

Sources. *Columns A-G from UNAIDS,* Report on the global HIV/ AIDS epidemic, 2002. *Available at www.unaids.org. Updates to end-2003 are due to be posted in July 2004. Columns H-I are from WHO, World Health Report 2003. Column J is from World Bank, World Development Report 2004, Appendix Table 1. Columns I-J use exchange rate conversions to US$.*

Appendix B. Global HIV/AIDS Estimates

UNAIDS and WHO (2003), *AIDS Epidemic Update: 20*

Adults and children estimated to be livin with HIV/AIDS as of end 2003

Total: 34 – 46 million

UNAIDS

Estimated adult and child deaths from HIV/AIDS during 2003

Tuesday, June 29, 2004
10:45 – 12:15

Plenary Sessions

Microeconomic Constraints on Business

(i) Investor Roadmaps

Cindy Clement, Presenter

(ii) Doing Business 2004

Simeon Djankov, Presenter

(iii) Mozambique Reform Program
Minister Carlos Morgado, Presenter
Kristin Randall, Moderator

The Message

1. All sustainable USAID project activity entails policy reform that is explicit or implicit, so it might as well be explicit.
2. Virtually all USAID project activity has an environmental component that is explicit or implicit, so it might as well be explicit.

An Illustration

Project activity aimed at improving the competitiveness of the country's enterprises in the global marketplace as a means of promoting trade, economic growth, and poverty reduction on a sustained basis.

CHEMONICS [redacted] USAID 1

The "Enterprise Competitiveness Diamond"

GOV'T

RIVALRY & STRATEGY

FACTORS → DEMAND

INDUSTRY CLUSTER

CHANCE

CHEMONICS Enterprise Competitiveness USAID 2

Why good environmental performance is critical for enterprise competitiveness

<u>Supply (factor, production) side:</u>
- high production efficiency
- low operating costs
- minimized environmental and other liabilities

<u>Demand (market, customer) side:</u>
- access to more retail markets
- respond to high-end niche markets
- access to supply chains of global corporations

CHEMONICS Enterprise Competitiveness USAID 3

Examples of policies to support enterprise competitiveness

- Sound environmental laws and regulations, fully enforced
- Financial or tax incentives to promote environmentally friendly technologies
- Procurement preferences
- "Extension services" for EMS and cleaner production to support good environmental practices and performance, and satisfy international standards

CHEMONICS

USAID

Enterprise Competitiveness

4

Some resources for competitiveness, environmental competitiveness, and enterprise competitiveness in development

Bendavid-Val, Avrom, and Nicholas Cheremisinoff. *Green Profits: The Manager's Handbook for ISO 14001 and Pollution Prevention.* Boston, Butterworth-Heinemann, 2001.

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"Environmental Competitiveness," *Sustainable Development International Edition 8*, June 2003 (article by Avrom Bendavid-Val-Val and Christopher J. Paine)

www.cleanerproduction.com
www.inem.org
www.ecologia.org

www.amazon.com

CHEMONICS

USAID

Enterprise Competitiveness

5

Mozambique Ministry of Industry and Trade

Mozambique Reform Program

USAID Workshop: Promoting Economic Growth in a New Era

Carlos Morgado – Minister of Industry and Trade

June 29, 2004

Introduction

- Every country has constraints that negatively impact the private sector.
- The challenge is to reduce these constraints in order to facilitate the growth and competitiveness of the private sector.
- Mozambique understands that the growth of the private sector, trade and exports is imperative for the growth of our economy and the reduction of poverty.
- Mozambique has embarked on an ambitious reform program to improve the business environment.

Introduction (continued)

- Today I will describe Mozambique Business Environment Reform Program.
- I'll be the first to admit that our business environment is far from perfect.
- The reform process should be simple, but it is really difficult.
- Bureaucracy and a non-authoritarian ethic slows reforms.
- But we are making progress and USAID's support is assisting with the reform process.

Background

- The concept of the private sector in Mozambique is something relatively new.
- During the Portuguese Colonial period, almost all private sector activity was prohibited and reserved for the government.
- After independence, the development model Mozambique adopted favored strong State involvement in the economy with little focus or support for entrepreneurs.

The Growth of the Private Sector

- Contrary to what has been practiced in other countries, in Mozambique, the Government that set about to foster the development of an entrepreneurial class.
- This process began in 1987 with the restructuring of state enterprises and ended when all state-owned enterprises were privatized.
- To promote the creation of the private sector, Mozambique adopted mechanisms that allowed access to the privatized enterprises at advantageous conditions

Public - Private Sector Dialogue

- Many of the state-owned enterprises were shut down soon after privatization because they could not remain competitive.
- The Government then decided to invite the private sector to dialogue with the government.
- This dialogue was intended to highlight reasons why the private sector could not remain competitive so that the government could work on addressing the problems.
- The first formal meeting between the government and the private sector took place in 1995.

Public - Private Sector Dialogue (continued)

- The first public-private sector dialogue in 1995 was not very productive because the public and private sectors just blamed each other for problems relating to the lack of competitiveness of the private sector.
- The meeting was successful in that it highlighted the necessity to further study and evaluate the problems that were highlighted at the meeting.
- It was recommended that a study be undertaken that analyzed the administrative barriers to investment (undertaken by the IFC and FIAS).

Public - Private Sector Dialogue (continued)

- The conclusions of the administrative barriers to investment study pointed to the existence of outdated and disorganized legislation.
- This legislation was implemented before independence and impeded, rather than promoted, private sector development.
- It was decided that it was necessary to update and modernize the outdated legislation in order to promote the economic success of the private sector.

Public - Private Sector Dialogue (continued)

- To assist with the updating of the legislation two important steps were realized:
  1. The creation of an Inter-Ministerial group, which would analyze the problems and change the legislation; and
  2. The creation of the Confederation of Business Associations of Mozambique (CTA) which would serve as the principal intermediary between the private and public sectors.
- These two groups met annually at the Private Sector Conference which developed, monitored and evaluated the work program for the improvement of the business environment.

Public - Private Sector Dialogue (continued)

- The Government and the Private Sector addressed the problems of the business environment at three levels:
  - Level One – included those reforms the Minister could resolve alone;
  - Level Two – included those reforms that required the approval of the Council of Ministers; and
  - Level Three – included those reforms that required the approval of the General Assembly's approval.
- The reforms that were addressed through this process were designated "First Generation Reforms", and were the most important reforms for improvement of the business environment.

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Public - Private Sector Dialogue (continued)

- The "First Generation Reforms" lasted until the 5th Private Sector Conference which took place in September 1999.
- Because it was deemed that the reform process was proceeding slowly, it was agreed that a new approach was needed.
- Nine new specific work commissions were created dealing with specific business environment related topics, such as the labor law, taxes, business registration, etc.
- These new work commissions met monthly and re-invigorated the work program for the reform of the business environment.

10

Results

- There has been a great improvement in the Government's attitude towards the private sector.
- More attention is being paid to the constraints that negatively impact the competitiveness of private sector enterprises.
- All of the reforms, laws and regulations that are of interest to the private sector have been submitted to CTA for comment.
- Some of the principal economic instruments, such as the Labor Law, the Commercial Code, and Business Licensing and Commercial Registration, are now undergoing revision.

Results (continued)

- The private sector continues to take part in several commissions formed specifically to study and improve specific matters related to the business environment, such as:
  - ➢ Tax reform
  - ➢ Legal reform
  - ➢ Customs reform
  - ➢ Land reform

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Conclusion

- In our experience, we think that it is possible to harmonize viewpoints between the public and private sectors in order to improve the business environment and assist the private sector become more competitive.
- USAID has been supportive in this process by supporting both CTA and the Government of Mozambique.
- USAID is also in the process of conducting an assessment of the business environment, jointly with CTA and the Ministry of Industry and Trade, to put some concrete numbers to the reforms we are making.

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Tuesday, June 29, 2004
1:30 – 3:30

Plenary Sessions

New Directions in USAID and EGAT, including relationships with State (Joint Strategy and Committees), assisting mechanisms, and HR issues

Emmy Simmons, Presenter
Steve Hadley, Presenter
Barbara Turner, Presenter
David Eckerson, Presenter
Paul R. Deuster, Moderator

Tuesday, June 29, 2004
4:00 – 5:00

Breakout Sessions

Breakouts by Backstops to Discuss Professional Concerns

Paul R. Deuster, Moderator
Brad Wallach, Moderator
Thomas, Moderator

Governance

Wednesday, June 30, 2004
9:00-10:30

Plenary Session

Millenium Challenge Account (MCA): Basis, Operations, and Implications

USAID economic growth officers in the field need to understand how the MCA may affect the development and implementation of USAID programs and project interventions. Some of the main points or questions to be discussed will be:

- The rationale for MCA and summary of the Millennium Challenge Corporation's (MCC) operational strategy.
- What kind of compacts is MCC seeking to negotiate in the 16 countries eligible for FY04? How will MCC resources be allocated and for what program/project purposes in the recipient countries for FY04
- What are expected to be the operational links between MCC programs and USAID field missions.

Presenters:

Clay Lowery, Millennium Challenge Corporation
Drew Luten, Millennium Challenge Corporation
Andrew Warner, Millennium Challenge Corporation

Moderator:
Stephen Brent, Millennium Challenge Corporation

EG WORKSHOP SESSION
Day 3 Theme: Governance
Assessing and Controlling Corruption

Wednesday, June 30, 2004

10:45 --12:15

I. Session Title: Assessing and Controlling Corruption

II. Session Theme, Objective, and Relevance to EG Officers:

This session will look at several key corruption issues facing USAID partner countries and will help EG officers to learn of possible program interventions that may have a substantial impact on assessing and controlling corruption.

III. Presenters/Discussants:

<u>Assessment of Corruption:</u>

Tony Lanyi (IRIS Center) will speak about current methods for assessing ("measuring") corruption, their uses and limitations, and improved methods focusing on corruption in specific sectors and institutions, including methods being developed under an E&E Bureau/IRIS project. (20 minutes)

<u>Control of Corruption:</u>

Jamie Boex (Georgia State University) will present a current case study of corruption and of fiscal reform anti-corruption measures that have been implemented in Tanzania. (15 minutes)

Sergio Chitara, Director, Confederation of Mozambican Business Associations, will discuss the problems that his private sector groups have faced in Mozambique, with corruption as a barrier to trade and investment and the experience that they have had after several years of "public-private" collaboration to reform regulatory obstacles in Mozambique. (15 minutes)

Questions and Discussion: 30 minutes

Introductions and wrap-up by Moderator, 10 minutes.

Moderator: David Meyer, E&E Bureau

Assessing and Controlling Corruption

Moderator
A. David Meyer
Office of Economic Growth
USAID Europe & Eurasia Bureau
dmeyer@usaid.gov

1

Three Presentations

I. Anthony Lanyi, IRIS Center, University of Maryland — Assessing Corruption
II. Jamie Boex, Georgia State University, — Controlling Corruption through Fiscal Reform Projects — Anti-Corruption Policies in Tanzania
III. Sérgio Chitará, Confederation of Mozambican Business Associations (CTA) — Controlling Corruption through Simplification

2

Why We Are (Not) Here

"It's awful hard to get people interested in corruption unless they can get some of it." Will Rogers

"Corruption is no stranger to Washington; it is a famous resident." Walter Goodman

3

Assessing Corruption Problems and Anti-Corruption Progress "Three Simple Questions"

"Is corruption increasing or decreasing in Tanzania?"

"What forms of corrupt practices are declining / increasing in Mozambique?"

"How good are our diagnostic tools and indicators of problems and progress?"

4

How True is This Conclusion?

"Because current measures are still imprecise, it is difficult to know with certitude whether corruption is declining or increasing. In the absence of more reliable and hard data on corruption, donors will find it difficult to target anti-corruption activities and more importantly . . . determine what impact, if any, their anti-corruption efforts are generating." *Corruption in Latin America: A Desk Assessment (June 14, 2004), USAID Americas' Accountability Anti-Corruption Project*

5

Measures of Corruption

What are the problems?

Are there solutions?

Tony Lanyi of IRIS will answer the former and identify approaches to the latter

6

Quantitative Assessment of Corruption

Tony Lanyi
IRIS Center, University of Maryland, College Park

Measuring corruption

- Assessments should be based on measurement, not just hearsay and impressions, but measurement is difficult because:
- Corrupt transactions are unrecorded.
- Corruption is multi-dimensional—aggregate measures have limited meaning and usefulness.
- Corruption is dynamic—it changes over time with growth and structural change in the economy and the political and social environment
- Proxies for corruption—like government integrity characteristics—are difficult to quantify.

The many types of corruption

- State capture *by* business (HL)
- State capture *of* business (HL)
- Bribery to escape taxes, regulations (LL)
- Bribery to receive routine public goods, services (LL)
- Extortion by state officials (or by criminals with state sanction) (HL,LL)
- [HL=high-level, LL=lower-level]

Approaches to Measurement or Qualitative Assessment) of Corruption

- Surveys of stakeholder perceptions
- Surveys of stakeholder experience
- Expert assessments; surveys of export opinion/perceptions
- "Hard" data (e.g., forensic accounting)
- Structured interviews and focus groups

10

Chief Corruption Measures Used in USAID

- Transparency International (TI): Corruption Perceptions Index (CPI)
- World Bank Institute (WBI): Control of Corruption Indicator
- Freedom House--Nations in Transit: Corruption Ratings (for E&E countries only)

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The TI Corruption Perceptions Index

- Aggregation of ten corruption indices
- These indices are mostly based on expert opinion, some on surveys of stakeholder perception
- CPI related to "general" corruption—no information on where corruption is or its mechanisms, and indices being aggregated don't all measure the same thing
- Comparison of *scores over time* make more sense than *country ranking*—but:
- International corruption standards and perceptions change over time, and
- The number of countries covered changes over time, and different surveys have varied country coverage

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World Bank Control of Corruption Indicator

- Like TI, based on aggregation of different indices or ratings
- Most indices/ratings are based on expert opinions
- Like TI, measure relates to "general" corruption, and indices making up this indicator don't all measure the same thing
- Like TI, there are problems with inter-temporal and inter-country comparisons

13

Nations in Transit Corruption Ratings

- For E&E countries only
- Based on studies by Freedom House's own staff, reviewed by panel of experts
- Based on legal and other factual characteristics—but no survey-based evaluation of whether rules are enforced, anti-corruption units are effective, etc.
- Little change in scores since 1999 for most countries in region: implying little progress or masking progress in some areas but not others?

14

Efforts to Look at Sectoral Corruption

- Business Environment and Enterprise Performance Survey (BEEPS)—World Bank/EBRD
- E&E Bureau/IRIS Center project to develop methodology for assessing corruption in specific sectors and institutions

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BEEPS

- BEEPS (2002) covered 6500 firms in 26 transition countries; firms interviewed per country ranged from 170 to 500, and they were differentiated by types of origin, location, sector, and size
- Five corruption aspects were investigated:
  - Corruption as an obstacle to business
  - Frequency of bribes
  - Size of the "bribe tax" (broken down by type of public service)
  - Manager's perception of the impact of state capture on the firm
  - Extent of the firm's direct participation in state capture

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BEEPS (2)

- The 5 corruption dimensions are related to the following possible causes, for each country:
  - Policy and environmental variables
  - Firm characteristics
  - Policy and institutional reforms
  - "Optimism"
  - Economic growth
  - Tenure of political leadership

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E&E Bureau/IRIS Anti-Corruption Assessment Project

- Aim: helping USAID missions assess corruption in specific sectors and institutions, in order to target, monitor, and evaluate anti-corruption programs more precisely
- Development of methodology that combines: existing sources of information, structured interviews (and/or focus groups), and carefully designed surveys of stakeholders
- Pilot studies in Georgia (commercial litigation); Romania and Russia (business registration and inspections); and Bulgaria (pharmaceutical procurement)

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E&E Bureau/IRIS Anti-Corruption Assessment Project (2)

- Pilot studies utilize structured interviews and surveys of at least two different groups of stakeholders, across different local governments units—for instance, business enterprises and officials responsible for business registration, inspections
- Survey results, together with other relevant data, are analyzed to compare prevalence of corruption in sectors with TAPEE factors in relevant state agencies (TAPEE= transparency, accountability, prevention, enforcement, and education)

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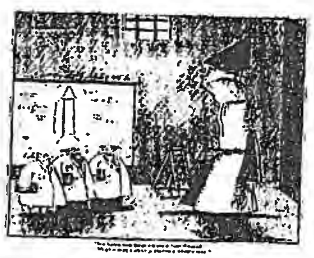
Measuring Corruption / Corrupt Practices

"It's time we face reality, my friends ... We're not exactly rocket scientists."



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Controlling Corruption

Two Presentations

First, Combating Corruption through Fiscal Reforms (Tanzania)

Second, Combating Corruption through Simplification (Mozambique)

Setting the Stage for Combating Corruption Tax and Budget Reform Interventions

- "The income tax has made more liars out of the American people than golf has." Will Rogers
- "Those who corrupt the public mind are just as evil as those who steal from the public purse." Adlai E. Stevenson

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Corruption and anti-corruption policies in Tanzania

Jamie Boex
Georgia State University

23

Overview

- Synopsis
- Anti-corruption responses in Tanzania
  - Institutional policy responses
  - Fiscal policy responses
- Impact on corruption measures
- Future challenges

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Synopsis of Corruption in Tanzania

- Anecdotal evidence of increasing corruption and reduction of civil service morale during 1970s and 1980s
- 1994: Number of donors freeze aid
- 1995: President Mkapa comes to office as Mr. Clean
- 1999: National Anti-Corruption Strategy and Action Plan (NACSAP)

25

Institutional reforms

- Leadership Code of Ethics Law (1995)
- Wariobi Commission (1995)
  - Petty corruption and grand corruption
- National Anti-Corruption Strategy and Action Plan (1999)

26

Fiscal anti-corruption responses in Tanzania

- Revenue-side reforms
- Expenditure-side reforms
- Local government finance reform

27

Revenue-side reforms

- Introduction of autonomous Tanzania Revenue Authority (1996)

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Expenditure-side reforms

- Introduction by National Treasury of integrated financial management system (2001)
- Tender reform

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Local government reform

- Public expenditure tracking survey (PETS)
- Elimination of a number of poorly administered local revenue sources
- Publication of disbursements
- Introduction of formula-based grants

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Impact on corruption measures

Year	Tanzania CPI	African Average CPI	Tanzania CPI Ranking	Tanzania CC	Tanzania CCI Ranking
1998	1.9	3.6	16	-0.96	42
1999	1.9	3.5	16	-	-
2000	2.5	3.5	14	-1.01	40
2001	2.2	3.3	14	-	-
2002	2.7	3.4	11	-1.00	35
2003	2.5	3.1	11	-	-

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Future challenges

- More energized implementation of NACSAP
- Shift focus from grand corruption to petty corruption
- Increase reliance on "bottom-up" anti-corruption approaches (transparency and grass-roots involvement)

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Controlling Corruption

Second Presentation on Controlling Corruption

Corruption and Over-Regulation Walk Hand-in-Hand

Consider the Principal Findings of "Doing Business in 2004"

33

Birds of a Feather
Corruption and Over-Regulation

1. "Poor Countries Regulate Business the Most"
2. "Cumbersome Regulation is Associated with Lower Productivity"
3. "More Regulation is Associated with Higher Costs and Delays"
4. "Heavier Regulation is Associated with Informality and Corruption"

Source: *"Doing Business in 2004: Understanding Regulation,"* The World Bank and IFC

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Controlling Corruption Through Simplification

The Mozambique Case

Sérgio Chitará
Confederation of Mozambican Business Associations (CTA)

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Why the Mozambican private sector is committed to fight corruption

- It is an old and well-known disease: e.g. Mr CUNHA; CHICONHOCA; CANDOGUEIRO
- Increases costs for doing business;
- Reduces business opportunities and competition;
- Creates uncertainties;
- Builds dependency and endless cycle of bribery;
- Government and institutions get poor quality at high prices - inefficient way of using taxpayer money;
- Dissipates tax base and leads to over-taxation of the honest or accessible.

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Corruption Realities

- More than 30 days to access agricultural land and more than 100 steps;
- It can be endless process to access land, to build in urban areas- bribes all the way;
- Easier to pay duties to the officials, not to government, quicker to pass the border;
- Labor and tax inspections: always something wrong, to fine you… it can be repeated … the fines are high and discretionary … so bribe!
- Tenders are not transparent processes: Government loses… private sector without opportunities

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Vilanculos

- Survey of 100 of 400 registered businesses in this tourist town found:
- 82% of businesses paid bribes averaging
- 9.5% of gross revenues, with
- Mozambican companies paying more than foreign companies, while
- Managing to evade about 2/3 of taxes.

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Controlling Corruption

- Simplify procedures, rules and regulations: e.g. through public/private sector reform commissions
- Public information on about steps required in any process: e.g. border notice board
- Remove discretionary decision-making from officials: e.g. foreign workers contracting
- Work with advocacy and lobbying groups to create awareness: e.g. CTA commissions
- Explain the rules publicly with examples: ETICA

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Efforts to Fight Corruption from Bottom Up Promising

- Civil society anti-corruption group, ETICA, comprehensive survey, TV program;
- Simplification of rules and regulations – pushed by CTA -- gaining understanding among regulators and decision makers;
- Public education and campaigns on going;
- Free and active press supports the fight against corruption.

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But Top Down Effort has Been Limited

- Anti-corruption law recently passed;
- Anti-corruption authority established;
- Both very slow in coming;
- And, no prosecution of senior officials identified by anti-corruption unit of AG;
- A core of senior figures appear to block all efforts to bring high-level problem under control.

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Final Words

Changing incentives,
reforming institutions,
embedding values,
and
increasing political and economic competition and opportunities take time.

There are no
silver bullets, magic elixirs or corruption-crushing quick fixes.

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CENTER FOR INSTITUTIONAL REFORM AND THE INFORMAL SECTOR
AT THE UNIVERSITY OF MARYLAND

THE IRIS DISCUSSION PAPERS
ON INSTITUTIONS & DEVELOPMENT

MEASURING THE ECONOMIC IMPACT OF CORRUPTION: A SURVEY

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Measuring the Economic Impact of Corruption: A Survey

Anthony Lanyi

Introduction[1]

Because corrupt transactions are by definition illegal—or at the very least, part of the "informal economy"—they are not recorded and therefore impossible to measure directly. Nevertheless, strenuous efforts have been undertaken, by the business sector, the donor community, and scholars, to measure corruption indirectly. As will be seen, this has taken the form of *either* collecting survey data of various types, in conjunction with "hard" data that are hypothesized to be related to corruption, *or* measuring variables related to institutions or behavior that are considered to be linked—whether positively or negatively—to corruption.

There are three kinds of uses to which data of this sort can be put. One is to track the rise or decline of corruption (or, conversely, the degree of "institutional integrity" or "good governance") in a particular country; another is to compare countries (in order to make statements such as "Shangri-la is the world's most corrupt country"); a third, beloved of economists, is to use the data in order to make econometric estimates of the causes of corruption, or of its effect[2] on such economic variables as growth of GDP, foreign investment, fiscal revenues, the level and composition of government expenditures, and other variables that measure living standards.

A companion paper, by Thomas and Meagher (2003), surveys and critiques the conceptual frameworks that have been used to analyze corruption. The present paper is intended to survey the already rather large literature on the topics sketched above, bearing in mind the general question: "What do we know about the economic impact of corruption?" Section II discusses the measurement of corruption itself, or related variables. Section III briefly reviews empirical work aimed at specifying the causes of corruption. Section IV discusses the econometric studies that try to tease out the impact of variables related to corruption (or governance institutions) on economic outcomes. Section V summarizes what can be concluded from the existing corpus of empirical research in this area.[3]

I. Measures of Corruption: The Problem and Attempts to Solve It

This section addresses the problem of measuring corruption—or its converse, good governance or institutional integrity. The first section is definitional and conceptual,

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[1] This paper has benefited greatly from discussions with and comments from Omar Azfar, Patrick Meagher, Peter Murrell, Melissa Thomas, and especially Shang-Jin Wei. I would also like to thank Darin Dalmat, Michael Kanaley, and Nuzaira Khan for their help with procuring documentation and manuscript preparation.

[2] Or, alternatively, the effect of institutional variables related to corruption.

[3] There are other surveys of the empirical research on corruption, in part covering similar ground but with purposes different from those of this study. Lambsdorff 1999 focuses on econometric results, with little discussion of measurement problems. Johnston and Kpundeh 2002 focus on the measurement problem in some detail, without any consideration of the causes and consequences of corruption.

addressing the question of whether there are institutional characteristics, the measurement of which provides a valuable indicator of corruption or the lack of it. The second discusses the pitfalls of trying to measure corruption. The last two sections survey attempts that have been made to measure corruption (Section II.C.) and institutional integrity (Section II.D.).

A. Corruption and Institutional Integrity: Two Sides of a Coin?

Donors such as the World Bank and USAID, in trying to assist developing and transition countries improve the capacity of government to develop their economies, have tried two partly distinct, partly overlapping, approaches: "anti-corruption" initiatives and building "institutional integrity" or "good governance." This distinction is based on a standard definitional usage: *corruption* is commonly defined as the abuse of public office for private gain, while *governance* may be defined as the formulation, promulgation and enforcement of rules, regulations, laws and other institutional procedures, in connection with such matters as how governments are chosen and replaced, how economic policies and public services are determined and carried out, and how civil and economic (e.g., property) rights are defined and upheld. Definitions of "governance" tend to be very broad—some would say too broad to be analytically useful.[4]

Corruption, strictly speaking, is a subset of the governance regime in a country, yet "corruption" is itself arguably too broad a term to serve as the basis of precise analysis. The many types of corruption—see Thomas and Meagher (2003) for examples—encompass a broad range of transactions, ranging from "high-level" favoritism, "cronyism," patronage, embezzlement, rent-seeking, *guanxi,* and "state capture," to "low-level" bribery and extortion. In all cases, these concepts refer to a set of political or economic circumstances in which an arm's-length relationship between government and business—a crucial component of Mancur Olson's "market-augmenting government"[5]— is violated, and/or in which there is "abuse of public office for private gain." But there are crucial differences among these different forms or near-relations of corruption in terms of substance of the transaction, identity of the actors, and economic and political contexts.

There are also semantic problems with the terms "institutional integrity" and "good governance." In part, such terms have become widely used by international agencies and bilateral donors because of possible diplomatic problems in applying the term "corruption" to a particular country. But while in some respects—as in the example given above—corruption and institutional integrity can be seen as two sides of the same coin, there are other respects in which this is not so. For one thing, "good governance"—the term most popular in the World Bank—and "institutional integrity"—a term much used in USAID—are not synonyms. "Good governance" has a broader meaning, encompassing such factors as macroeconomic policies, the regulatory regime, the rule of law, civil rights, and political stability, while "institutional integrity" is concerned more narrowly with the transparency and accountability of government processes. Important aspects of good governance are sometimes referred to as "the rule of law," a term that is itself occasionally used as a near-synonym of good governance. The concept of "good governance"—or just "governance," as it is usually called in the World Bank—is arguably so broad that, like "corruption," its meaningfulness as a tool of analysis is severely compromised. For example, "measurements" of governance by the

[4] I am grateful for Shang-Jin Wei's comments on this point.
[5] Olson 2000.

World Bank (see Section II.D) include variables related to representative democracy, yet there are important cases of countries with authoritarian governments but apparently good governance in a number of important respects over extended periods.[6]

The analytical distinction between the "corruption" and "governance" approaches has, to some extent, operational consequences. For example, if the problem is perceived as bribery of officials for doing what they are supposed to do (customs officials for passing goods through customs or government clerks for granting permits), the anti-corruption approach would emphasize raising penalties for wrongdoing, installing an anti-corruption agency or department to keep an eye on officials, setting up mechanisms for citizens' complaints, and creating an independent oversight agency with investigatory and perhaps also prosecutorial powers. The institutional integrity (or good governance) approach would involve such actions as civil service reform (linking hiring, promotion and pay strictly to qualifications and performance), establishing ethical codes and rules for each government office, and also, as in the previous approach, establishing anti-corruption units.

Thus, the two approaches are, operationally, both somewhat distinct (if complementary) and somewhat overlapping. Furthermore, where political institutions and cultural values are such as to encourage corrupt practices, distinctions between anti-corruption measures and building good governance may be immaterial, as both kinds of initiatives would be closely bound up with what would in effect be an effort to change existing political structures and/or cultural values.

Nevertheless, economists who want to explore the economic effects of corruption may choose to focus on the effects of institutions that are hypothesized to be associated with corruption, for the simple reason that institutional indicators are easier to measure than corruption itself. Efforts to carry out both types of measurements are summarized in the following sub-sections, and in Parts III and IV of this paper, where the literature on the causes and economic impact of corruption is summarized, attention is also given to econometric estimates based on institutional variables thought to be associated with corruption.

B. Why is Corruption So Difficult to Measure?

The problem of measuring corrupt transactions is loosely related to that of measuring criminal or informal activity more generally: how does one measure transactions that are being carried out essentially in secret? Formal, open economic activity is measured by a variety of means: income tax reporting (by both employers and employees, as well as financial institutions and corporations paying interest and dividends); corporate reports; industrial and agricultural data reported to the government and private trade associations; foreign trade transactions passing through customs; revenue and expenditures reported by governments at every level; and so on. From such data, we derive aggregate economic data on such variables as gross domestic product (GDP), foreign trade, employment, profits, household income, and investment. As corrupt transactions—such as bribes, payoffs, and gifts—are not reported, there is simply no way to compile data on them, in a way that is parallel to operations of the formal economy. Even informal economic activity, in the aggregate, can be estimated from certain types of hard data—e.g., by comparing changes in measured economic activity with parallel changes

[6] See Lanyi and Lee (1999, 2003) for a discussion of the implications of authoritarian government for economic governance.

in such variables as currency in circulation, electricity and gasoline usage, airplane passenger miles, and "errors and omissions" in international payments data. But since corrupt transactions, unlike informal economic activity, involve no creation of value added—but rather, transfer payments between individuals (or downright theft from the government)—it is far more difficult to find even indirect ways of measuring the total volume of such activity.

The succeeding sections specify, and give examples, of the measures that have been actually attempted by scholars and organizations. These measures fall into the following categories:

- *Surveys of perceptions* of "experts," business people, households and officials.
- *Surveys of the direct experience* of business people, households and officials.
- *Indirect "hard data" measures* of variables thought to be the result of or associated with corruption.

None of these measures is without serious difficulties. First of all, in any survey, one must deal both with systematic biases and with reluctance to answer honestly. Biases can be especially strong in surveys of perceptions: for example, perceptions of behavior close to the person being surveyed will be more accurate than those of phenomena with which the surveyed person is less familiar. Biases of perceptions can also be heavily influenced by the perceptions of others—e.g., published reports (which may or may not themselves be accurate). Biases can arise from other, extraneous factors: e.g., if you're in the political opposition, you will tend to assume that those in power are more corrupt than members of your own group.

Surveys based on interviewees' experience may run afoul of their fears of answering honestly, especially if they have themselves been directly involved in corrupt transactions: thus, while it is often believed that surveys are more accurate if focusing on experience rather than perceptions, absence of bias is probably impossible to achieve in either case. Moreover, whether surveying perceptions or experience, bias in surveys may be built in by those designing or implementing the survey; and if surveys are designed abroad and implemented locally, the survey administration may itself be carried out in a way that introduces further biases and errors (e.g., in translation of key concepts). None of these sources of biases and error has as yet been properly studied, nor ways of overcoming them yet successfully devised.[7]

A further problem—discussed in Thomas and Meagher—is that surveys of whatever variety tend to address certain kinds of corruption, like bribery of officials delivering government services, and not others, like high-level embezzlement or bribery in connection with government procurement or preferential policies.[8] Yet the latter kinds of corruption may involve both greater amounts of money and larger economic distortions. Moreover, international comparisons of corruption among countries suffer, because the surveys on which such comparisons are based do not take into account the variations among countries in the relative importance of different kinds of corruption.

[7] See Thomas and Meagher, pp. 16-17.

[8] Recently, as reported by Kaufmann 2003, the first such surveys of these types of corruption have been undertaken.

For all these difficulties, researchers using cross-country surveys for empirical investigation often point out that since results from different measurements tend to be highly correlated with each other, as well as with certain types of "hard" data, they do appear to be pointing to real tendencies. These surveys are considered by many to be inherently reliable, insofar as they reflect the perceptions of businessmen deciding where to place their foreign direct investments, who tend to be well-informed and who have the incentive of having to make decisions about their own funds, ensuring that they investigate carefully the situation in potential host countries.[9]

In principle, hard data—for instance, comparing procurement prices—would seem to be a more reliable basis for evidence of corruption, although obtaining such data often meets severe constraints.[10] Here, the problem is that what is being measured is not corruption itself but rather an indirect indicator of corruption. In effect, a hypothesis has been made linking the data being examined and corruption, and while the linkage may seem self-evident or common-sense, one must still be aware that it is itself a hypothesis that cannot be tested directly. Nevertheless, when the results of such a study—focusing, for instance, on possible corruption in hospital procurement—are compared with the results of a survey focusing on the same issue, and both results point to the existence of such corruption, the conviction that the corruption exists is certainly stronger than if the only "evidence" were purely anecdotal. Corruption is therefore one of those fields of study where it is highly desirable to gather different types of evidence, in the hope of achieving a reasonable degree of corroboration. This is one of the reasons why major programs of gathering data—like those of Transparency International and the World Bank—are based on collecting and comparing results from a large variety of sources.

C. Measures of Corruption

There have been a number of attempts to "measure" corruption—though "measure" needs to be in quotation marks, because what "measurement" in this context means is not entirely clear. Alternative meanings of "measuring corruption" could include measuring:

1. The *prevalence* of corruption in particular contexts: how often bribery (for example) is encountered in a particular economic activity or public sector function. One indirect measure under this heading might be the amount of time that enterprise management spends dealing with government officials (assuming that the prevalence of bribery is correlated with the amount of red tape.

2. The *level* of corruption—for instance, the proportion of an enterprise's or household's income that is spent on bribes or other corruption-related costs. This becomes more difficult to define when one is talking about high-level, state-capture types of corruption. (What is the size of payoffs to officials relative to government procurement costs?)

3. The *relative level or prevalence* of corruption in a country, compared to other countries: this involves a subjective ranking by those surveyed, without any effort to attach dollar-valued magnitudes to the corruption levels perceived.

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[9] These points are made by Mauro 1995, Tanzi (1998, 2002) and Wei (note to the author).

[10] Ibid., p. 16.

4. The *impact* of corruption is yet another method of quantification: for example, firms can estimate the costs they incurred because of corruption (in value of bribes, and time lost in transactions with those demanding bribes).

One difficulty in the second of these measures is that the larger the scope of the corruption measure, the more unreliable it is. People answering a survey can tell you how much of their income they spend on bribes, or what is the average bribe for a particular purpose; but they become quite inaccurate when trying to make a national estimate.

Because of the important role played by corruption in determining the quality of the business environment and the rate of return on investment, several of the aggregate corruption measures mentioned below have been created by business-oriented organizations. Some are easily available (e.g., on the Internet), others require a payment for access. Appendix I summarizes in tabular form the different sources; the list below gives some of the more important ones.

1. One of the longest-established business services is the International Country Risk Guide (ICRG) published annually by Political Risk Services (PRS): this set of data is based on the views of foreign businessmen and experts with knowledge of each country.
2. The Business Environment Risk Intelligence (BERI) service provides, for 50 countries, a Political Risk Index (political stability), an Operation Risk Index (bottlenecks for business), and an R factor (related to the ability of firms to repatriate profits).
3. A rival of ICRG and BERI is Business International (BI)—now run by the Economist Intelligence Unit—which publishes indices of "country risk factors" based essentially on a network of experts and analysts. BI calculates separate indices for a number of factors, including political change, social stability, the legal and judicial system, bureaucracy/red tape, and corruption.
4. The World Bank's World Business Environment Survey (WBES), conducted in some 80 countries, has a number of corruption-related questions and can be used to relate corruption factors to business sales and investment.
5. A newcomer to the field is the Opacity Index, constructed by the PricewaterhouseCoopers endowment for the Study of Transparency and Sustainability. The OI leans heavily on surveys, conducted in 35 countries, of highly placed business executives (typically chief financial officers), equity analysts, bankers, and PWC staff working in foreign countries. The OI is a composite index made up of separate scores for five factors: corrupt practices, legal and judicial opacity, economic policy, accounting/corporate governance, and regulatory practices.
6. Freedom House's *Nations in Transition* publishes "democratization" and "rule of law" scores for 27 former socialist countries in Eastern Europe and Central Asia. These indices include factors for both "governance" and "corruption."
7. The World Economic Forum publishes Competitiveness Reports for various regions, notably Africa, which includes corruption measures. The latter are based on the Executive Opinion Survey, which concentrates on the business community, and has yielded detailed data that the World Bank is now comparing to its governance indicators (described in a later section).

8. Perhaps the most famous aggregate measure is the Corruption Perceptions Index (CPI), published each year by Transparency International (TI), the most important international NGO dedicated to the fight against corruption. The CPI—available from TI's website—is constructed from data from 15 other sources, including most of the sources mentioned above (one not included is the ICRG).
9. The World Bank's aggregate governance indicators—described in the next section—include one that is devoted exclusively to corruption.

The aforementioned indicators, collected by organizations with substantial resources and wide-ranging networks, are convenient for businessmen and researchers alike. But they all tend to be rather general and, some would argue, subjective. To policymakers—e.g., officials of donor agencies—and researchers interested in greater detail about corruption prevailing in a particular organization or institution in a particular country, much more careful measurement is in order. Surveys—whose pitfalls have been enumerated earlier—are a favorite instrument. In some detailed studies, surveys are supplemented by in-depth interviews and focus-group discussions.

Another source of information comes from a careful examination of existing hard data for clues that might reveal the existence of corruption: this method includes what is sometimes called "forensic accounting." Such an examination of government or business books can, indeed, reveal mishandling of funds; more often than not, however, in countries where tax evasion is part of the local culture, businesses are in the habit of keeping two—or even three—sets of books, and there are many governments where accounts are badly kept or not at all.[11] Sometimes corruption can be indicated by comparison of prices paid by government for procured goods and services with prices prevailing in the market. DiTella and Savedoff (2001) found corruption in Latin American hospitals by comparing certain hard data—like procurement prices and the percentage of births that were by Caesarian section—with survey data from the same hospitals. In another study using "micro-data," La Porta, Lopez-de-Silanes and Zamarripa (2003) expose the causes of corruption in the banking sector by showing the overlap between the directorates of banks and their debtor firms. Thus, just as in criminal investigations, unearthing corruption requires a combination of persistence, ingenuity, and luck.

Reinikka and Svensson (2003) have recently provided an interesting review of the various ways of collecting quantitative micro-level data on corruption. Their review focuses on public expenditure tracking surveys, service provider surveys, and enterprise surveys, as well as on means by which corruption can be measured in individual schools, health clinics, and firms. The authors point out that such measures provide a better basis than do broader surveys for studying the mechanisms involved in corruption. An example of using data of this sort is provided by Svensson (2003), who combines an enterprise survey with financial data from firms surveyed to show that public officials, in extracting bribes from firms, act as price discriminators (across firms with different abilities to pay) and that the prices of public services are partly determined in order to extract bribes.

[11] Again, see Thomas and Meagher, p. 16.

D. Measures of Governance and Institutional Integrity

A number of the private surveys conducted include certain variables related to the quality of governance or institutional integrity. For example, the International Country Risk Guide (ICRG) includes, among its components of political risk, such factors as democratic accountability, bureaucratic quality, government stability, and law and order—although it might be pointed out that the last two of these factors are only ambiguously related to corruption.[12] The annual Index of Economic Freedom, prepared by the Heritage Foundation and The Wall Street Journal, includes corruption-related measures such as government intervention in the economy—which many economists believe is positively related to corruption—property rights (negatively related to corruption), regulation and the black market (both positively related to corruption); these estimates are prepared for 161 countries. Both these numbers are based on expert opinion and assessments of the research staffs of these two organizations.

The major work in bringing together a large amount of data on different aspects of governance has been performed by Daniel Kaufmann and his colleagues at the World Bank.[13] In this work, the World Bank economists gather together the largest number of ratings and scores available for each country, and aggregate them under six main Governance Indicators: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. (Examples of the country scores calculated by the Bank are given in Appendix II.) Of course, only the last of these six groups is directly related to corruption; and the country scores are really not strictly comparable, since the number of sources on which the score is based differs from country to country. (This is because of differences in country coverage among the various surveys on which the Bank's scores are based.) [14] The authors themselves point out that these data need to be interpreted with great caution, as standard deviations are large relative to the units in which governance is measured. This seems to be particularly true for the indicators for rule of law and corruption.[15]

Knack et al. (2002), in a report prepared for the World Bank and U.K. Department for International Development, argue that the type of governance indicators just described have several failings: they do not lead to clear targeting of reform measures, "are unspecific, and are intrinsically difficult to accept politically." [16] Knack et al. try to develop *second generation indicators*, which are replicable, available across many countries and over time, accurate, and specific to particular institutional arrangements. Such indicators can be categorized as "process measures"—e.g., budget processes, legislative oversight—and "performance measures," such as budgetary stability and quality of service delivery. Such

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[12] See Kaufmann, Kraay and Zoido-Lobatón (KKZ) 1999, p. 50.

[13] See especially KKZ (1999 and 2002), and Kaufmann and Kraay (2002a and 2002b).

[14] Recently, this corruption indicator was used to provide a cut-off point for countries eligible, and those ineligible, for financing under the Millenium Challenge Account. Unfortunately, those responsible for separating these sheep and goats used the median score as the cut-off point value—rather than a range of scores as the authors suggest—leading to results that, in this author's opinion, are questionable.

[15] See Kaufmann and Kraay, 2002a, pp. 13-15. Shang-Jin Wei, in a note to the author, points out that high correlation among the six measures raises doubts about whether these are separate measures of different dimensions of governance.

[16] Knack et al. 2002, p. 8.

indicators can at least in part be measured in strictly quantitative terms. Among the indicators regarded by the authors as most promising are the timeliness of audited financial statements, budgetary volatility, the ratio of average government wages to average wages in non-governmental sectors, international trade tax revenue, and "contract-intensive money."[17] A number of these measures, combined with the kinds of survey data already described, can be combined into "governance scorecards" for countries. This attempt to create sets of "hard" data relevant to governance, to supplement the "soft" data derived from surveys, is certainly laudable. From the viewpoint of measuring corruption, however, the connection between corrupt practices and governance measures may be quite unclear: poor scores on many of these indicators can be the result of weak organization and capacity of government, and just plain poor economic policies and management, rather than corruption *per se.*

II. Estimates of Causes of Corruption

There is a much larger literature on (a) quantitative measures of corruption (covered in the preceding sub-sections) and (b) estimates of the economic *impact* of corruption (covered in Section III) than on quantitative estimation of *causes* of corruption. This is so despite—as shown in the companion paper by Thomas and Meagher—the large amount of theorizing that has been carried out on this topic. While corruption is often thought to result from failures in political and governmental institutions, analysis along such lines is subject to the criticism that *both* "corruption" *and* lack of "institutional integrity" may stem from the same cause or set of causes. Another factor discussed by some authors is the influence of cultural and social values on corruption, although here the direction of causation, especially over the long term, is murky. There is no doubt, of course, that long-established "corrupt" practices are associated with a "culture of corruption" that has evolved over time—dictating, for example, which types and sizes of bribes and kickbacks are considered acceptable and expected, and which are considered overreaching.[18]

In contrast to institutional or cultural approaches, economists tend to embark upon their empirical investigations with the general presumption that corruption stems from *over-regulation of the economy*, which creates both opportunities and incentives to pay officials to reduce the delays and expenses involved for businesses. While this proposition has been cogently argued by a number of prominent economists,[19] it has not (to the knowledge of this author) been directly tested. Perhaps the proposition is too broad to test; or perhaps it is simply definitional, in the sense (for example) that if there is an import licensing system, there is the possibility of bribing officials who grant licenses, and if the system is eliminated, that option disappears.

This cause of corruption is often stated in even broader terms, namely, that corruption is positively related to the *extent of government intervention in the economy*—including not only regulation, but also taxation, subsidies, direct controls over foreign trade and investment,

[17] The last of these measures is, essentially, the ratio of bank deposits to total money supply. Knack et al. believe this is an excellent proxy for the rule of law in a country; the author disagrees with the use of this variable as a reliable governance indicator.

[18] On this topic, see, for example, Lipset and Lenz 2000. I am indebted to Shang-Jin Wei (note to author) for illuminating this point.

[19] For instance, Bhagwati 1982, Krueger 1974, and Tanzi 1998, 2002.

price controls, quotas, rationing systems, and, very importantly, state ownership of enterprises. Such intervention creates the possibilities of "rents"[20] that can be obtained by entrepreneurs, giving them command over scarce or artificially rationed resources or privileges—licenses, import permits, foreign exchange (where this is controlled and rationed), and so on. There is a whole literature on "rent-seeking," an activity that is often associated with corruption. It is easy to see, for each type of intervention, ways in which rent-seeking by private firms and individuals could result in bribery and other official abuses. In addition, as pointed out by Shleifer and Vishny, rent-seeking results in the redirection of scarce entrepreneurial resources from productive management to rent-seeking activities.[21]

While these general propositions have been discussed in theoretical terms, a number of hypotheses relating to more specific causes of corruption have been empirically tested. These include the following possible causal relationships.

1. Corruption may stem from *"industrial policies,"* which involve discretionary decisions by government officials with regard to subsidies, tariff concessions, zoning decisions, special credit facilities, grants, etc. The mechanism here is that official discretion leads to rent-seeking behavior by affected firms, possibly involving corrupt transactions. Ades and Di Tella (1997) find positive evidence from a sample of 32 countries that active industrial policy promotes corruption, whose impact detracts from the otherwise positive effect of industrial policies on investment. Gatti (2000) suggests that differential tariffs—a common manifestation of industrial policy—creates corruption by giving customs officials discretion to classify goods in higher- or lower-tariff categories.

2. Corruption has been argued to be related to *civil service pay*—and more broadly, whether the recruitment, pay and promotion decisions in the civil service are determined on meritocratic criteria. The mechanism involved here is not simple or unambiguous. Corruption is also affected, for example, by the levels of bribes and by the probability and penalties of detection: if bribes are low, and detection is likely and costly (e.g., the loss of one's job), wages need to be less high to deter corruption than if the opposite were the case. Meritocratic pay and promotion criteria also enhance the incentives to refrain from corrupt behavior. Van Rijckeghem and Weder (2001, 2002) have found cross-country evidence supporting the relationship between low pay and corruption. The evidence suggests, further, that wages must be raised higher if unaccompanied by policies to increase transparency and accountability in the civil service. The authors warn that cross-country correlations may reflect other factors than a causal link from government wages to corruption,[22] and the results do not support a conclusion that in the short run raising pay leads to lower corruption. The authors do point out, however, that there are case studies showing higher tax revenues resulting from pay reforms in tax administration.

[20] Economists formally define "rent"—not to be confused with payment to the owner of a house or apartment—as "that part of a person's or firm's income which is above the minimum amount necessary to keep that person or firm in its given occupation." (Henderson and Quandt 1958, p.101) In other words, it is the income resulting from the use of some scarce (or artificially rationed) resource or privilege that raises income above the level that would prevail under perfect competition.

[21] See Shleifer and Vishny 1998, Ch. 4.

[22] For example, "corrupt countries tend to have poor budgetary performance and face strong budgetary pressures, or may subscribe to the view that civil servants already earn sufficient income from corruption" (Van Ryckeghem and Weder, 2001, 2002).

3. A further strand in the literature suggests that *ethnic fragmentation* may encourage corruption, by leading local or national governments to engage in rent-creating policies that favor particular ethnic groups. Moreover, as Shleifer and Vishny (1998)[23] have argued, uncoordinated bribe-taking by rival bribe-takers may result in greater corruption than if bribery is centrally coordinated; and ethnic fragmentation will tend to lead to more uncoordinated corruption. Mauro (1995) shows a correlation between ethnic fragmentation and corruption. In greater detail, focusing on African countries (but comparing them to other regions), Easterly and Levine (1997) show that high ethnic diversity is correlated closely with weak economic policies and public goods delivery. While their data does not include an explicit corruption variable, the authors interpret some variables—like the black market premium for foreign exchange—as evidence that "interest group polarization leads to rent-seeking behavior."[24] However, Treisman (2000) finds no effect of ethnic division on corruption, when a number of other variables are included in the equation.

4. An intriguing but empirically (and theoretically) complex issue is whether there is a direction of *causation from income to corruption* (or "good governance"), as well as in the opposite direction (discussed in the next sub-section). Here, findings differ among scholars. Treisman (2000) finds a strong relationship of higher per capita incomes being associated with reduced corruption: "Rich countries are perceived to be less corrupt than poor ones." Kaufmann and Kraay (2002a), however, find evidence of negative feedback from rising per capita incomes to better governance outcomes. They explain this somewhat surprising result by arguing that higher incomes do not automatically lead to demands for better institutions, and may be accompanied, at least at first, by such phenomena as "crony capitalism," elite influence, regulatory capture, or "state capture"; these phenomena have been observed in varying degrees in East Asia, Latin America, and the transition economies of Central and Eastern Europe, even during upswings in output. The policy implication of this is that "no virtuous circle can be counted upon" and "interventions to improve governance are warranted."[25]

5. Whether *federalism* contributes to corruption or not is a matter of some debate in the literature. Treisman (2000) finds a strong positive relationship, suggested earlier by the theories of Shleifer and Vishny (1998, Ch. 5), on grounds that federalism will tend to create vertical competition for bribes among officials of different levels of government; another way of putting this is that a more centralized government tends to create more coordination (and therefore lower amounts) of corruption. Moreover, Bardhan and Mookherjee (2002) give reasons why decentralization might lead to capture of local governments by local elites, but adduce no empirical evidence on this point. Against this, Fisman and Gatti (1999) find a strong negative relationship between fiscal decentralization in government expenditure and corruption, but their results also show that decentralization in revenue generation may be necessary to ensure this result. Along parallel lines, De Mello and Barenstein (2002) find "a positive association between decentralization and governance," although closer examination of their results does bear out the fears of Shleifer and Vishny that graft and corruption may rise with decentralization; De Mello and Barenstein get stronger positive results when regressing decentralization against the positive World Bank governance indicators (rule of

[23] Shleifer and Vishny 1998, Ch. 5.
[24] Easterly and Levine 1997, p. 1241.
[25] Kaufmann and Kraay 2002a, p. 29.

law, voice and accountability, government effectiveness). What the authors—and all other thoughtful commentators—emphasize is that whether decentralization leads to better governance depends on the way it is carried out. Somewhat contradicting the Fisman-Gatti findings, De Mello and Barenstein find that governance improves with the share of non-tax revenues, grants, and transfers from higher levels of government in total subnational revenues, and that using tax mobilization rather than increased user charges as a means of financing public services may lead to worsening governance, as subnational governments, in danger of capture by local elites, may be subject to overly soft budget constraints. This is clearly an area where more empirical work is needed.

6. Another general approach to causes of corruption is to examine *the impact of particular institutions or sets of institutions*—but here, it is easier to show correlations than to tease out the direction of causality. In a study of transition economies, Broadman and Recanatini (2002) find the same broad economic and political causalities as do most global cross-country studies: i.e., that corruption tends to decline with economic development, strengthening of democratic processes, and (to some extent) greater openness of trade. They also find, however, that corruption is encouraged by high barriers to new business entry and soft budget constraints on incumbent firms.[26] In a broader study, Kaufmann (2003), utilizing global surveys and governance indicators of the World Bank, finds close correlations among the indicators for "rule of law," "voice and accountability," and "control of corruption."

7. Sociological factors have also been shown to contribute to corruption. For instance, Swamy, Knack, Lee and Azfar (2001) present data that suggest that corruption is less severe when there is greater participation of women in economic and political life.

8. Treisman (2000) has carried out one of the most comprehensive cross-country investigations of the factors—economic, political and sociological—determining corruption. This study is unusual in its almost total neglect of economic policy regimes (apart from trade openness) as a causative factor. Rather he finds—aside from the level of economic development and federalism, already discussed—the following explanatory variables:

- A period of British rule (with evidence that the distinctive feature here is the emphasis on procedural fairness in the administration of justice).
- The proportion of Protestants in the population—perhaps because of the historically greater independence of Protestant churches from the state, and Protestants' greater focus on an individual-centered rather than family-centered morality.
- A continuous democratic system in place since 1950.
- Openness in trade. (Other studies have found that while openness is partly a function of economic policy, it also depends on a number of other factors, such as economic size, stage of economic development, geographical location, and historical factors that overlap with some of those already mentioned).

[26] This conclusion is especially pertinent to the People's Republic of China, although the PRC was not included in the sample of countries covered in this study.

III. Estimates of the Economic Impact of Corruption (and Institutional Integrity)

The work in this area takes two tacks: first, estimating directly the impact of corruption and per capita income, or growth of income; and second, estimating the effect of corruption on various economic variables that have a proven or widely-assumed effect on growth. Section III.A looks at the first type of study; the following sections examine studies of effects on variables that contribute to growth.

A. Impact on Overall Growth and Development

The effect of corruption on economic growth and development was discussed for many years before it was actually tested. It seems odd—given the general consensus now that corruption undermines investment and growth—that some of the early work on this subject argued in the other direction: namely, that corruption may "grease the wheels of commerce" in the face of government's unwieldy and unhelpful involvement in the economy, thereby eliminating red tape that would otherwise impede production and commerce. These arguments were made in often-cited works by Leff (1964) and Huntington (1968).

Perhaps the two most important studies directly examining the linkage between growth and corruption are those of Paolo Mauro (1995) and Kaufmann and Kraay (2002a). Mauro uses the Business International (BI) indices (or country risk assessments), and finds that the separate BI indices are correlated with each other—for example, corruption is more widespread in countries with more "red tape." Taking an average of several key indices, Mauro finds a correlation between the BI average index and per capita output, as well as between the BI index and *growth* of per capita output. These results show an impact of quite substantial magnitude: for example, if Bangladesh's BI index were as favorable as Uruguay's, its investment rate (as a percentage of output) would be five percentage points higher, and its annual output growth over half a percentage point higher.

The later work of Kaufmann and Kraay (2002a) uses different explanatory variables, regressing per capita income on the main World Bank good governance categories—voice and accountability, political stability, governmental effectiveness, regulatory quality, and control of corruption. They get high and positive correlations between good governance and per capita income in all instances, taking into account a variety of other possible factors.

A different—and certainly more broad-brush approach—is taken by Tanzi and Davoodi (2001, 2002), in which they simply regress per capita output on the Transparency International Corruption Perception Index. The correlation is again high and significant.

Another strand of the literature regresses per capita income, or the rate of growth of income, against various categories of good governance. An early and well-known effort of this sort was that of Knack and Keefer (1995), in which investment and growth were found to be positively related to a set of ICRG and BERI indicators. The ICRG index Knack and Keefer use is constructed from five of their indices: Expropriation Risk, Rule of Law, Repudiation of Contracts, Corruption in Government, and Quality of Bureaucracy. They find close correlation among these indices, arguing that high levels of corruption are associated with lower credibility of government commitments. Thus, while their conclusions are couched in terms of "security of property rights," this concept is closely related to that of "corruption in government."

B. Impact on Fiscal Variables

A number of studies have found that corruption reduces revenues and distorts public expenditure in several growth-reducing ways.

Tax revenues. Tanzi and Davoodi (1997, 2002) show that corruption tends to reduce tax revenue, presumably because of corruption in the tax administration, including the customs (a rich source of corruption anecdotes). Lower tax revenues may be correlated with a lower rate of economic growth, but only to the degree that government spends its resources in an efficient and productive manner.

Composition and quality of public expenditures. Mauro (1997, 2002) finds that corruption (measured by the ICRG corruption index) reduces those expenditures that are relatively less "profitable" for corrupt officials—namely, expenditures on health and education, and those for operation and maintenance of existing infrastructure—and increases expenditures on those that tend to be associated with high-level and large-scale procurement corruption. In the same vein, Tanzi and Davoodi (2001, 2002) find that corruption (measured by the TI Corruption Perception Index) increases expenditure on new public investment, while Gupta, de Mello, and Sharan (2001, 2002) show that corruption is also positively correlated with military expenditures. In addition, Tanzi and Davoodi also find that corruption reduces the *productivity* of public investment, further dampening growth.

This conclusion is not surprising, considering that a higher proportion of corruption-related government expenditures—such as large-scale investments and military expenditure—seems likely to be associated with both greater leakage of government resources into private pockets and with procurement decisions taken on the basis of bribery and connections rather than proper bidding procedures. To the extent that such procurement represents investment in productive capacity, or a diversion of resources away from government expenditures that are growth-promoting (health, education, infrastructure), there is a clear negative impact of such corruption on overall economic growth and development.

The association between corruption (or governance quality) and *fiscal decentralization* was discussed above in connection with causes of corruption; in dealing with this relationship, the literature tends to treat decentralization as exogenous and corruption as endogenous. However, De Mello and Barenstein (2002) point out that corruption can also be regarded as undermining the effort to improve governance through devolution of expenditure authority to subnational government; Azfar et al. (2000) make this point more strongly, showing, in a detailed study of the Philippine and Ugandan cases, that corruption reduces the effectiveness of public service delivery by subnational governments (see III.D. below).

C. Impact on Trade, Business, and Investment

The view prevailing among economists is that corruption hurts trade and business. Nevertheless, at a time before there were systematic surveys of corruption and econometric estimates of its effect, anecdotal evidence suggested that corruption might have its uses. What Kaufmann and Wei (1999) have termed "the efficient grease argument" suggested that bribery was required to cut through red tape. However, what is true for the individual businessman—bribing in order (for example) to expedite an import shipment through customs—may not be true for the collectivity of businessmen, because in fact "bureaucratic harassment" may not be a given fact of life but "endogenous," i.e., arising from the culture of bribery itself. Using data from World Bank business surveys, Kaufmann and Wei find a positive relationship between bribe payments on the one hand, and bureaucratic burden and delay on the other. Thus, imposition of international laws and standards may reduce both bribes and the harassment faced by firms.

There are several aspects of corruption's effect on trade and business that have been examined. First, there are the effects of corruption on *general business activity*, focusing sometimes on the barriers to entry faced by smaller businesses. Second, there is the impact on *investment*, and especially *foreign direct investment*. The effect of corruption on FDI is of particular significance, because it reveals the presumably well-informed inter-country comparisons made by global business corporations. These comparisons are also a factor in the result that more corruption (or less transparency) is correlated with greater *financial instability*, both leading to financial crises and contributing to capital flight during such crises. Finally, there is evidence that corruption leads to *less open foreign trade regimes*, which other studies have found tend to impede long-run economic growth.

A major source for the *relationship between corruption and business activity* is the World Bank's World Business Environment Survey (WBES), which represents a large, systematic effort to pick out the various constraints identified by firms, by means of a survey of 10,090 enterprises in 80 countries. The survey focuses on constraints imposed by policy instability, taxes and regulations, inflation and price (including exchange rate) instability, finance, "governance" (including the legal system and corruption) and the quality of public services and the infrastructure. For four developing regions—South Asia, Africa, developing East Asia (including China), and the Middle East/North Africa—corruption is one of the three most important constraints. The survey includes detailed questions about bribe payments: for instance, almost two-thirds of respondents in South Asia and developing East Asia reported "irregular additional payments to officials." Econometric estimates show a negative relationship between the sales growth of enterprises and corruption, as well as between investment growth over the previous three years and corruption.[27]

Kaufmann (2003) reports on recent strengthening of the Executive Opinion Survey, carried out for the World Economic Forum. The Survey now includes questions on different *types of corruption with which businesses may have experience*. Comparing three types of bribery—for access to public utilities, public procurement contracts, and "capture" of laws and regulations—Kaufmann finds that while in some regions—South Asia and the former Soviet Union—the scores for all three types of bribery are high, in others there are sharp differences: for instance, in developing East Asia (including China), bribery is much higher for public procurement than for public utilities. Kaufmann argues that strengthening governance must not concentrate solely on the government, as if the private sector were a passive recipient of the business climate created by the government. Bringing together results from the World Bank Governance Indicators with those of the Executive Opinion Survey, Kaufmann shows that poor official governance tends to be correlated with poor corporate governance and state capture—where elite (sometimes foreign) firms and conglomerates illicitly shape laws, policies, and regulations to their own advantage. He argues for a broad-based attack on lack of transparency in both the public and private sector.

[27] See Batra, Kaufmann and Stone 2002 for a report on the most recent of these results.

A major impact of corruption on business activity appears to be the *effect on both domestic and foreign investment*. The "grabbing hand" of government officials effectively raises the cost of doing business and lowers the rate of return on investment. Mauro (1995), using the BI index as an independent variable, finds a substantial impact of an average of corruption and integrity variables on the investment rate, even taking into account a variety of possible other factors. Shang-Jin Wei (2000) has shown that corruption—measured by the usual expert surveys and the Transparency International composite of surveys—significantly reduced inward foreign direct investment (FDI) and "may tend to distort the composition of capital inflows away from FDI and toward foreign bank loans." This compositional effect makes the capital-receiving country more vulnerable to the kind of currency crisis that hit several East Asian countries in 1997.[28] In a separate estimation, Wei calculates that the FDI received by China is in line with the same factors calculated for other countries, and that "corruption is just as damaging to FDI into China as it is elsewhere."

In a different study, Wei uses the PricewaterhouseCoopers Opacity Index to estimate how much more FDI a country would have attracted if its opacity level were reduced to a low-opacity benchmark based on the average opacity scores of Singapore, the U.S., Chile, and the U.K. His conclusion is that the negative effects of opacity (i.e., the difference from the benchmark) are equal to those that would result from large increases in corporate tax rates (e.g., a rise in the Chinese tax rates of 42 percentage points).

Asking somewhat different questions, Hellman, Jones and Kaufmann (2002) find that corruption not only reduces FDI, it also attracts lower-quality investment in terms of the governance standards of the investing companies. In fact, where domestic governance is poor to start with, the FDI attracted tends to work toward magnifying governance problems—for instance, state capture and procurement kickbacks.

Another important effect, already alluded to, is the impact of corruption on *financial stability*. Kaufmann (2003) finds a broad correlation between countries' performance on the corruption index and the stability of their domestic banking systems. Wei (2000) and Gelos and Wei (2002) show that countries with poorer scores on surveys of corruption and transparency tend to attract a larger proportion of capital inflow in the form of easily reversible short-term lending (instead of foreign direct investment), and that capital flight tends to be heavier during crises from countries that have relatively poor transparency.

While Treisman (2002) finds that lack of *openness of trade* is a causative factor of corruption—and corruption in customs is a widely observed phenomenon[29]—Lee and Azfar have found evidence that runs in the other direction: namely, that tariff rates—in the context of a generally liberalizing trend in world trade—have tended to decrease less rapidly in more corrupt countries. This is a particularly interesting finding because the well-known phenomenon of corruption in connection with border trade has ambiguous effects on the volume of trade. Whether trade rises depends on the balance between a possibly positive effect on trade of corruption as "greasing the wheels of commerce"—which could even lower

[28] As Wei points out, this effect is compounded by the fact that the type of assistance extended by international financial institutions, in the event of a currency crisis, tends to bail out creditors of bank loans rather than those losing value on their foreign direct investment.

[29] See, for example, Klitgaard 1988, Ch. 5, and Lanyi, Guevara and Bell 2000.

the effective cost of imports to residents[30]—and a possibly negative effect of corruption, which could raise the effective costs of foreign trade (by adding bribes, such as "speed money," on top of official import taxes that must also be paid). Whether one or the other scenario prevails depends on the particular circumstances in each country.

The conclusion from this broad range of studies is that corruption is a phenomenon that includes both government-created impediments to business generally and business-induced creation of special privileges that tend to suppress competition and thus skew resource allocation. Attack on the latter type of corruption must be based on examination of the roles of both the public and private sectors.

D. Impact on Poverty, Public Goods and Income Distribution

Because of the negative impact on growth discussed above, corruption necessarily also worsens poverty. But in addition to this, there is a general consensus among economists that corruption tends to worsen income *inequality*. Among the reasons why this is supposed to be true are (1) tax evasion tends to favor the rich and well-connected; (2) social programs tend to get mistargeted, with funds siphoned off to benefit the middle and upper classes; (3) initial inequities in asset ownership are magnified by the wealthy class's ability to use their influence to obtain rents from the government; (4) corruption (as already noted) reduces education, health and other government expenditures that help improve incomes of the poor; and (5) wealthy urban elites use their influence to bias social expenditure toward higher education and tertiary health care. Direct evidence of the impact of corruption on income distribution is provided by Gupta, Davoodi, and Alonso-Terme (2002), who use a combination of BI and ICRG corruption indicators as well as the TI Corruption Perception Index. Their statistical work also confirms that income inequality can be ameliorated by reallocation of government resources toward social programs and health and education, provided that health and education expenditures are used efficiently and directed toward lower-income groups.

Gupta et al. do not formally explore the relationship between their corruption indicators and such variables as education expenditures and their distribution. The impact of corruption on the health and education sectors in most developing and transition economies is widely reported by donor agencies, if not always statistically documented. An IRIS Center study for the World Bank (Azfar, Kähkönen, and Meagher 2000) demonstrates econometrically that corruption can lead to poorer health and education outcomes resulting from reduced public sector services in those areas; this study also illustrates that decentralization of public service provision does not, in and of itself, either decrease or increase corruption, but rather can be made to work better or worse depending upon a number of factors, including local government capacity, access to resources, and corruption. World Bank public expenditure surveys show that often shockingly low percentages of funds appropriated for local-level expenditures on health and education actually reach their intended uses. DiTella and Savedoff (2001), in a series of studies, show how corruption undermines the efficacy of health care in Latin America.

[30] This would occur if bribing officials to allow undervaluation of imports (or unregistered importation) lowered the effective tax (including bribes) on imports.

There is a presumption among those writing on governance that a properly functioning democracy—with free media, independent NGOs, rule of law, and accountable elected officials—would avoid the extreme cases of corruption undermining government programs aimed at the welfare of the most vulnerable groups in the society. There is not, however, to my knowledge, any strictly quantified evidence in this regard.

IV. Conclusions

All the econometric results reviewed in this paper point in the direction that corruption is bad for economic growth, and also bad for a number of economic factors that tend to be correlated with growth: domestic investment, the quantity and composition of foreign direct investment, government expenditure on health and education, the quantity and quality of government investment in infrastructure, and generally the returns to business and trade. Similarly, governance institutions that are likely to be associated negatively with corruption—such as the transparency and fairness of the legal system, civil liberties, enforcement of contracts, security of property rights, a free and independent press, free and fair elections, a high-quality government bureaucracy, a low relatively low regulatory burden, and "the rule of law"—are associated positively with economic growth.

Yet it is obviously also true that "measurement" of governance institutions is still at a very early stage—as Knack et al. (2002) have pointed out. And it might be added that other factors contributing to (or affected by) corruption—such as cultural factors and social norms, which some quite legitimately regard as of great importance and possibly of policy relevance—are extremely difficult, if not impossible, to measure. Because economic variables are so much easier to measure, they may tend to play a disproportionate role in empirical work on this subject, and thus empirical results may tend to overstate the importance of economic factors as compared to cultural and political ones.

There is an important caveat attaching to all these econometric results, and that is that corruption "data" are often subject to quite a large range of statistical error. Moreover, data collected may relate to certain types of corruption and not to others; while the underlying reality may be that some types of corruption undermine economic growth more than others, and corruption may take different forms in different countries. It follows that corruption rankings among countries based on general perceptions of corruption may in fact be based on comparisons of apples and oranges. Furthermore, even if we knew more than we do about the relationships of different forms of corruption to growth, those relationships might depend on a country's stage of economic development: i.e., the effect of corruption on such variables as investment and economic growth may be different at different stages, and the prevalent forms of corruption may be different, too (see discussion below).

This brings up the complex topic of *corruption dynamics*. There is a clear dynamic implication inherent in the simple econometric exercises which suggest that corruption is a causative factor of lower levels of domestic and foreign investment, less productive government expenditures, and lower rates of economic growth; the implication of these results is that strenuous efforts to reduce corruption will be rewarded by more growth. This scenario would be even more benign were it the case—as found by Treisman (2000)—that higher income levels were found to lead to less corruption—for example, if growth in turn reduced corruption by increasing opportunities and incentives to participate in productive economic activity rather than private rent-seeking or public office.[31] But if Kaufmann and Kraay (2002) are right that higher incomes do not necessarily lead to lower corruption, then economic development may create new and larger possibilities for corruption, as new areas of investment (and therefore new rent-seeking opportunities) open up. In the absence of strong leadership in the anti-corruption and anti-monopoly fields, this impact of growth on corruption might be especially perverse. Nevertheless, economic growth over the long run influences political development—although in ways that differ among countries and are difficult to predict, and there is the real possibility—proven by historical examples[32]—of strong political leadership changing the administrative culture and social norms of a society. Such social and political evolution has so far been the province of the historian or political scientist, not the econometrician.

The dynamics of corruption emerges from this survey as largely *terra incognita.* Since the World Bank results—like most of the others—are based on cross-country data rather than time series for individual countries, they leave unanswered questions about what happens to a particular country as it traverses the various stages of economic development. For one thing—as Thomas and Meagher (2003) suggest—even the definitions of corruption may be in effect modified as economic and political structures and arrangements evolve. This will certainly be true, also, of *corruption perceptions*—including those of the experts and business executives who are surveyed for the key governance and corruption indicators cited earlier in this paper. But this means that country "scores" for various corruption and governance variables, aside from not being easily comparable across countries, may also be poorly comparable across years for the same country.

If all this is true, it makes all the more difficult tracing the *impact* of corruption on a country's economic development. In addition, while data on corruption is barely two decades old, the processes of economic development play out over long periods. One hopeful sign is the "Second Generation Indicators" being developed by Steven Knack and his collaborators at the World Bank (see above), which might make it possible to look backward over a meaningful period and trace the parallel movement of governance indicators and economic variables.

A final complication is that, as the evolutionary processes of economic and political development move forward, the effect of particular types of corruption on economic growth may change—in some cases, from good to bad. For instance, the East Asian cronyism cited earlier, which may play a useful coordinating role at earlier stages of economic development, may at later stages become an impediment to the transparency required for participation in global markets (Indonesia provides a dramatic example in this regard).[33] In view of these conceptual problems, combined with the data limitations earlier described, researchers may have to be content with a relatively descriptive, qualitative approach.

A well-known example of such descriptive work is provided by the case studies of Robert Klitgaard (1988), which examine episodes of anti-corruption initiatives in several Asian countries. These case studies illuminate the key role of government policies in the historical evolution of corruption in a country. For example, Hong Kong, up to the early 1970s, suffered—despite its economic success—from an extremely corrupt police force. The

[31] See Johnston 1997.
[32] See, for instance, examples of Hong Kong and Singapore described in Klitgaard 1988.
[33] See Lanyi and Lee (1999, 2003) for further analysis of this point.

subsequent clean-up of the police, to become a model of institutional integrity, was brought about by a concerted, high-profile, well-designed and rigorously enforced initiative by the Hong Kong government. The factors tested by econometricians (Section II.E) played no part in this success story. What this and other case studies demonstrate is that the stance of the political leadership, and their administrative capabilities, can be a major factor in the evolution of corruption and therefore of its impact on the national economy.[34]

[34] I am indebted to Shang-Jin Wei for pointing out the relevance of this point to this discussion.

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Appendices

Table 1. Selected Sources of Governance Data

Source and publication	Type of poll or survey	Country coverage	Content coverage
Business Environment Risk Intelligence (BERI): Business Risk Service	Poll of panels of worldwide experts, including diplomats and political scientists, plus data from international network.	50	Political risk index includes social conditions, restrictive govt. measures, fractionalization; operation risk index includes enforceability of contracts, various economic conditions, bureaucratic delays, policy continuity
Economist Intelligence Unit (EIU): Country Risk Service	Poll of global network of >500 information gatherers, checked by panel of regional experts	115	Country Risk Service: defines seven categories of country risk—political, economic policy, economic structure, liquidity, currency, sovereign debt, and banking sector. Political risk divided into "political stability" and "political effectiveness," latter includes corruption, transparency, and bureaucracy.

Table 1 (Cont.). Selected Sources of Governance Data

Source and publication	Type of poll or survey	Country coverage	Content coverage
Freedom House: Freedom in the World	Poll of team of academic advisors, in-house experts, published resources and local correspondents (including human rights activists, journalists, politicians.)	192	Freedom in the World assessment divided into Political Rights, Civil Liberties, and Freedom of the Press. Civil Liberties includes "freedom from extreme government indifference and corruption"
Freedom House: Nations in Transit	Poll of team of in-house experts and outside advisors (academics, journalists, etc.)	27	Nations in Transit "Democratization Rankings" are limited to former USSR republics, COMECON members, Yugoslav successor states, and Albania. A "democratization score" covers electoral processes, civil society, independent media, and governance, and a "rule of law" score covers human rights, judicial independence and reform, and corruption.
Gallup International: Gallup Millenium Survey	Survey of large number of citizens in countries covered	60	Surveys the degree of corruption perceived among: 1) politicians, 2) trade unionists, 3) public officials, 4)businessmen, 5) judges, 6) ordinary citizens, 7) clergy/priests, 8) journalists

Table 1 (Cont.). Selected Sources of Governance Data

Source and publication	Type of poll or survey	Country coverage	Content coverage
Heritage Foundation/ Wall Street Journal: Economic Freedom Index	Assessment draws on a large number of public and private sources	161	Large number of economic and governmental factors, including protection of property rights, enforcement of contracts, corruption in the judiciary, corruption within the bureaucracy, regulatory burden, black markets (in various sectors), and smuggling
Political Risk Services: International Country Risk Guide (ICRG)	Assessment based on poll of a worldwide network of experts and peer review at subject and regional levels	140	Political Risk components include government stability, internal conflict, corruption, military in politics, law and order, ethnic tensions, democratic accountability and bureaucratic quality, as well as some economic and external factors
PriceWater-houseCoopers: Opacity Index	Survey of international experts	35	Constructs indices for corrupt practices, effect of legal and judicial opacity (including shareholder rights), economic policy, accounting and corporate governance, and regulatory opacity

Table 1 (Cont.). Selected Sources of Governance Data

Source and publication	Type of poll or survey	Country coverage	Content coverage
Standard and Poor's DRI ; McGraw-Hill: Country Risk Review	Poll of country analysts, reviewed by regional review committees	111	Short-run and long-run risk events: based on policy risks (tax and non-tax factors); outcome risks (price and non-price); domestic political risks; external political risks; and economic risks
World Bank: World Business Environment Survey	Survey of local businessmen	81	Surveys the perception of firms on the constraints imposed upon them by government actions (or inactions), including taxation, bribery, regulation and infrastructure
World Economic Forum: Global Competitiveness Report	Executive Opinion Survey	75	Questions relate to various aspects of trade barriers, government bureaucracy, tax system, financial system, legal and judicial system, bribery, crime, and market competition

Table 2 (a). Illustrative Governance Data from the 2002 World Bank Indicators

	Voice and Accountability		Political Stability		Government Effectiveness	
	Est.	S.E	Est.	S.E	Est.	S.E.
Argentina	0.12	0.17	-0.74	0.19	-0.49	0.15
Australia	1.5	0.17	1.18	0.20	1.84	0.16
Austria	1.32	0.17	1.29	0.21	1.79	0.16
China	-1.38	0.17	0.22	0.20	0.18	0.15
Congo	-1.1	0.21	-1.64	0.31	-1.25	0.24
Denmark	1.72	0.17	1.26	0.20	1.99	0.16
France	1.29	0.17	0.73	0.20	1.67	0.16
Hungary	1.17	0.13	1.08	0.20	0.78	0.13
India	0.38	0.17	-0.84	0.20	-0.13	0.15
Indonesia	-0.49	0.17	-1.37	0.20	-0.56	0.15
Italy	1.11	0.17	0.81	0.21	0.91	0.16
Japan	0.99	0.17	1.2	0.20	1.07	0.16
Malaysia	-0.27	0.17	0.51	0.20	0.92	0.15
Mexico	0.33	0.17	0.22	0.19	0.15	0.15
Pakistan	-1.1	0.18	-1.26	0.22	-0.5	0.17
Singapore	0.51	0.18	1.28	0.21	2.26	0.16
South Africa	0.73	0.17	-0.09	0.20	0.52	0.15
United States	1.32	0.17	0.34	0.21	1.7	0.16
Venezuela	-0.41	0.17	-1.2	0.19	-1.14	0.15
Zimbabwe	-1.5	0.18	-1.62	0.23	-0.8	0.17

Table 2 (b). Illustrative Governance Data from the 2002 World Bank Indicators

	Regulatory Quality		Rule of Law		Control of Corruption	
	Est.	S.E.	Est.	S.E.	Est.	S.E.
Argentina	-0.84	0.17	-0.73	0.13	-0.77	0.14
Australia	1.64	0.18	1.85	0.13	1.91	0.15
Austria	1.67	0.18	1.91	0.13	1.85	0.16
China	-0.41	0.17	-0.22	0.13	-0.41	0.15
Congo	-1.0	0.23	-1.22	0.19	-0.94	0.21
Denmark	1.74	0.18	1.97	0.13	2.26	0.15
France	1.25	0.18	1.33	0.13	1.45	0.15
Hungary	1.21	0.16	0.9	0.12	0.6	0.13
India	-0.34	0.17	0.07	0.13	-0.25	0.15
Indonesia	-0.68	0.17	-0.8	0.13	-1.16	0.15
Italy	1.15	0.18	0.82	0.13	0.8	0.16
Japan	0.97	0.18	1.41	0.13	1.2	0.15
Malaysia	0.58	0.17	0.58	0.13	0.38	0.15
Mexico	0.49	0.17	-0.22	0.13	-0.19	0.14
Pakistan	-0.77	0.19	-0.7	0.14	-0.73	0.17
Singapore	1.89	0.18	1.75	0.13	2.3	0.16
South Africa	0.6	0.17	0.19	0.13	0.36	0.15
United States	1.51	0.18	1.7	0.13	1.77	0.16
Venezuela	-0.54	0.17	-1.04	0.13	-0.94	0.14
Zimbabwe	-1.61	0.18	-1.33	0.14	-1.17	0.16

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A CORRUPTION PRIMER: AN OVERVIEW OF CONCEPTS IN THE CORRUPTION LITERATURE

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A Corruption Primer: An Overview of Concepts in the Corruption Literature

Patrick Meagher and Melissa Thomas

Introduction

There has been a growing interest in the subject of corruption, as policymakers and academics have traced its impact on economic growth and the quality of governance. The purpose of this paper is to give the policymaker a brief, critical overview of some of the key ideas and debates regarding corruption, drawn from the several literatures of political science, political economy and economics. Section I considers the definition of corruption. Section II examines explanations of the causes of corruption. Section III considers some typologies of corruption. Section IV looks into the dynamics of corruption. Section V briefly discusses some of the challenges of measuring corruption[24] (and thereby determining its impact). Section VI presents conclusions.

I. What is Corruption?

The word "corruption" is a strange term for social scientists to use, in view of its normative implications. The Webster New World Dictionary defines "corruption" as, " the act of making, becoming, or being corrupt," while "corrupt" is defined as "1. orig., changed from a sound condition to an unsound one; spoiled; contaminated; rotten; 2. deteriorated from the normal or standard; specif., (a) morally unsound or debased; perverted; evil; depraved. (b) taking bribes; venal. . . ." (Webster (1970) 1980). A number of alternate definitions of corruption have been advanced, and researchers and policymakers should check their implicit assumptions whenever the term is used. According to Nye, "Corruption is behavior which deviates from the formal duties of a public role because of private-regarding (personal, close, private clique), pecuniary or status gains; or violates rules against the exercise of certain types of private-regarding influence" (Nye (1967) 1997, p. 966).

"Corruption" may not be an appropriate term to describe behaviors that are the norm in a given society and which may enjoy broad local legitimacy or even legality. While a small current in the literature objects to the culture-bound condemnation of corrupt acts, the continued use of the term and its definition do find some justification in the fact that today most governments condemn corruption publicly, and most corrupt acts are illegal. (For a review of legal provisions aimed at curbing corruption, see Ofosu-Amaah et al. 1999.) Few governments will openly claim the right to engage in corrupt practices as an expression of local culture (but see Box 1).

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[24] The following chapter, "Measuring the Economic Impact of Corruption: A Survey," addresses the literature on the economic impact of corruption in greater detail.

Box 1: In His Own Words

Defending his overseas bank account through which hundreds of millions of French francs had transited, President Omar Bongo of Gabon explained why he needed large sums of money–for redistribution. President Bongo explained that he paid from his own pocket for student expenses in Paris, for cars for professors, for demonstrations, for agricultural meetings, for women's day, for agricultural equipment. "A leader who does not have money to redistribute receives neither respect nor consideration." he said. He implied that he also paid for the secret service from his own money. In response to the journalist's question of why he had to pay such expenses in place of the state, President Bongo asked rhetorically, "Was the Palace of Versailles built with the money of France or of Louis XIV?" (Bongo 2001, 287-291; Louis XIV of France, the Sun King, was famous for his statement, "I am the state.")

The definition currently most widely used is "the use of public office for private gain" (see, e.g., Gray and Kaufmann 1998). While many people think first of bribe exchanges when they think of corruption, the definition of corruption as the "use of public office for private gain" encompasses a wide range of behaviors. Any form of government authority can be sold; any government property can be embezzled; any special access to information can be exploited. In addition to bribe solicitation and bribe taking, the definition includes embezzlement, self-dealing, insider trading, selective law enforcement, and the passage of special interest legislation, if done for "private gain." "Private" gain is for the gain of the official herself or any group of private persons with which she is affiliated, including family, friends, business associates, fellow political party members, or fellow members of an ethnic group. "Gain" need not be monetary. The definition of corruption encompasses a government official's submission to threats to keep herself from harm, or the staffing of government jobs with party activists as a reward for their work during the campaign, or attempts to bias an election process in order to remain in power. Corruption can encompass coercion and violent crime, as where police conduct executions for hire or prisoners are left in cells beyond their terms because they have not paid bribes (see Box 2).

The definition of corruption as "the use of public office for private gain" differs from Nye's definition, which hinges on violations of rules and formal duties. "The use of public office for private gain" does not depend on the legality of the act in question. Although most corrupt acts are criminal, others may be legal, or even specifically endorsed by law. For example, Ugandan law provides that incumbents can use all the resources of their public office in their own re-election efforts;[25] while many Europeans regard U.S. corporate contributions to political campaigns as a legal form of corruption.

As discussed in Section II, the definition of "corruption" as "the use of public office for private gain" implies the existence of a particular type of political system. Where this is lacking—as where, for example, neither citizens nor government actors believe that the role of government is to serve the public—the use of public office for *public* purposes will only be possible with a fundamental redefinition of the purpose and role of government.

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[25] See Republic of Uganda, *The Presidential Elections (Interim Provisions) Statute*, 1993, Art. 8; *The Parliamentary Elections (Interim Provisions) Act*, 1995, Art. 52.

Box 2. Examples of Corruption

- Politicians make policy decisions to ensure their own re-election, rather than policy decisions in the public interest. Government services, such as phones, transportation or franking privileges, are used by incumbents for campaign purposes.
- Police take bribes rather than write tickets.
- National government officials demand bribes from local government officials to release routine transfers.
- Central Bank and Treasury officials steal money from the Central Bank.
- Businesses that want public contracts must stop at the headquarters of the political party and "make a donation" before signing papers.
- Customs agents, judges, teachers, and policc must purchase their posts and pay substantial fees to remain in them.
- Government officials give contracts to themselves, their family members, their party members, or persons who pay large bribes.
- Police and soldiers rent their guns to bandits at night.
- Health care workers ignore dying patients unless the patients or their families pay bribes.
- Educators charge bribes to enroll children in school or to release transcripts or diplomas.
- Safety officials overlook dangerous conditions in return for bribes.
- Police torture and assassinate, as paid private agents.
- Judges render decisions based on the party that paid the most, or based on instructions from a high-ranked government or political party official.
- Directors of pension funds invest them in businesses in which they have an interest.
- Forestry concessions are given to military generals or other persons of political influence; violations of environmental regulations are overlooked.
- Customs officials accept bribes to classify goods at a lower tariff.
- Oil ministry officials buy shares in oil projects that they themselves regulate.

The definition "the use of public office for private gain" has been criticized because it focuses *exclusively* on the behavior of government officials. Some have objected that the definition should be broadened to include the actions of private actors in public/private transactions (such as giving bribes to public officials), or even actions that take place cntirely within the private sphere (such as embezzlement from a private company). Accordingly, they have broadened the definition to include "private corruption," stressing abuse of confidence. The definition of corruption used by Transparency International (TI), the leading non- governmental organization in global anticorruption efforts, is an example: corruption is "the misuse of entrusted power for private gain."[26] Similarly, the Asian Development Bank states: "Corruption involves behavior on the part of officials in the public and private sectors, in which they improperly and unlawfully enrich

[26] http://www.transparency.org/faqs/faq-corruption.html#faqcorr1.

themselves and/or those close to them, or induce others to do so, by misusing the position in which they are placed."[27] Following the more common practice, however, in this paper we focus on public corruption.

II. Causes of Corruption

Analyses of the causes of corruption can be loosely divided into two main approaches. The first focuses on structural causes, such as the structure and legitimacy of the political regime, history, culture, values, norms and loyalties. While these analyses contribute to a deeper understanding of the drivers of corruption, and help explain variation in extent and forms of corruption, they are often difficult to translate into policy solutions for the reduction of corruption. The second approach relies on individualist analyses rooted in New Institutional Economics (NIE), focusing on the incentives that drive individuals to choose corrupt acts. While the tighter focus of these analyses lends itself to the generation of policy solutions, there remains the question whether corruption problems can be treated without regard to the broader context in which they are situated.

A. Structural causes

Structural causes of corruption include: (1) what might be termed the "political prerequisites" for the definition of corruption to be applicable; (2) the pattern of dominant loyalties and obligations in the society; and (3) the degree to which government is constrained from within or without by other centers of power.

1. Missing Political Prerequisites

The definition of "corruption" as "the use of public office for private gain" implies a political system that many countries lack. In particular, the definition implies:

- The existence of a government. If there is no government, then there are no public offices.
- A population ruled by the government. If there is no agreed population, then there is no "public" for the government to serve.
- A separation between public and private spheres. If there is no such separation, then it is meaningless to insist that government offices are "public" offices to be used for "public" purposes.
- An established norm that "public" offices should be used for "public" purposes. If there is no such understanding, then the implicit assumptions of the corruption definition mask a fundamental disagreement about the purposes of government.

These factors are discussed in greater detail below.

(1) No government. Trivially, zones in anarchy lack public offices and the definition of corruption does not apply. For example, the extortion of protection fees by local warlord militias to be used for their private enjoyment, while deplorable, is more easily termed "banditry" than "corruption."

[27] http://www.adb.org/Documents/Policies/Anticorruption/anticorrupt300.asp?p=policies.

(2) No nation (no "public"). Where there is no sense of national identity, there is no "public" in whose interest "public power" should be wielded. A number of states, recognized as such by the international community, have a citizenry that is unaware that they share membership in an entity known as a nation; alternatively, the membership may be disputed. Countries emerging from a history of colonialism often struggle to build a sense of nationhood. The fragility of this sense of nationhood is seen in the resurgence of parochial interests, such as the renewed importance of clans in Kazakhstan. Where ordinary people do not feel any sense of "public" duty, or where they are honestly unable to identify the "public" to whom such a duty might be owed, it is not clear that a public exists for whose purposes an office might be used. Such citizens will not feel any compunction about demanding that friends and relatives in government perform services and favors that are at odds with a "public" duty that they do not recognize. Cultural values can further aggravate this problem. Some groups do not acknowledge duties of honesty to a stranger, while some in fact actively reward stealing from others for the benefit of the group. (See, e.g., CNN 2000) This can support corrupt behaviors where, for example, government officials steal from government for the benefit of their clan or village.

(3) No separation of public and private spheres. Alternatively, the government may exist and be effective, but there may be no recognized separation between public and private spheres. An extreme example is absolute monarchy. Where the monarch "owns" the territory, its inhabitants and their assets to dispose of as he wishes, there is no distinction between the government and the private person and purposes of the monarch. He cannot steal state assets because he cannot steal from himself. (See Rose-Ackerman 1996).

Absolute monarchies are an example of patrimonial regimes (Box 1). Max Weber (1964-1920), one of the founders of the field of sociology, defined "patrimonial" systems as a sub-type of traditional authority systems in which the leader has a purely personal administrative staff and a military force under his control, and in which the leader makes the claim of full personal powers (Weber 1964 (1947), p. 347). The administration is staffed "from persons who are already related to the chief by traditional ties of personal loyalty. . . . In traditionalistic organizations, it is very common for the most important posts to be filled with members of the ruling family or clan" (Weber 1964 (1947). p. 328). Patrimonial retainers can be supported by allowances from the stores of goods or money of the chief, usually allowances in kind; by right of use of land, or through "benefices," a right of extraction of property income, fees or taxes. "When an administrative staff, according to its fundamental principle of organization, is supported in this form, it will be said to be based on 'praebends'" (Weber 1964 (1947), p. 351). Although the leaders of such systems may not have the same broad authority as absolute monarchs, there is no distinction between their persons and the government.

Few modern governments are officially administered according to Weber's definition of the "patrimonial state." Colonialism has left behind formal laws and institutions that mirror those of the former colonizers; some countries, however, have never been organized around the legitimacy of these rules. Accordingly, although Weber was drawing on historic regimes to develop his taxonomy, his work has influenced many political scientists who felt that his description of patrimonial regimes describe some modern governments. Drawing on Weber's vocabulary, political scientists have described such governments as "patrimonial", "neopatrimonial" and "praebendial" or "prebendial" states (Joseph 1987). The leader's political authority is based on his ability to distribute government assets and authorities as private goods to his supporters (Scott 1972). In these systems, there is no clear distinction between public and private purposes and assets, and "corrupt" behavior is implied by the political structure of the state. (See Box 3).

Box 3. The Patrimonial Regime

The political scientist James Scott observed that in 17th century England the state was the reigning family and the offices of the state were the personal property of the monarch. No office holder

> ever conceived of himself as a servant of that abstract entity known as the state, much less a servant of the public. Some regarded themselves simply as personal servants of the monarch while others considered themselves the owners of valuable posts which they were free to use to their advantage. . . . Thus the traditional concept of office-holding prevailing in the seventeenth century led directly to practices we would now consider corrupt. . . . It was thus not thought unseemly for an official to sell off the subordinate offices in his department or give them to favorites, to speculate with the revenues he collected before passing them on, or to make a profit from the inside information he acquired. . . .

Much the same may be said for administrative behavior in less developed nations which, despite formal norms to the contrary, is influenced by more traditional norms of office holding.

– Scott 1972, pp. 38-39.

Alternatively, public and private sectors may be fused. The intermingling of enterprise, finance, and public sectors – as in many rapidly industrializing and transition countries – provides a convenient vehicle for high-level cronyism and organized corruption. These behaviors appear to have increased several East Asian economies' vulnerability to crisis in the late 1990s, and intensified their distress. At the root of their problems was "crony capitalism," fostered by the prevalence of conglomerate structures in major industries. These structures had narrow capital bases, designed to keep control within the family, but they were therefore vulnerable to external shocks. Indonesia provides some notable examples. In one scandal, the central bank and the bank restructuring authority were accused of funneling over $60 million through an insolvent bank and a front company to the former ruling party. The Bank Bali affair led to detention and criminal charges against the governor of Indonesia's central bank.[28]

[28] "Indonesia Jails Central Banker," *International Herald Tribune*, June 22, 2000, p 14. A comparative empirical study found increased government ownership of banks, generally, to be associated with a range of governance problems. These include: (i) lower overall quality of government (i.e., greater intervention in the economy, lower efficiency, less legal security, higher incidence of political and financial crises); (ii) more restricted political rights; (iii) worse bureaucratic performance and higher corruption (though the latter is affected by income levels);

Another form of mingling public and private spheres is designated in the literature as "*state capture*," whereby individuals, groups or enterprises seek to influence the formulation of laws, regulations and policies so as to secure special advantages. This concept refers not to lobbying per se, but to illicit provision of private gains to policymakers in exchange for informal, nontransparent and preferential channels of access to government policy making. This reflects the earlier notion of "regulatory capture," in which government agencies come under the influence of regulated industries and do their bidding. For example, a Russian oligarch who controls a network of mining, energy, and banking concerns could exert a powerful influence on the Kremlin or a regional government, extracting tailored policies and laws reflecting his private interests. (World Bank 2000.)

While the concept of state capture has some utility, it is not entirely adequate. It assumes a non-state captor infringing on the pre-existing autonomy of public and private sectors. This infringement is presented as partial, perhaps involving a sector, policy, agency, or branch of government—and due in part to unfamiliarity with standards of public/private interaction. In many countries, however, it would be more accurate to say that state institutions continue to operate as tools of a ruling elite or network that may also control most non-state economic, social, and political activity. In transition countries, members of the former party elite (*nomenklatura*) converted official position into wealth as the transition got underway, and have continued to interminge state office and commerce for private gain. Either business and the state "capture" each other, or the public-private distinction is so soft as to be meaningless. Mafias play a major role alongside state agencies in enforcing oligarchic rule—an arrangement that has been described as a "criminal syndicalist state" (CSIS 2000).

A variant of this has played out in Russia's regions. Severely constrained revenues and unfunded mandates encouraged aggressive revenue-seeking by regional governors. Many have translated their authority into major economic gain, whether through direct ownership and control of regional monopolies or via the sale of private bills[29] to oligarchs (Polishchuk 2002). China provides a contrast, in that adequate revenue instruments and more effective vertical checks appear to have preserved local markets from Russian-style official monopoly and predation (Qian and Weingast 1997)—though not from corruption (Pei 2002). Here again, we have a situation of mutual capture, or better, oligarchic interests operating through linked regional governments and companies.

(4) No norm of use of public office for public benefit. The definition of corruption as "the use of public office for private gain" implies a norm that public office should not be used for private gain (but rather, presumably, for public purposes). When public and private sectors are effectively fused or do not exist, it may not be meaningful to speak of public office used for private gain. This is even more the case if such fusion reflects a

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(iv) slower productivity growth and financial development (subsequent to state intervention in banking); (v) misallocation of resources (lower proportion of credit allocated to firms outside the top 20 and higher interest rate spreads); and (vi) lower overall economic growth (La Porta et al 2000).

[29] A private bill is a law that is not universally applicable, but grants powers or benefits to a particular person, corporation or association.

common accord that the purposes of government are something other than to serve the public.

Most countries have legal codes that criminalize corrupt actions (although there are notable exceptions). But such laws may not accord with popular beliefs of right and wrong. Tyler studied why people comply with law, and found that although the threat of sanction plays some role, legal compliance is primarily explained by a sense that the laws themselves are fair, fairly applied, and promulgated by legitimate authority (Tyler 1990). Accordingly, while the law may prohibit corrupt acts, where legitimacy and fairness are lacking, the law may be little regarded, including by government actors. Moreover, the government may lack the capacity to implement and enforce law. Without social norms that prohibit governmental self-dealing, there is no reason to expect that government offices will be used for public purposes.

In some cases, norms describing appropriate government behavior may be lacking altogether. Norms regarding conflict of interest and insider trading, for example, developed in Western countries only in the 20th century and are as yet undeveloped in many countries. Alternately, weak norms may be trumped by more strongly held norms and loyalties. Examples of specific cultural norms that may trump the obligation to use public office only for public benefit include norms that tie social status to wealth, or tie leadership to conspicuous consumption and wealth redistribution. This can foster what is sometimes called "big man politics." (See Boxes 1 and 5). Another example is that of traditional gift-giving practices (Mauss 1954). The suggestion is that the concept of "corruption" is a *post hoc* condemnation of traditionally acceptable gift-giving practices, or that the existence of such traditional practices makes it hard for people to distinguish between appropriate and inappropriate behavior. (See Box 4.)

Any shock that threatens one of the political prerequisites for corruption is likely to have implications for the use of public office for public purposes. For example, a coup disturbs settled expectations of how government office should be used and may give rise to corrupt behavior. A civil war that leaves the population divided without a sense of nationhood or a sense of mutual duty may call into question the existence of a "public" for whom government office should be used. Rapid social change that requires the government to act in domains where there are as yet no settled expectations can also present an opportunity for increased corruption.

Box 4. Gift Giving and Bribes

In Thailand gift giving is highly valued, and people believe that if an official provides good service, they should show their appreciation with a gift. These gifts are part of the patron-client relationship between ruler and ruled. In a recent study, people differentiated between gifts and bribes in terms of value. Small gifts were tokens of appreciation; large ones were illicit bribes. . . But value is relative. A businessman may view an automobile as a gift. A person observing the transfer may view it as a bribe. If the "normal" commission is 10 percent, anyone asking for 20 percent will be viewed as corrupt.

-- Rose-Ackerman 1999, pp. 91-92 f. 2.

It makes little sense to complain about corruption in countries that lack even the pretense of government for the people. In other countries, although the constitution and laws may provide for government for the people, in practice, these objectives as well as any limits on government power are ignored. Examples include Kazakhstan and Cameroon which, though nominally republican democracies, operate as authoritarian dictatorships. Such countries are often classed as "systemically corrupt." when a better characterization would be that they lack a commitment to government in the public interest notwithstanding their formal rules. The difference is more than semantic. It is a recognition that where the political prerequisites are lacking, supporting the use of public office for public purposes will require a fundamental redefinition of the role of the government, rather than marginal technocratic fixes to current institutions.

Box 5. Corruption in Papua New Guinea

The 'wantok system,' a good thing in many situations, is an abuse when officials appoint friends and relatives to high paying positions for which they are not qualified. This is a form of corruption that encourages incompetence and is detrimental to the common good. Many corrupt practices of leaders arise because of pressure from wantoks who have unrealistic and even illegal expectations of their "Bigmen." We all share blame for corrupt behavior if our own demands force our leaders to behave this way.

-- from Catholic Bishop's Conference of Papua New Guinea and Solomon Islands. "Statement On Corruption in PNG." Annual General Meeting, Goroka (April 27, 2001).

One reason why the focus more often rests on the degree of corruption than on the nature of the political system is that development agencies are the principal participants in research and dialogue on corruption. The World Bank, for example, has played a leading role in research on corruption. However, its charter forbids it to consider political factors in lending. While bilateral aid agencies are permitted to address political factors, they may stop short of demanding a change of political regime. As a consequence, proposed policy solutions may focus unduly on shallow technocratic reforms that are unlikely to accomplish their objectives within the given political context.

2. *Competing Loyalties*

Where the actions of government actors are not regulated by law, and where norms prohibiting governmental self-dealing are weak or non-existent, government actors tend to privilege other loyalties. Several lines of literature focus on various social relationships that command loyalty. These relationships play a role in corruption to the extent that government actors find the obligations associated with these relationships more compelling than the obligations of formal laws regulating corrupt acts. These relationships flow from individuals' memberships in families (or other kinship groups), school groups/classes, religious organizations or secret societies, gangs or criminal organizations, villages or regions. (See, e.g., Cartier-Bresson 1997; Clapham 1982; Eisenstadt and Lemarchand 1981; Joseph 1987; Lemarchand 1988; Olivier de Sardan 1996; Schmidt et al. 1977.) Ties to societies such as the Masons and the Rosicrucians are thought to have facilitated Franco-African corruption (see, e.g., Fitchett and Ignatius 2002). In ethno-linguistically fragmented Papua New Guinea, duty to "wantoks"—literally, "one talk," or those who speak a common language—is considered to be a key factor in prevailing high levels of corruption (see Box 5). Because strong bonds are often built in the military, military ties can also facilitate corruption where such ties take precedence over duty to law. In Uganda, according to some observers, one cause of corruption is President Museveni's loyalty to the "historicals," the fellow fighters who were with him in his guerilla days and who expect financial reward. One paper argues that elite networks, facilitated by the stability of the elites, contributes to Chinese corruption (Yao 2002).

One important strand of the literature on other loyalties focuses on patron/client relationships. In patron/client relationships, people offer their personal loyalty to a more powerful patron in return for protection and opportunities for advancement. In the absence of strong impersonal institutions, such alliances may be the only way for people to protect themselves and their property. Patronage relationships are implicated in corruption insofar as the exchange of favors or services relates to public powers or assets, as where a powerful government actor uses his influence to place his client in a government job. Where these relationships are an important part of the way in which power is organized, political scientists write alternately of patronage or clientelist politics or states. (See Eisenstadt and Lemarchand 1981.) Such relationships are essential elements of neopatrimonial regimes.

3. *The Unchecked Government*

Other structural explanations focus on the absence of constraints on government arising from competing social groups or organizations (such as the business sector, political parties or labor movements), from financial needs, or from checking institutions within the structure of government itself. Where checks on government are weak, government actors are not prohibited from engaging in corrupt activities. The absence of competitors means that the government is "virtually uncontrolled, responsible only to itself, and thus free to pursue a policy of self-aggrandizement" (Scott 1972 14-15).

Where the private sector is comparatively small and weak, government jobs present an unparalleled opportunity for prestige and financial gain. The government attracts wealth-seeking candidates who, in other countries, would find their ambitions better satisfied in the private sector. Bayart, studying hungry Sub-Saharan Africa, wrote of "the politics of the belly," calling attention to the fact that corruption is described by eating metaphors across the continent (Bayart 1993). Ugandans speak of making someone "vomit up what he is eaten," Nigerians argue about division of the "national cake," and Cameroonians call a government job a "meal ticket."

The balance between state and society could tilt in either direction, with imbalances fostering corruption. Johnston (1997) places corruption in a comparative framework in order to shed light on its political impacts: for example, whether it supports political stability, whether it galvanizes movements for reform, or whether it leads to violence and collapse. In an effort to explain these disparate effects, he suggests the concept of "sustainable democracy." This concept looks beyond the existence of liberal political and economic institutions to the "existence of multiple and broadly balanced political forces" (discussed more fully in the following section). Two balances are involved here:

- between the *accessibility* and *autonomy* of political elites: i.e., although private interests can influence policy, officials can formulate and carry out policies authoritatively;

and

- between *wealth* and *power*: i.e., political and economic paths of advancement are sufficiently numerous and available that trading wealth for office (or vice-versa) is not a serious temptation.

When these factors are in balance, corruption remains under control and does not destabilize politics—but serious imbalances foster corruption. Particular combinations of imbalances give rise to characteristic systems and problems of corruption.

Another potential check on corruption is the government's budget constraint, which affects the relative power of government with respect to its citizens. Governments that depend on citizens for their income must bargain with their citizens, while governments funded from other sources have wider latitude to ignore citizen demands. Knack found that "aid dependence can undermine institutional quality by weakening accountability, encouraging rent seeking and corruption, fomenting conflict over control of aid funds, siphoning off scarce talent from the bureaucracy, and alleviating pressures to reform inefficient policies and institutions" (Knack 2000). Moore et al. found that "governments that are dependent on their own citizens for critical resources appear more effective at converting material resources into human development" (Moore et al. 1999). Because this factor affects government accountability, it may also affect levels of corruption.

Checks and balances may also be provided by the formal institutions of government. This literature emphasizes the importance of clean elections, an independent judiciary, effective audit systems, and good record keeping, all complemented by a free press. This literature often declares that "corruption is a symptom of institutional dysfunction"; the suggested policy solutions tend to be laundry lists of technocratic fixes to formal government institutions.[30] Informal institutions receive little attention in this literature,

[30] This phrase is often repeated at the World Bank. See: http://www.worldbank.org/html/extdr/gc/governance/governance.htm;

and the underlying reasons for the weakness of internal checks and balances are not explored.

4. Summary

The causes of corruption include societal or structural causes such as the structure of political power and cultural values, norms and expectations. At the limit, the concept of corruption may not be a useful one in countries where the government does not rule in the public interest. The strength of the work on structural causes is that its depth contributes to our understanding of why corruption in Russia may not have the same causes or take the same forms as corruption in Gabon or in the United States. However, much of this work does not focus on corruption *per se*; rather, behavior that could be characterized as corrupt is a feature of the political system under discussion, or a reflection of a norm that is being analyzed. Accordingly, this work does not have much to say about either the dynamics of corruption or policy interventions that might be used to reduce or control corrupt practices. Moreover, factors such as history, legitimacy, loyalty, culture and norms are hard to operationalize, which makes it difficult to test hypotheses about them or to design policy interventions that would affect them. To the extent that the causes of corruption are society-wide, changing corruption levels means changing an entire society, a daunting project. To date, therefore, the policy relevance of the structural literature has been limited.

B. Individualist Causes

While political scientists, sociologists and anthropologists focus on issues of legitimacy, identity, culture, history and values, economists and political economists (as well as some political scientists) have applied New Institutional Economics (NIE) to approach the study of corruption differently. Their unit of analysis is the individual, who has rational preferences[31] and expectations, and who makes choices so as to maximize his own utility. NIE scholars analyze the incentives of individuals who choose corrupt actions, and their policy solutions focus on changing those incentives. Because the prospect of attempting to change society-wide structural factors is daunting, and because most of the policy work on corruption is written by and for aid donors who have two- to five-year project cycles, most policy recommendations relating to corruption have been drawn from this more narrowly focused literature.

An example of an individualist analysis is Klitgaard's oft-repeated formula explaining corruption: Corruption = Monopoly + Discretion – Accountability (Klitgaard 1988). When a government actor has a monopoly of some good, service or authority, with discretion about how it is to be allocated, and no accountability for how the agent allocates it, the agent is liable to allocate it in such a way as to ensure his own gain. The policy recommendations that flow from such an analysis are evident: provide competition in service delivery to break up monopolies of authority; reduce the discretion of the actor; and increase accountability for the actor's actions.

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http://www.worldbank.org/html/extdr/spring99/corruption-pb.htm;
http://www.worldbank.org/publicsector/overview.htm.

[31] The term "rational" is a term of art, meaning that preferences are complete, reflexive and transitive.

More broadly, NIE scholars have looked to the incentives of government actors to engage in corrupt acts, focusing on (1) opportunity (discretionary authority), (2) temptation (salaries), (3) monitoring and supervision, and (4) sanctions (such as job loss or reputational damage).

1. Opportunity

The Klitgaard formula defines discretion as a contributor to corruption. Because all power is discretionary by definition, some reduce the formula to an assertion that corruption is a function of public power, and that it can be eliminated by eliminating public power, as where a corrupt public bureaucracy is privatized and becomes a corrupt private bureaucracy. There has similarly been an attempt to determine who holds public power by consulting the law, and to limit power by revising the law. This effort is not likely to be successful in countries with weak rule of law. However, where a simple transaction is rendered costly because of the number of officials who can demand bribes — it is not unheard of for government claims processing to involve 80 different steps, forms, and officials — reformers have often advocated streamlining bureaucratic processes and creating "one-stop shops" for functions such as business regulation and licensing.

Rose-Ackerman has suggested that competitive service provision might be an answer. If service providers competed, they would bid down the equilibrium level of corruption (Rose-Ackerman 1978). Monopoly, as noted above, figures as one of the chief determinants of corruption in Klitgaard's formula (Klitgaard 1988). A number of scholars have explored the impact of competition on corruption (see, e.g., Shleifer and Vishney 1993). Finally, a literature focuses on the effect on corruption of specific government policies such as rationing, price controls, privatization and exchange rate setting.

2. Temptation

In considering incentives for corrupt acts, a number of scholars and practitioners have argued for the need to raise civil service salaries. Certainly, civil servants in developing countries often flag low pay levels as one of the principal causes of corruption. A number of arguments have been advanced that better-paid officials will have less incentive to participate in corrupt acts:

In a number of poor countries, a significant percentage of full-time civil servants are below the poverty line. Because they are not paid a "living wage" that enables them to meet basic needs such as rent, food, medical care and children's school fees, they are obligated to supplement their incomes through side businesses or through the creative use of their offices. If their urgent needs were met, they would be able to work honestly.

- The temptation to engage in corrupt acts is reduced when civil servants are better paid, implicitly because of the diminishing marginal utility of consumption.
- Based on efficiency wage theory from economics, another argument holds that if a civil servant is paid more than his next-best opportunity, he will not want to lose his job and will work honestly. (See Box 6.)

- Another argument states that civil servants are more likely to be corrupt if they or others perceive their wages as unfair.
- Yet another argument holds that higher wages will attract better quality (more honest) civil servants.
- Another argument, often raised by civil servants in developing countries, is that wages are insufficient to allow civil servants to meet social expectations and to support their social status. If wages were raised, they would not need to meet these needs by corrupt means.

These discussions have been accompanied by a debate on whether civil service salaries are currently too high or too low compared to private sector wages, a discussion complicated by the very poor quality of data in developing countries. Paradoxically, while civil service wages may be too low to allow urban civil servants to house and feed themselves and their families, much less to meet the aspirations of an educated urban elite, civil service wages are often dramatically higher than those of the average citizen. While a living wage may be necessary to reduce corruption, the prevalence of corruption among higher-paid government actors shows that this is not sufficient. (See Box 6.)

3. Monitoring and supervision

Much microeconomic work on corruption uses a principal-agent model as the basis of analysis. The principal/agent (or "P/A") model was developed in the context of the theory of the firm. There, the principal is the business owner and the agent is her employee. The principal would like to ensure that the agent is productive, but cannot monitor her perfectly or costlessly. P/A problems revolve around the principal's decision about how much to spend on monitoring, and how to structure the agent's incentives so as to encourage her to work.

Some NIE scholars have applied P/A models to the problem of corruption, treating the government actor's hierarchical superior as the principal confronted with the problem of preventing the agent from engaging in corrupt acts. (See, e.g., Becker and Stigler 1974; Banfield 1975; Rose-Ackerman 1975, 1978; and Klitgaard 1988, 1991.) Klitgaard suggests that the principal has several possible avenues of recourse: select agents less susceptible to corruption, change the rewards and penalties for the agent's acts, or change the structure of the relationship by, for example, changing a rule so that the agent does not have discretionary powers (Klitgaard 1988).

It is important to note that the P/A model rests on two assumptions: that the principal is interested in using his power to halt the agent's corruption; and that the principal has control over the agent's incentives. Although some P/A models cast the government actor's hierarchical superior as the principal, the assumptions of the model are unlikely to be met in systemically corrupt governments. The superior may be driving corrupt activities as reflected in the saying that "the fish rots from the head." Moreover, it is by no means clear that the agent's hierarchical superior can control his or her incentives. The subordinate may have a powerful patron, or be well-protected by civil service regulations. Alternately, it may be the case that the agent's gains from corruption are so attractive or the social pressures on the agent are so great that they eclipse any threat of sanction that the superior could hope to muster. Similar problems attend models that cast the electorate as the principal.

4. Sanction

Scholars have explored the optimal punishments to discourage corruption (Polinksy and Shavell 2001), as well as the reputational consequences of corruption (Andrianova 2001).

The NIE work is attractive insofar as an incentive-based analysis leads easily to policy recommendations. However, the incentive focus of NIE overlooks other explanatory factors for behavior that may be critical. Tyler, for example, finds that most people comply with law not because they fear punishment, but because they believe that the laws or the institutions that generate them are fair and legitimate (Tyler 1990). Moreover, although the NIE focus on the individual makes the problem of corruption seem more tractable, the impression may be deceptive. "Fighting corruption is like squeezing a balloon full of gas," complained one donor, "it just pops out somewhere else." While acknowledging some of the structural arguments about the causes of corruption, Klitgaard rejects the notion that it is necessary to change the structure or values of a society in order to reduce corruption. But a number of the vignettes that purport to show successful anticorruption efforts end in defeat. Advances are made by an individual reformer, who is then fired, transferred or resigns; the reforms are not sustained (Klitgaard 1988).

Box 6. Applying Efficiency Wage Theory to Corruption

The "shirking" models of efficiency wage theory argue that paying employees more will make them perform better. By raising salaries, employers raise the cost to the employee of losing the job; anxious to keep the job, employees will work harder. (See, e.g., Shapiro and Stiglitz 1984.) Some scholars have argued that, similarly, raising wages will reduce corruption. *But the efficiency wage theory is premised on the idea that shirking employees will lose their jobs.* In systemically corrupt governments, however, officials do not risk job loss for corrupt acts. Indeed, they may risk their jobs by refusing to participate in ongoing corrupt schemes (see Van Rijckeghem and Weder 1997). Besley and McLaren also point out that the success of an efficiency wage scheme depends on a number of preconditions, and that in most cases, simple monitoring may be preferable (Besley and McLaren 1993).

One problem is that the NIE work is usually a partial analysis, focusing on some key aspects of the problem while ignoring others. This means that assumptions about the incentive environment are often unrealistic. Much NIE work focuses exclusively on formal institutions as represented through laws and organizational charts, assuming that laws describe behavior. But where Rule of Law is weak, corruption systemic, and social causes of corruption are powerful, formal institutions do not operate as described on paper and the incentives that they provide may be dwarfed by those provided by social or informal institutions. An example of how these kinds of assumptions can lead to benighted policy recommendations is the periodic attempt to apply efficiency wage theory to reduce corruption. (See Box 6.)

5. *Summary*

In sum, the literature on the causes of corruption is divided between those who look at systemic factors—history, culture, values, legitimacy, the distribution of power between government and private organizations —and those who focus on the individual's decision to engage in a corrupt activity. The "big picture" analyses are problematic in that they do not lend themselves easily to policy recommendations. Instead, they imply that the entire society must be changed for corruption to be reduced. Moreover, they are often difficult to test rigorously. The "individualist" analyses lend themselves more easily to policy recommendations, but are often unnecessarily shallow and based on unrealistic assumptions about individual incentives, raising the question of the extent to which corruption can be treated discretely without regard to its social and institutional context. Accordingly, current NIE analyses may be most useful in understanding corruption in those countries where corruption is an individual act and the rule of law is strong, rather than where corruption is an organized, systemic, or society-wide pattern of behavior. While many of their hypotheses are more easily operationalized for statistical testing, such testing is compromised by the quality of available data on governance and corruption, as will be discussed in the next section.

What both approaches imply is that the causes of corruption vary from one country to another, and even from one institution to another. Moreover, causality is complex, with the same factors appearing both as causes and consequences of corruption. For example, a government may lose its remaining legitimacy because of its corruption; as its legitimacy diminishes, fewer and fewer people feel bound by the government's laws, and corruption increases. Corruption and lack of legitimacy are both cause and consequence.

III. Typologies of Corruption

Because the catch-all term "corruption" includes many different behaviors, with different causes and impacts, scholars have attempted to draw distinctions between different "types" of corruption or even to create complete typologies. No effort is made here to present idiosyncratic typologies. Some common distinctions drawn in the literature are as follows.

A. "Systemic" versus "individual" or "opportunistic" corruption

Scholars differentiate among those governments in which corruption is systemic, and those in which corruption is aberrant and individualized. In governments with systemic corruption, corruption is organized, and the formal institutions charged with ensuring the legality of government actions—such as the police, the judiciary, the legislature, and the electoral system—are themselves compromised.

In countries with individualized or opportunistic corruption, the formal institutions are sufficiently free of corruption to be able to play their constraining roles. Corruption is not generally organized, but instead is an individual deviant act. An intermediate case may be where the formal institutions are partially compromised, as, for example, the Rampart Division in the Los Angeles Police Department,[32] or the Cook County court system, which was the subject of two major FBI operations (Lockwood 1989). As the

[32] http://www.pbs.org/wgbh/pages/frontline/shows/lapd/scandal/cron.html.

number of people and agencies in a scheme of corruption grows, not only is more money needed for sharing, but a greater investment is required for secrecy and coordination (see Box 7). Elaborate group arrangements of this kind are variously termed collective, institutionalized, or structural corruption—as well as organized or white-collar crime (Karklins 2002; Gong 2002). Examples include organized smuggling, collective embezzlement, moonlighting enterprises using government property, and state enterprise asset-stripping.

Box 7. Many Hands Grabbing

An example of a highly successful organized corruption scheme is the smuggling enterprise that operated in Zhanjiang, a city in China's Guangdong province, during the late 1990s. An estimated 100 officials were involved in the smuggling of more than 60 million RMB[33] (US $7.3 billion) worth of goods, in return for bribes or smuggling opportunities. Among those involved were:

- the customs office, code-named the "vehicle for smuggling";
- the anti-smuggling investigation office, known as the "smuggling office," which arranged auctions of smuggled goods;
- the city's party chief, nicknamed the "umbrella for smugglers," who arranged a city loan to finance his son's smuggling and was himself a smuggling "king";
- the vice-mayor, himself a major smuggler;
- the port authorities;
- the state tax bureau.

The ring was eventually broken. A trial of conspirators in 1999 led to six major offenders receiving the death penalty and 25 others being sentenced to prison terms of five to fifteen years. (Gong 2002.)

B. "Grand corruption" versus "petty corruption"

Another distinction is sometimes drawn between *grand corruption* and *petty corruption*. These terms have been variously defined, but are used to distinguish between the corrupt acts of higher level government actors (involving larger amounts of money) and the bribe-taking of lower-level service providers such as policemen and health workers. Jain provides a much narrower definition, equating grand corruption with "the acts of the political elite by which they exploit their power to make economic policies," in contrast to "bureaucratic corruption," which he defines as "corrupt acts of the appointed bureaucrats in their dealings with either their superiors (the political elite) or with the public" (Jain 2001).

C. "State capture" versus "administrative corruption"

We alluded previously to "state capture," i.e., the provision of illicit favors to politicians in order to influence the formulation of laws, regulations and policies, so as to secure special advantages. By contrast, "administrative corruption" refers to the use of illicit favors to distort the implementation of existing policies. This distinction underlies the

[33] *Renminbi*, more commonly known as *yuan*, is the Chinese unit of currency.

World Bank's analysis of corruption challenges and priorities in the transition countries, categorized according to their level (high or medium) of these two broad types of corruption. Thus, in the high state-capture countries, the concentrated power of economic interests obstructs reform and restricts access to policymaking processes. Moreover, a high level of state capture suggests insufficient overall attention to market-oriented restructuring of the economy, in favor of dividing spoils among influential oligarchs and arrivistes with the cash to buy policies. Hellman et al. (2000) find support for these propositions in a multi-country analysis of data from the 1999 World Bank BEEPS[34] surveys. High state capture creates a "capture economy" in which officials sell basic public goods such as contract and property security to the newer large firms, while established firms are protected by long-standing influence—and the rest suffer from officials' weak incentives to provide these public goods free of charge. In other words, the policy and legal environment is shaped to the captor firm's advantage and at the expense of the business sector (and the populace) generally. This situation obtains once a private sector with civil liberties is in place (prior to this, there is in effect nothing to capture and no means to attempt capture), and before transition has ushered in effective competition and constraints to corruption.

D. "Good" versus "bad" corruption.

One line of economic literature has argued that corruption can be good if it allows businesses to circumvent bureaucratic obstacles that impair market efficiency by "buying" less red tape (Leff 1964; Lui 1985). Kaufmann and Wei point out that these models are partial equilibrium models that fail to take into account the fact that bureaucrats may control both the regulatory burden and the delay; accordingly, firms that pay bribes would not necessarily face less harassment (Kaufmann and Wei 2000).

E. Centralized versus decentralized corruption

One strand of literature argues that corruption does less harm if it is centralized. There are several arguments in support of this thesis. One is that centralized corruption is more predictable. If businesses can predict the amount that they must pay in bribes, they can factor it in as any other tax; it is the unpredictability that cripples business (see, e.g., Campos, Lien and Pradhan 1999). Others argue that a centralized authority that determines the amount taken in bribes will limit bribe amounts so as not to destroy businesses, which would lower long-term revenues (see, e.g., Olson 1993; Shleifer and Vishny 1993). This claim has never been tested, and rests on unarticulated assumptions concerning the discount rate of centralized authorities, the marginal utility of consumption, and the degree to which destruction of individual businesses will reduce the authorities' overall take.

IV. Dynamics of Corruption

Understanding patterns in the breadth and persistence of corruption is of central importance to policymakers. Yet, the dynamics of corruption are not well understood, and relatively little work has been done in this area. Political scientists have focused on the process of democratization, either seeing corruption as incompatible with a healthy

[34] Business Environment and Enterprise Performance.

modern democracy or alternatively, seeing democratization as creating new constraints and opportunities (see, e.g., Scott 1969). Several economics papers have presented corruption as stable at different levels (multiple equilibria) and explore the impact of individual factors that may result in a higher- or lower-level equilibrium (see, e.g., Celentani and Ganuza 1999). A small literature explores the persistence or "stickiness" of corruption (see, e.g., Dawid and Feichtinger 1996). Bardhan (1997) neatly summarizes the findings in this area. In general, the literature in this area is much more theoretical than empirical.

A. Societal Balance and Change

What causes corruption levels to remain steady at high or low equlibria, or to shift? One framework for analysis is proposed by Johnston (1997), who argues that the political balance of forces shapes corruption trends. Where a balance exists between economic and political power, and between autonomy of and access to elite officials, corruption remains under control. Imbalances can destabilize politics and foster corruption, and particular combinations of imbalances give rise to characteristic systems and problems of corruption. Moreover, these situations are dynamic, with social ferment, economic change, and political contention shaping opportunities—and influencing where society draws the line between the state and the market and between acceptable and unacceptable influence.

1. Johnston's four scenarios

Johnston's analysis yields four ideal-typical "syndromes" or scenarios, where particular imbalances generate different political dynamics and forms of corruption. These scenarios are:

- Moderate-corruption scenarios:

(1) "*Interest group bidding*," typical of industrial countries where economic opportunities exceed political opportunities and the accessibility of elites (i.e., their vulnerability to interest-group pressure) outweighs their autonomy.

(2) "*Patronage machines*," such as those in Suharto-era Indonesia or 19th century U.S. cities, where a dominance of political over economic opportunities and greater elite autonomy produces significant, but reasonably well-organized, corruption.

- High-corruption scenarios:

(3) "*Elite hegemony*," as in some military regimes and authoritarian East Asian states during the 1980s and 1990s, where both economic opportunity and elite autonomy have been high, and lack of accountability at the top can lead to extreme corruption.

(4) "*Fragmented patronage*," typical of many African countries and of Russia during the 1990s, where high elite accessibility and predominance of political opportunities leads to indiscipline, oligarchic fiefdoms, and potentially extreme corruption.

2. Equilibrium and shifts

Corruption appears to move in chaotic patterns, comparable to those of street crime, disease, and financial markets. Some periods experience a steady state, while in others the equilibrium becomes unstable and shifts. A number of possible mechanisms might account for such trends. The basic theoretical construct employed here is the "frequency-dependent equilibrium," occurring between the polar extremes where either everyone or no one is corrupt. Individuals choose strategies based on their expectation that their transacting partners are either more likely than not to be corrupt, or less likely, or indifferent. Initial conditions and external shocks determine trends in one direction or the other. Several mechanisms are potentially at play here. For example, corrupt agents may prefer to transact with other corrupt agents, and hence would seek them out and revise upward their general estimation of likely corruption with each corrupt partner they meet. Further, higher rates of corruption increase the probability that supervisors and watchdogs are compromised, making punishment less likely. Reputation mechanisms are also at work. Certain players, such as middlemen or "fixers," have an interest in spreading rumors of corruption and giving the impression that bribery is rampant. Once such an impression takes hold, it may be difficult to change (Bardhan 1997).

Instabilities can arise during periods of rapid social or economic change, consolidation of a new regime, or a successful anti-corruption campaign. For example, both the late 19th-century "Gilded Age" in the U.S. and the period from late communism through early transition in Russia witnessed rapid change and proliferating opportunities. These changes apparently led to substantial increases in the amounts and forms of corruption. First of all, social changes attending modernization and urbanization can generate excessive demands on antiquated political systems. In particular, where dominant groups could previously exert mild informal pressure on elites without resorting to bribery, changes in political and social structures may now require them to buy off policymakers to get their way (Scott 1972).

Second, economic change creates instabilities that can cut in either direction. As the economy expands and becomes more complex, public and corporate officials discover more opportunities to profit from their official decisions. In transition settings in particular, a dual-track economy creates endless possibilities for profitable collusion and self-dealing (Bardhan 1997, Aslund 2003). The insecurity of property rights in these environments is also thought to increase corruption. It encourages the use of alternative means, including rent-seeking accompanied by bribery, to protect investment interests. In these environments, restructuring, and especially establishing the key infrastructure for competition in the economy, is necessary to restrain corruption. GDP growth alone is insufficient. Some empirical evidence is emerging to support these points (Broadman and Recanatini 2002, Kaufman and Kraay 2002, Keefer and Knack 2002).

Changes in regimes and political systems can also have destabilizing effects. Political scientists have studied the process of democratization and widening public participation (See, e.g., Huntington 1993). Introducing democracy in a given context may enhance transparency and the enforcement of laws, while increasing the cost and difficulty of coordinating corrupt transactions; however, it may at the same time make it harder to protect the integrity of lawmaking processes (Bardhan 1997). Further, where polities do not demand clean government, or where they are unable to monitor corruption levels in government, democratization alone is unlikely to lower corruption levels.

Perversely, to the extent that democratization widens political participation to include people who do not demand clean government, or who are less able to monitor corruption, it could actually *increase* corruption. It is no accident that Tammany Hall, the corrupt political machine that ran New York City, was born in the wake of the elimination of property holding requirements as voting eligibility criteria in 1821. For the next century, Tammany drew its political power from the waves of poor uneducated immigrants who traded their political support in exchange for facilitation in interacting with the U.S. system, for the possibility of jobs, or even for a bucket of coal in the winter.

A high level of corruption appears exceedingly difficult to reverse. Theoretical models, reflecting the difficulty of reducing corruption, characterize it as "sticky." This suggests that both upward and downward shifts in the level of corruption may happen in a sudden, catastrophic fashion, but only after a long build-up of favorable conditions. Why is this so? The few attempts to answer this question seem to suggest that this pattern reflects the particular interests being advanced by means of corruption. Most obviously, an increase in corruption attracts stakeholders in corrupt benefits—and once vested, these interests will not be surrendered lightly. Indeed, as networks of corruption emerge, members defend their interests by weakening institutions of restraint (in some cases by murdering rivals and watchdogs), thereby further increasing the level of corruption. This has classically been the pattern with illegal narcotics trade, smuggling rings, organized criminal enterprises, and other black markets arising in response to government controls (see, e.g., van de Mortel and Cornelisse 1994, Morris 1999, Jain 2001, Gong 2002).

In practice, a high-corruption equilibrium is likely to shift downward only as a cumulative result of many types of changes—economic, political, social, domestic and international. Rapid reversals are rare, but they do exist, Hong Kong since the early 1970s being the leading (if somewhat idiosyncratic) example. This last case suggests that dramatically reducing corruption means concentrating efforts to create a "tipping point" that leads to reversal of a trend. By contrast, keeping corruption under control sometimes means acting comprehensively to stop small infractions and an incipient atmosphere of impunity from growing into a wave of corruption.

B. The Normative Dimension

Levels of corruption also seem to reflect shifts in social norms. Some relevant work has been done on the dynamics of norms and rule obedience, such as the acceptance of womens' voting rights or other human rights, or the disappearance of once-accepted practices such as dueling (see Box 8). Socialization and expectations about others' behavior reinforce the individual's tendency to follow broadly accepted standards and to avoid practices clearly within the society's definition of corruption. Individuals will normally interpret others' behavior consistent with such norms as indicating their acceptance of those norms—and will tend to derive satisfaction from others' adherence to the norms. Should the individual be tempted, she/he would be restrained by "expectation-dependent remorse" or feelings of shame derived from the individual's expectation that others will disapprove. In some cases this expectation (and the underlying interpretation of wide support) may be false, with the result that observed behavior supports an unpopular norm that appears too costly to break (Clague 1993, Huang and Wu 1994, Bicchieri 1997). Posner (2000) interprets these dynamics in terms of *signaling*. In this view, social norms are self-enforcing, because people feel compelled to signal their "type," i.e., "good" types comply with the norm.

Box 8. Women's Suffrage: An Example of Norm Dynamics

Research on women's suffrage globally provides support for the idea of the life cycle of norms and the notion of a "tipping point" or threshold point of normative change. Although many domestic suffrage organizations were active in the 19th century, it was not until 1904, when women's rights advocates founded the International Women's Suffrage Association (IWSA), that an international campaign for suffrage was launched. In fact, rather than a single international campaign for women's suffrage, there were three or four overlapping campaigns with different degrees of coordination. A quantitative analysis of the cross national acquisition of suffrage rights reveals a different dynamic at work for early and late adopters of woman suffrage. Prior to a threshold point of 1930, no country adopted woman suffrage without strong pressure from domestic suffrage organizations. Between 1890 and 1930, western countries with strong national women's movements were most likely to grant female suffrage. Although some original norm entrepreneurs came from the U.S. and U.K., this was not a case of "hegemonic socialization," as the first states to grant the right to vote were not hegemons (New Zealand, Australia, Finland), and the United States and U.K. lagged 10-20 years behind. After 1930, international and transnational influences become far more important than domestic pressures for norm adoption, and countries adopted woman suffrage even though they faced no domestic pressures to do so. For woman suffrage, the first stage of norm emergence lasted over 80 years: it took from the Seneca Falls Conference in 1848 until 1930 for 20 states to adopt woman suffrage. In the 20 years that followed the tipping point, however, some 48 countries adopted woman suffrage norms.

-- Finnimore and Sikkink 1998.

Importantly, examples set by leaders and the surrounding equilibrium of behavior help to sustain (or erode) the individual's rule-obedience. An individual who desires to break the rule will tend to seek out examples of rule violation in order to resolve the cognitive dissonance caused by inconsistent behavior (or desires). Changes in the surrounding social environment can undermine a rule, setting off a behavioral cascade in a new direction. In some cases, a determined minority with commitment to a norm can block the wholesale reversal of a behavioral equilibrium and indeed initiate a move to re-establish widespread adherence to the norm (Clague 1993, Bicchieri and Rovelli 1995).

This work is relevant to the extent that corruption declines in response to the establishment of political norms such as those discussed in Section II (see "Missing Political Prerequisites"). Those norms call for the separation of public and private spheres, emphasize that the purpose of government is to serve the people, and hence disapprove of self-dealing in public office. More broadly, it seems likely that the level of corruption is primarily a function of the norms of those in power. Changing the level of corruption would therefore either involve changing the norms of those in power and those to whom they answer, or replacing them with people who hold norms against corruption and who are answerable to constituencies that demand clean government.

V. Measuring Corruption and Its Impact

Measuring any corrupt practice is difficult because corrupt behaviors are usually criminal and take place in private. While the impact of corruption could presumably be determined by examining financial and inventory records, it is perhaps not a coincidence that governments with systemic corruption have very poor record keeping (and can be prone to inexplicable documents fires). It is impossible to know how much government property has been stolen if no inventories of government property are kept. Similarly, audits of government contracting are not effective unless there is a complete trail of documentation regarding a government purchase (but see Box 7). Attempts to measure corruption by counting the number of complaints to the police are unsatisfactory because they confound the incidence of corruption with recognition of corruption and faith in the honesty and effectiveness of the police. Similarly, attempts to measure corruption by counting press reports of corruption confound the incidence of corruption with the freedom of the press, the professionalism of the press, the availability of information on corrupt activities, and popular concern about corrupt acts. Because of the variety of types of corrupt practices, and the inability to directly measure any of them, *all* measures of corruption are partial measures. Estimates of the costs of corruption are often thinly supported.

Efforts to measure corruption have focused primarily on survey data of perceptions or experiences. *Perception questions* ask interviewees to rate the levels of corruption in particular government agencies, or to report whether they think levels of corruption have gone up or down. But public perceptions may not be well informed. A household survey of perceptions of corruption in the justice system, for example, is not a good proxy for evaluating the level of corruption in the justice system because so few people have contact with the system, and even fewer understand it. Perceptions may also be heavily influenced by media reports. It is not uncommon for people to report that corruption has increased when an anti-corruption campaign results in more public attention to corrupt activities. Finally, perceptions often lag years behind reforms.

Experience questions in surveys ask interviewees how frequently and to what government agencies they have paid bribes. While surveys targeting personal experience may produce more reliable data, people may hesitate to report their own involvement in corrupt activities. They may also have difficulty interpreting their experiences. When no official fee schedule for government services is posted, or where fees have been adjusted by custom over decades, people may not know whether they paid the official fee or a bribe. When a government office lacks paper, or the police lack a car, and a citizen is asked to provide paper or transportation services in order to receive a government service, it is not clear whether furnishing such supplies or services counts as a bribe.

Survey techniques have another drawback. Survey questions must be drafted in advance, and administered in precisely the same way to a substantial pool of respondents. This means that survey techniques are well-adapted for learning about types of corrupt practices that are widespread and well-understood, such as bribe exchange, but much less useful in learning about types of corruption that do not involve a large number of people, or that are not known to survey designers in advance. More flexible investigatory and interview techniques are required to learn about less common corrupt practices or particular corrupt schemes that involve smaller numbers of people. *Qualitative research* using skilled interviewers and investigators may be needed to learn more about patterns of corruption in a particular agency or locale, and to supply complementary information that can better help researchers formulate survey questions and understand the answers. But while these techniques help paint the broader picture, they provide only a partial view and do not produce "measures" of levels of corruption either.

Because the business community is particularly interested in knowing about levels of bribe exchange between the private sector and government, there are business risk-information services (such as Business Environment Risk Intelligence and International Country Risk Guide) that conduct surveys of foreign investors, asking about their perceptions of and experiences with corruption. Transparency International, a non-governmental organization that combats corruption, provides an annual ranking of the perceived levels of corruption in various countries. The ranking, used to pressure governments to take action, draws on such surveys conducted by business risk services as well as other surveys of foreign investors. The World Bank and other donors conduct household surveys that explore public perceptions and experience with various government agencies.[35] Another approach to measuring corruption is that of the World Bank's "public expenditure tracking surveys" (PETS), which attempt to determine the flow of funds from the treasury to schools and health clinics by means of a series of surveys administered to the different levels of administrative officials (Reinikka 2001).

More recently, researchers at the World Bank have developed an aggregate index (Governance Research Indicators Country Snapshot, or GRICS) that makes use of the other available surveys to calculate a "Control of Corruption" variable. While GRICS pulls together the sum of what is known, for some countries there is very meager information. There is an unfortunate relationship in fact between poverty, poor governance and poor data. In the words of the authors, "Our main finding is that the available data do not permit very precise estimates of governance. . . . The most striking feature . . . is that these confidence intervals are large relative to the units in which governance is measured" (Kaufmann et al. 1999, p. 15).

Because development is dominated by economists whose primary empirical tools are statistical techniques, most of the empirical work on corruption is statistical and therefore most of it focuses on bribe exchanges. Moreover, most studies focus on bribe exchanges between foreign investors and government, or between the average householder and government. *This does not necessarily mean, however, that these are the most important bribe exchanges, or even that bribe exchanges are the most important form of corruption.* For example, the Goldenberg scandal in Kenya involved the embezzlement from the treasury and central bank of approximately U.S.$1.1 billion by a small network of

[35] In addition, as the World Bank moves to allocate aid based on the quality of governance, it is using an internal measure called the "Country Policy and Institutional Assessment" (CPIA). The CPIA is a survey of the World Bank staff who work on a given country, and among other ratings, it asks staff to rate the "transparency, accountability and corruption in the public sector." The utility of this measure depends on the actual knowledge of World Bank officials, and as yet there is no systematic collection of information on these topics by the World Bank. The CPIA is confidential to the World Bank.

government officials and private sector actors; in Mozambique, three people investigating banking corruption were murdered (CNN 1999; Hanlon 2002).

While researchers are obliged to use available data to test hypotheses about the causes and consequences of corruption, these efforts are made more difficult by the poor quality of data. Notwithstanding, a number of researchers have made use of these indices for empirical analysis. (See, e.g., Mauro 1995 and Knack and Keefer 1995.) Economists have studied the impact of corruption on variables of economic interest, such as growth, distribution, government expenditures and foreign direct investment. (This literature is discussed in more detail in the companion paper, "Measuring the Economic Impact of Corruption: A Survey.") Non-economic impacts, while less studied, are equally important. These include the impact of corruption on a range of public issues, including the quality of public service delivery, public policies, public administration, morale, the rule of law, and mortality or life expectancy.

VI. Conclusion

The literature on the causes of corruption can be loosely divided into two types: the literature that addresses systemic and structural reasons for corruption; and the literature that addresses the incentives facing individual government actors. Because of the separation of the disciplines, these two perspectives are not yet adequately integrated. Both sets of factors are likely to be important in explaining variations in the levels of corruption across countries, regions and institutions, and it seems unlikely that a solution that neglects either of these facets could succeed in reducing corruption. Indeed, where the political prerequisites are lacking, it is reasonable to ask whether we need to focus on corruption or on the political system.

Overall, the literature on corruption has the feel of theoretical exploration. Some effort has indeed been made to test the many hypotheses about the causes and effects of corruption. Nevertheless, the many faces of corruption, the difficulty in operationalizing variables, and the poor quality of data—complicated by the incoherence created by the division of the discussion into different academic disciplines—have prevented the literature from building on itself and moving forward in a definitive way.

There is no shortage of policy recommendations for reducing corruption, most deriving from the NIE literature: promote competition, increase salaries, improve monitoring, reduce discretion, reduce public power and the size of government, increase sanctions. More broadly, policy recommendations advocate strengthening the institutions that check government. These include the government institutions that check government from within, such as the legislature, the judiciary, administrative law and procedure, audit systems and record keeping. They also include institutions that check government from without, including the free press, human rights associations, government watchdog associations, think tanks, universities and business associations; and international organizations. The recommendations also include informational campaigns and improved access to government information. While these recommendations are intuitively appealing, it is unclear how well they can be implemented in systemically corrupt environments, or what the expected impact might be. The poor quality of data certainly hampers efforts to test hypotheses about the causes and consequences of corruption. Aside from a few successes that have become iconic—like the cleanup of

Hong Kong under the Independent Commission Against Corruption—it is not clear to what degree these interventions have been successful, or whether we have sufficient data to determine which interventions have been successful.

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Wednesday, June 30, 2004
9:00-10:30

New USAID Strategies: Dealing with Fragile States and the Agency's Anti-Corruption Strategy

Fragile states have posed a growing problem since the end of the Cold War and are now recognized as a source of our nation's most pressing security threats. Corruption is widely recognized as a major constraint to development as well as a driver of fragility. This session will feature presentations on two new Agency strategies (currently in draft) that aim to address these central issues, and offer opportunities for comment and discussion on relevance to EG programs and policy recommendations.

Presenters:

- Melissa Brown, Senior Policy Advisor for Democracy and Governance, USAID/PPC
- Neil Levine, Senior Adviser for Governance, USAID/DCHA/DG

Thursday, July 1, 2004
3:30-5:00

Breakout Session:
Public-Private Alliances as Enablers of Economic Growth: The Private Sector Perspective

Alliances are an effective mechanism for improving a country's enabling environment for economic growth. The Global Development Alliance business model underscores the importance of joint planning to solve complex development problems as well as leverage significant resources to better combat the problems. Representatives from the private sector will relate their experiences working in partnership with USAID and the alliances contribution to economic growth.

Allen Eisendrath, Presenter, Moderator
Mark Gellerson, Moderator

Thursday, July 1, 2004
1:30-3:00

Breakout Session:

Applying New Institutional Analysis

Presenter: Clifford Zinnes, Director of Research Coordination, IRIS Center. It has now become common wisdom in the policy community that institutions—both formal and informal—create and perpetuate incentives so that institutional design must be commensurate with the goals of economic development. However, the practice of identifying the underlying institutions at play and the incentives they create, as well as the importance of monitoring and measuring outcomes, is still in its infancy. This presentation summarizes three attempts to redress this situation. The first borrows the practice of clinical trials from the pharmaceutical industry and introduces a methodology to statistically evaluate whether and why a donor intervention was successful or a failure, thereby allowing rigorous lessons to be learned regardless of project outcomes. The second introduces a methodology to test alternative institutional arrangements to see whether the incentives they create lead to behavioral responses in the target population that are consistent with what is required for a proposed donor intervention to be successful. Both of these were developed under EGAT sponsorship during the "Forums" Project and tested in The Philippines. The third application, funded by the Investment Promotion Office of UNIDO/Bologna and underway in Morocco, uses the concept of inter-jurisdictional competition to create a "game" for municipalities to play in which fulfillment of commitments to improve the business and investment environment by strengthening local governance "wins" substantial financial and technical rewards for their SME firms. This technique both allows donors to identify serious reformers as well as multiplies the amount of reform a given technical assistance budget can generate.

Presenter: Peter Boettke, Deputy Director, James M. Buchanan Center for Political Economy, George Mason University. After decades of flirtation with pure formalism, economics over the past few decades has brought institutions back into the center of economic analysis. Legal, political and even social institutions are now focal points. With this recognition comes the need for a new approach to assess the institutional environment and design reform initiatives. It is not enough to simply add new variables into standard analysis. This presentation briefly summarizes the contributions that an understanding of an institutional perspective can make to the practice of development and then presents two applications drawing on a new methodology that fits this perspective, with illustrations from the field. The first addresses the importance of recognizing a disconnect between the *de facto* (unofficial) and *de jure* (official) rules which govern the economic life of the individuals within a given society. The implication being that only those reforms that reach the actual behavior of the individuals within a reform environment, rather than the behavior described by the laws of a country, have a chance to succeed. This is illustrated by an examination of the institutional conditions in which entrepreneurial activity occurs, within a property rights regime. The second application demonstrates a method for uncovering the political economy of a reform environment and discusses the implications of this undertaking for the success of a reform initiative. These applications are intended to provide development practitioners with the tools to improve the design, targeting, and sustainability of reforms, increasing the chances of success.

Wednesday, July 30, 2004
1:30-3:00
Breakout Session:

Roundtable: Success Stories in Tax Reform

USAID has supported tax reform in many countries of the world, such as El Salvador, Egypt, Guatemala, Tanzania, Mongolia, and many other countries. Tax reform levels the playing field, funds government programs, supports stability, reduces corruption, and is needed for private sector development. Through case studies of Jamaica, El Salvador, Egypt, Kosovo and Tanzania, participants will discuss the importance of tax reform (both tax policy and tax administration) for the economy, and particularly the factors for success in brining about tax reform.

Presenters/Discussants:

- Paul Davis, Moderator
- Mark Gallagher, Fiscal Reform Project, El Salvador and Egypt
- Sam Skogstad, Fiscal Reform Project, Jamaica and Kosovo
- Fran Greaney, Bearing Point
- Richard Bird, Fiscal Reform Project, Managing Tax Reform

Managing Tax Reform

6/18/2004 1

The Key Questions

- What is to be done?
- How is it to be done?
- Who is to do it?
- When is it to be done?
- What will happen as a result?

6/18/2004 2

Policy Formulation: The Ideal Institutionalization

- Better packaging
- More flexibility
- Better defense against attack
- Better control of outcomes

6/18/2004 3

Lessons from Experience

- Timing, timing, timing
- Simplify – don't "complify"
- Sequencing
- Scope

6/18/2004 4

El Salvador Tax Reform

Introduction

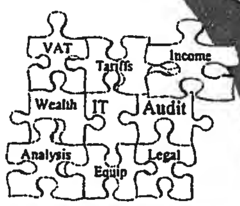
- USAID assistance to reform tax system
- Lessons learned for USAID
- How many of you are working in tax reform, tax policy, tax administration, fiscal reform in economic governance or post conflict states?

Agenda

- Nature of reforms
  - VAT
  - Tax rationalization, administration
  - Trade liberalization, customs
- Prior conditions
- USAID assistance
- Measures of success
- Lessons learned

Integrated approach

- Tax and trade policy
- Tax and customs administration



Conditions

- End of civil war
- End of PDC popularism
- Elected conservative party
- US assisted in setting gov't agenda
- ES was embracing change
- IT lead

Tax policy reform

- Eliminated stamp and related taxes
- Introduced VAT – changed the rules of the game
- Simplified income taxes for individuals and businesses
- Reduced tariff
- Raised from 0 tariff rate
- Eliminated wealth tax

USAID assistance

- 4 year project, $7 million
- About 18 years LOE LTTA
- Much IT and equipment
- Observational travel to Mexico
- Train tax and customs administrators

Mark Gallagher – Fiscal Reform Project

Impacts/Success

- Lower rates
- Fewer taxes
- Simpler and easier to comply
- Higher tax revenues
- Productive taxes (VAT and Income)

Mark Gallagher – Fiscal Reform Project

Where to Get More Information

- This and some of the other case studies discussed here today will soon be on the Fiscal Reform Project's website:
- http://www.fiscalreform.net/usaid_ta/usaid_ta.htm

Mark Gallagher – Fiscal Reform Project

Factors of Success

- Political capital and commitment
- Participation and public informat
- Committed counterparts at all level
- Comprehensive scope
- Country ready to embrace change.
- Observational travel

Mark Gallagher – Fiscal Reform Project

Wednesday, July 30, 2004
1:30-3:00
Breakout Session:

Making Policy Reform Happen

This workshop session is intended to share lessons that have been learned in diagnosing, designing, implementing, and assessing policy reforms over a decade of field-based policy reform experiences to enhance economic growth. It is also designed to provide policy practitioners practical and pragmatic operational guidelines for broad or subject matter based policy reforms and development, including counterparts in government, local NGOs, and stakeholders, as well as donors and donor-funded policy advisors. Over the last decade, practitioners have developed a growing appreciation for policy reform, development, and implementation, alone or in concert with traditional forms of technical assistance to obtain far greater, and more enduring, economic growth prospects. This is an opportunity to both share and discuss Lessons Learned and Best Practices among the "policy community." While the benefits of well-conceived policy reforms are substantial and easily recognized, policy changes – either at the macro or sector level – often require institutional reforms and affect vested, politically well-connected economic interests. As a consequence, donors and their partners require a good understanding of development diplomacy, the complications and difficulties of the policy reform process, and an appreciation for the local context for policy and institutional capabilities.

Presenters/Discussants:

- Kenneth Baum, Senior Economist, EGAT/AG
- Russell Misheloff, Senior Policy Advisor, International Resources Group
- Avrom Bendavid-Val, Vice President, Chemonics International
- Betsy Marcotte, Vice President, PA Government Services, Inc.

PA Consulting Group

National Trade Policy and the Environment

Betsy Marcotte
PA Government Services, Inc.
30 June 2004

Trade Policy and the Environment

Trade Reform – the potential and the concern

Using the "Policy Wheel" to incorporate environmental considerations into trade policy development

PA

Trade and the Environment

"Global benefits of free trade . . . would be enormous (possibly running into the trillions of dollars). According to some, the budget outlays needed are practically zero, implying not just a huge flow of net benefits but also a benefit-cost ratio of infinity. Beat that!" (*The Economist, 7 June 2004*)

So why the opposition? . . .   Among other things . . .

Trade liberalization needs to be accompanied by progress on social issues (environmental protection, poverty alleviation, human health improvements) so that benefits are realized by all. Can't wait for the benefits to trickle down – action is required now.

PA

Environmental Considerations

Without strong environmental protection policies, expanded economic activity resulting at least in part from increased trade may be harmful to public health, the environment and a country's long-run development goals.

Trade negotiations and agreements (e.g., CAFTA, SACU-FTA) provide a point of leverage – and therefore the opportunity to address gaps and long-term needs

What Is Needed for Success?

Both sides must be willing to invest:

- Developing country governments must be committed to achieving real improvements in public health, environmental, and social conditions
- U.S. must be committed to support reform and enforcement of environmental laws and programs. To date, U.S. track record of actually committing resources to implement technical assistance agreements has not been very good
- Increased public participation and engagement on environmental and social issues

Where Does USAID Fit In?

Technical assistance is needed in all areas –

- Policy reform; enforcement; measurement of results; public participation; improved governance

Timing is key –

- Take advantage of the opening provided by trade negotiations to push for environmental reform. There may be no better opportunity.

There are many opportunities for stretching technical assistance resources –

- Public-private partnerships
- Consumer driven strategies
- Public disclosure as an enforcement tool

Using the "Wheel" to Incorporate Environmental Considerations Into Trade Policy Development

DIAGNOSIS – Identify opportunities for demonstrating benefits of linking trade and environmental issues

Use *DIALOGUE* to raise awareness, draw broader set of stakeholders into the debate, dispel myths about adverse effects of environmental considerations, identify opportunities for reform

Engage stakeholders in *DESIGNING* trade policies that are built on sustainable development principles -- clean technologies, best practices, "polluter pays" incentive schemes

Strengthen capacity to *IMPLEMENT* programs through training and technical assistance

Measure and *EVALUATE* results using agreed-to benchmarks and indicators

Policy Reform
Lessons Learned

Introduction

What is Policy Reform?

Definition:
Policy reform and development is all about changing and implementing "rules."

Two Paradigms for Policy Reform

1. Ad Hoc
2. Planned and Organized

Ad Hoc Characteristics

- Policy rules and processes viewed as a Black Box
- Policy reform approached as an Art
- Low Probability of Success
- Few Clearly Defined Deliverables
- No diagnostics for follow-on activities

Planned and Organized Characteristics

- Policy process defined as a set of understandable rules and processes
- Policy Reform approached as a Science
- High Probability of Success
- Many clearly defined deliverables
- Articulated diagnostics for follow-on activities

Policy Wheel

Russell Misheloff
Deputy IQC Manager, IRG

IRG

The Policy Wheel Portrays

- Factors in moving the policy process forward – the hub
- Stages of the policy process – the rim
- Process progression – the arrows
- Continuous nature of the process – a wheel
  - Corollary of the wheel – no obvious beginning or ending point

IRG

Problem Diagnosis

- An analytical process
- Driven by perception that there is a problem – possible connection to evaluation stage
- Analysis attempts to better define problem, sources, implications, and root causes – setting stage for design phase
- "How" (the hub) is as important as "what" – Participation, communications, & dialogue critical to gathering information, understanding perceptions/impacts, & building consensus

IRG

Policy Design

- Identifies & analyzes options; involves:
  - Assessing alternatives – tools & intervention points
  - Developing info on a short list
  - Selecting one
- Non-environmental considerations
  - Social, cultural, economic impacts, & their distribution
  - Incentive structures
  - Feasibility of implementation
  - Bottom line: stakeholder participation, broad dialogue, open communication are critical

IRG

Policy Implementation

- Setting the stage
  - Establishing/adjusting legal & regulatory frameworks
  - Establishing/clarifying institutional roles
  - Building capacity (as necessary)
- Implementation *per se*
  - Monitoring, feedback, and adjustment
  - Importance of baselines
  - Importance of two way dialogue/communications
  - Flexibility to make mid-course adjustments
  - Generates information needed for evaluation

IRG

Evaluation

- Reviews performance of policy
- Uses monitoring data and other information
- May confirm efficacy of policy design, suggest minor implementation adjustments, partial or comprehensive redesign, or need for policy (re)diagnosis
- Stakeholder perceptions critical

IRG

Wednesday, June 30, 2004
1:30-3:00
Breakout Session

Trade Capacity Building Interventions: Best Practices

USAID is committed to helping developing countries to integrate into the global economy and use trade as an engine of economic growth and poverty reduction, and is dedicating increased resources to trade capacity-building efforts. This session will feature three case studies: customs reform in the Philippines, mainstreaming trade into the national poverty-reduction strategy in Mozambique, and preparing the Dominican Republic's apparel-producing firms and workers for heightened global competition from other developing country producers following the elimination of quotas in January 2005 that have, for decades, restrained such competition. A common thread in these case studies will be USAID support for the institutions and processes used to build national consensus on often-contentious trade-related initiatives.

Presenters:

Robert Wuertz
Timothy Born
Arturo Peguero
Erin Endean, Moderator

USAID Workshop: Promoting Economic Growth in a New Era

Building a Consensus for Trade Liberalization

Trade Mainstreaming in Mozambique

Timothy Born, USAID/Mozambique
June 30, 2004

Outline

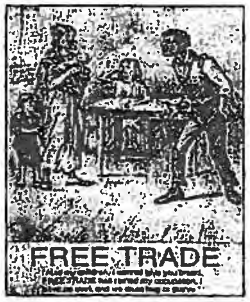
1. What are we trying to do and how important is trade liberalization to our purpose?
2. What gets in the way?
3. Brief history of Mozambique's trade debate
4. Trade Capacity Building
5. Conclusions

What are we trying to do?

Decrease poverty

- Trade increases growth; growth reduces poverty.
- Evidence that trade liberalization is good early move – and not hard to implement.
- In Mozambique, unlikely to hurt poor, even in transition period.

What gets in the Way?



Alas my children, I cannot give you bread. FREE TRADE has ruined my occupation, I have no work and we must beg or starve.

Why not open up?

- Infant industry; revenues; sequencing.
- Intellectual and political tradition based on Marxism and Salazarism – control.
- Result – no bulwark against vested interests.
- Challenge is as much intellectual as political.

History

- Mozambique liberalized economy beginning in late 1980s -- but trade lagged.
- 1996 – tariff reform, to five band system, ranging from 35% to 0%
- 1998 – privatization of customs
- 2000 and 2003 – reduction of high tariffs, reducing dispersion, to 30% and 25%; further 5% planned within two years

History (continued)

- 1998 – Private sector pushed SADC FTA
- 1994 – 1998: Cashew debacle hurt reformers, undermined MFIs credibility.
- Protection as a policy tool: sugar heavily protected beginning in about 2000; rice likely next.
- AGOA, EBA, and SADC served notice that it was time to join the world economy.

SADC FTA

- Mozambique's corn laws debate.
- USAID played critical role by convincing key private sector figures that avoidance was a mistake.
- Showdown between Minister of Finance (see logo) & Minister of Trade.
- Minister of Trade was champion partly because Finance was against.

DTIS Background

- SADC work made USAID lead donor;
- Trade mainstreaming followed naturally;
- IF brought other donors – and need for coordination in Mozambique, Washington and Geneva;
- Mozambique test case of bilateral DTIS
- DTIS presentation in September to launch true mainstreaming of trade into PRSP.

Lessons for TCB

- TCB should include liberalization;
- Simultaneously building up negotiation capacity also makes sense – with it comes confidence.
- USAID/W has to coordinate other USG & donor – especially for IF;
- Trade liberalization should be a part of any economic growth program.

Mainstreaming limitations

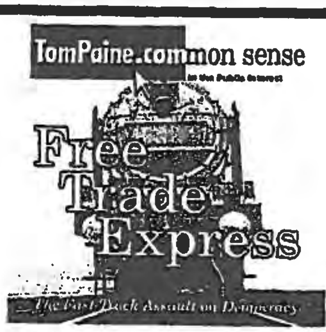
- IF & mainstreaming put trade at center of development – poverty may be better overall guiding principle.
- And for growth programs, competitiveness may be a better guiding principle than trade/TCB. Is there a difference?
- Absence of consensus exacerbated by institutional issues – Finance vs. Trade.

USAID's Role

- Took lead with SADC FTA (domestic debate and negotiations);
- Conducted a trade mainstreaming study in 2000/2001;
- Supported Mozambique's IF application;
- Drove the process from the beginning – partly because of little interest from others.
- IF required considerable coordination by Washington.

Conclusions

- TCB must be based on conviction that trade increases growth reduces poverty;
- Mainstreaming & IF have led to a much better understanding of trade/growth/poverty links.
- Also increased attention on range of business environment issues – licensing; labor law, etc.
- Opposition is as much political and intellectual tradition as it is vested interests;
- Debate should be public and populist – trade for the poor and the workers.



Wednesday, July 30, 2004
3:30-5:00
Breakout Session:

Roundtable – Approaches to Fiscal Decentralization

Presenters/Discussants:

- Anwar Shah
- Richard Bird
- Carlos Gadsden
- Mark Gallagher

Breakout Session:

Property Rights, Finance, and Secured Transactions

This session highlights the importance of the legal and administrative system for defining property rights and creditor rights as it relates to investment finance for SMEs and other businesses. Participants will hear about the links between property rights and access to finance; and about the legal and regulatory environment that enables secured transactions (for both moveable and real property). The session will identify best practices in the above areas by host countries – and the donor interventions by USAID and the World Bank – that have had (or are projected to have) a dramatic impact on the cost and/or wider availability of formal credit to SMEs in selected cases. It will also introduce the methodology and preliminary results for the World Bank's Doing Business 2005 that will provide cross-country indicators of the steps, time and cost to register property, and of the legal provisions that strengthen property rights and enhance the efficiency of property registries.

Presenters/Discussants:

- Heywood Fleisig, Director of Research, Center for the Economic Analysis of Law
- Caralee McLeish, World Bank

ingbusiness in 2005
oving Obstacles to Growth

Access to Finance
Property Rights and Collateral

Caralee McLiesh
World Bank Group
June 30th, 2004

1

Doingbusiness indicators

	2005	2006

• Regulation of Entry
• Labor Regulations
• Contract Enforcement
• Credit Markets
  • Credit information
  • Collateral
• Bankruptcy
	• Bureaucratic Hassle
	  • Business licenses
	•Corporate Governance
	• Property registration
	
	•*Updates of '04 topics*
		• Taxation
		• Trade Infrastructure
		  • Transport
		  • Customs
		  • Standards
		• Protection of Property
		  • Law and Order
		
		•*Updates of '04 and '05*

145 economies, rru.worldbank.org/doingbusiness

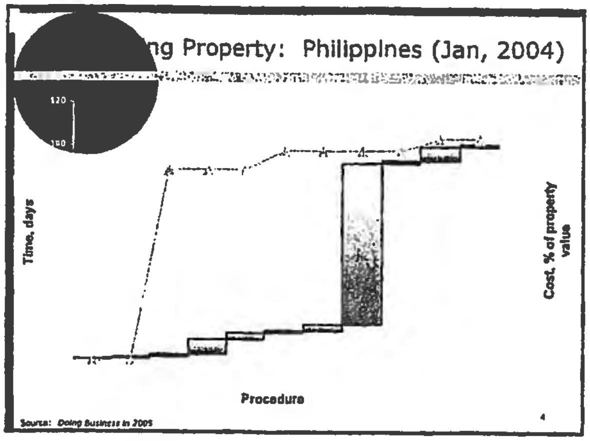
2

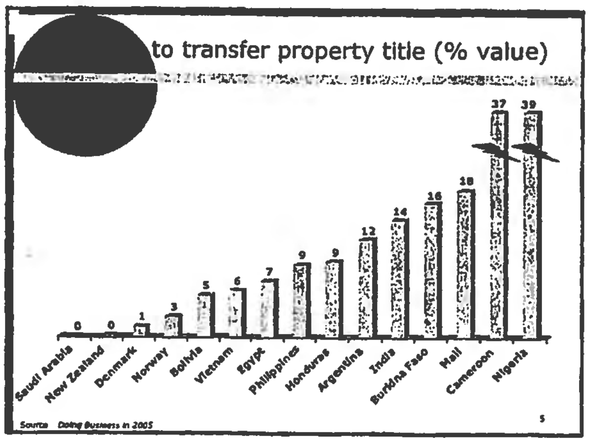
Example of Methodology: registering property

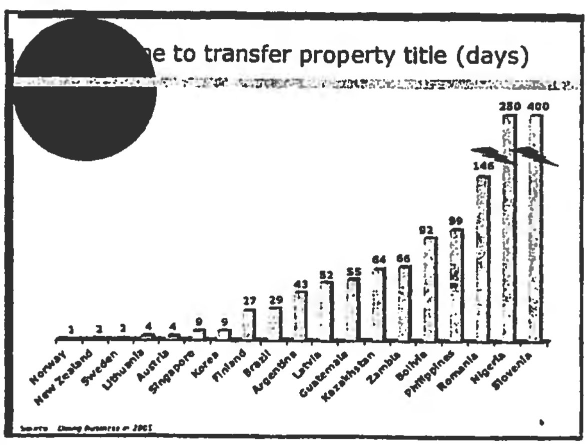
Study
- bility
- Domestic SME
- Largest city
- Wants to purchase land and warehouse in peri-urban area
- Value of property = 50 x GNIpc
- Property is registered and free of title dispute, etc
- How to transfer ownership?

Indicators
- Procedures
- Time
- Cost (% Value)
- Documentation

3


ng Property: Philippines (Jan, 2004)
Time, days
Cost, % of property value
Procedure
Source: Doing Business in 2005
4


to transfer property title (% value)
0
0
1
3
5
6
7
9
9
12
14
16
18
37
39
Saudi Arabia
New Zealand
Denmark
Norway
Bolivia
Vietnam
Egypt
Philippines
Honduras
Argentina
India
Burkina Faso
Mali
Cameroon
Nigeria
Source Doing Business in 2005
5

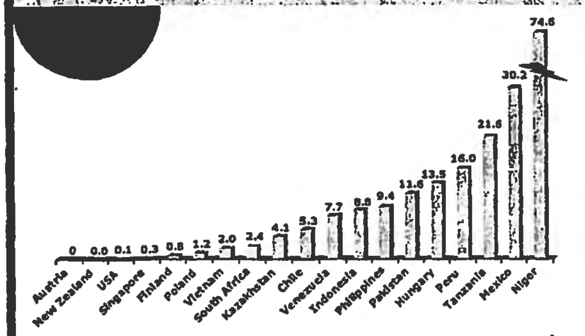

e to transfer property title (days)
1
2
3
4
4
9
9
27
29
43
52
55
64
66
92
99
146
280
400
Norway
New Zealand
Sweden
Lithuania
Austria
Singapore
Korea
Finland
Brazil
Argentina
Latvia
Guatemala
Kazakhstan
Zambia
Bolivia
Philippines
Romania
Nigeria
Slovenia

Property title is not enough

- a borrower use as security for a loan?
- to create and perfect a security agreement?
- How can the lender enforce security if the borrower defaults?
- Who else can take priority to security?

7

eate and register (movables, %GNIpc)



Source: *Doing Business in 2005*

8

encourages access to credit?

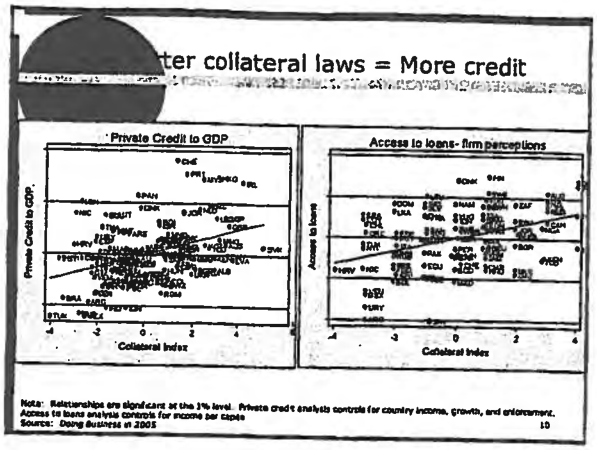
Collateral Index

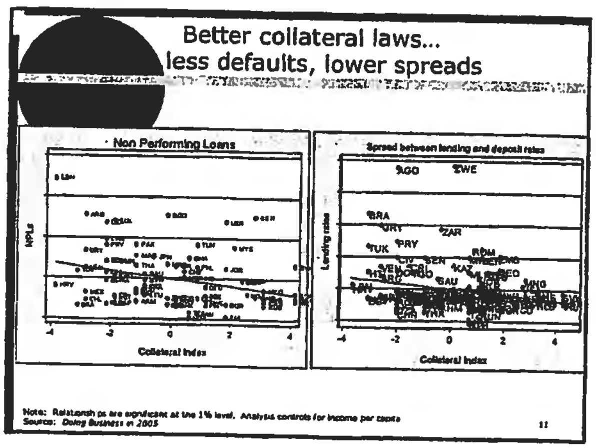
st	Lowest
nd	Sri Lanka
Singapore	Togo
Slovakia	Uruguay
United Kingdom	Venezuela
Australia	Yemen
Canada	Brazil
Hong Kong	Croatia
Latvia	Egypt
Netherlands	Haiti
New Zealand	Lebanon
USA	Nicaragua
Albania	Turkey

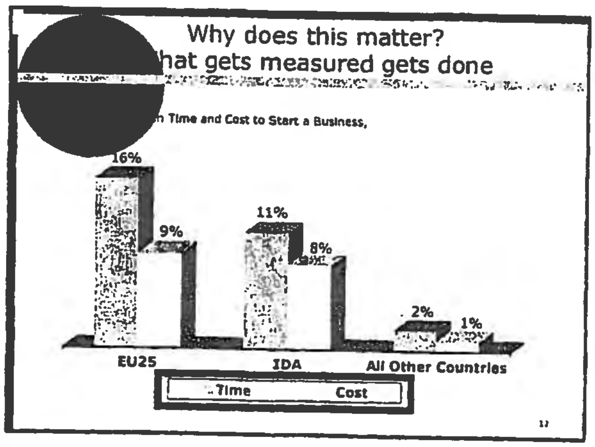
Note: Index based on eight factors relating to the requirement for specific descriptions of assets and debt, geographically linked and electronic registry, priority over taxes and out of court enforcement

Source: *Doing Business in 2005*

9


ter collateral laws = More credit
Private Credit to GDP
Private Credit to GDP
Collateral Index
Access to loans- firm perceptions
Access to loans
Collateral Index
Source: Doing Business in 2005
10


Better collateral laws...
less defaults, lower spreads
Non Performing Loans
NPLs
Collateral Index
Spread between lending and deposit rates
Lending rates
Collateral Index
Source: Doing Business in 2005
11


Why does this matter?
hat gets measured gets done
n Time and Cost to Start a Business,
16%
9%
11%
8%
2%
1%
EU25
IDA
All Other Countries
Time
Cost
12

Center for the Economic Analysis of Law

WASHINGTON, DC

Reforming the Legal Framework for Secured Transactions: Why? How?

Heywood Fleisig

June 2004

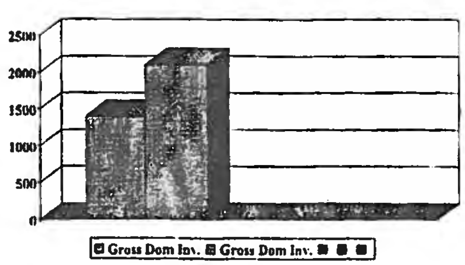
Collateral and Secured Transactions

- Economic growth and private finance
- Private Credit and Collateral
- The Problem:
  - Property cannot serve as collateral
    - Legal Roots
    - Economic consequence
    - Legal Solution

Developing Countries

Gross Domestic Investment, MFI, Aid

($ Billion, 1999-2001)



Conclusion:

- Donors will not finance investment necessary for LDC growth

LDC Investment

- Domestic, publicly financed?
- Domestic, privately financed?
- International, privately financed?

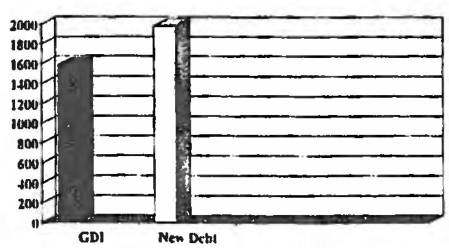
Conclusion:

- Greater LDC investment will requires greater local and foreign private financing

Equity or Debt?

US Gross Domestic Investment, New Debt, New Equity (2001)

US Gross Domestic Investment, New Debt, New Equity (2001)



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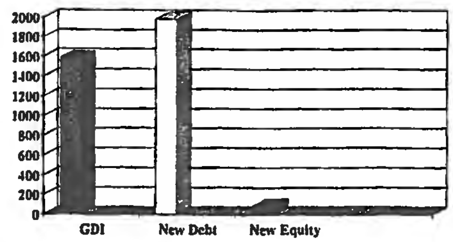


Conclusion:

- Greater LDC investment will require more private debt financing

Main question facing any private lender:

- How do I get my money back?

Answer:

- Unsecured lending
- Secured lending
  - movable property
  - real estate
  - fixtures

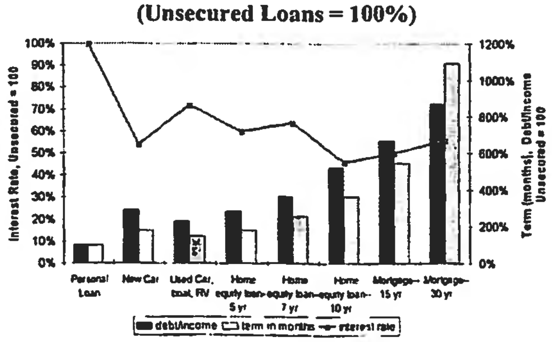
COLLATERAL: IMPORTANCE FOR LENDERS

Example-- I

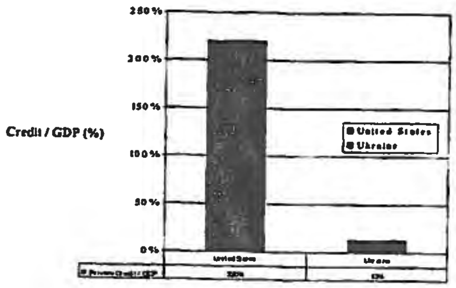
IFC/World Bank/IMF/FRB Credit Unions

	interest rate	term	debt/ borrower income
Personal loan	12.50%	33	50%
New Car	6.75%	60	144%
Used Car, boat, RV	9.00%	48	113%
Home equity loan	7.50%	60	142%
	8.00%	84	182%
	5.75%	120	261%
Mortgage	6.25%	180	334%
Mortgage	7.00%	360	434%

Loan Terms with Different Collateral, (Unsecured Loans = 100%)



Private Credit / GDP. LDCs v. U.S.



Elements in the Legal Framework for Secured Transactions

- Creation
- Priority
- Publicity
- Enforcement

Examples of LDC Problems

Conclusion:

- Expanding debt financing requires reform of the laws and institutions governing secured transactions

Improving Access to Credit: Myth

- Abuse the law
- Make the loans despite legal problems
- Reform state-run banks
- Reform supervision and regulation of banks without reforming the law
- Substitute equity finance for debt finance
- Guarantee funds
- Mini-legal reform: Leasing, warehouse receipt, securitization, bankruptcy

Improving Access to Credit: Reality

- Reform the laws governing debt creation and collection
- Permit more non-bank private lending
- Phase out state banks and government lending guarantees
- Expand effectiveness of land titling projects by linking to mortgage reform
- Expand effectiveness of microlending by securitizing portfolios of microlenders; transition to collateral

Secured Transactions: The Power of Collateral

HEYWOOD FLEISIG

In many developing countries, businesses are unable to get low-cost, long-term loans from private lenders to finance investment projects. Reforms that make it easier for borrowers to use movable property as collateral would give comfort to lenders, stimulate investment, and boost productivity and growth.

THE FIRST question any private lender asks is, "How do I get my money back?" Given the risks involved in lending—borrowers may be unlucky, unwise, or dishonest—what conditions give comfort to lenders?

Two basic loan transactions have evolved in private markets: unsecured and secured. When a borrower offers an unsecured promise to pay, the lender must rely on the borrower's reputation, or trust that the borrower will pay back the loan in order to have access to future loans. In secured transactions, promises to repay are backed by collateral that lenders can seize and sell in the event loan payments are not made as agreed. Collateral may be real estate or personal property—tangible personal property such as inventory, equipment, livestock, and tractors; or intangible personal property such as unsecured accounts owed to merchants (accounts receivable) and secured agreements (chattel paper). Secured transactions have advantages for borrowers and lenders alike—transaction costs are lower and lenders do not need to gather as much information about borrowers.

The issue of collateral is one of great economic importance. When borrowers cannot use their assets as collateral for loans and cannot purchase goods on credit using the goods themselves as collateral, interest rates on loans tend to be higher to reflect the risk to lenders. In many developing countries, where legal and regulatory constraints make it difficult to use movable property as loan collateral, the cost of loans makes capital equipment more expensive for entrepreneurs relative to their counterparts in industrial countries; businesses either postpone buying new equipment or finance it more slowly out of their own limited savings. Small businesses, in particular, are hit hard by the scarcity of low-cost financing, but the whole economy suffers because the lack of new investment dampens productivity and keeps incomes down. Estimates put welfare losses caused by barriers to secured transactions at 5–10 percent of GNP in Argentina and Bolivia.

Legal barriers

Movable property is widely used as collateral in the industrial countries. About half the credit offered in the United States is secured by some kind of movable property: about two-thirds of bank loans are secured by either movable property or real estate, and nonbank institutions that lend against movable property—such as leasing and finance companies—do almost as much lending as banks.

In contrast, private lenders in developing countries rarely make loans secured by movable property unless at least one of two conditions is satisfied: borrowers must own real estate that can be attached if they do not pay, or borrowers must place the movable property under the physical control of the lenders, as in a pawnshop or warehouse financing. If neither of these restrictive conditions can be met, private lenders rarely make loans secured by movable property. They may still make unsecured loans, but these are likely to be smaller loans with higher interest rates and shorter maturities. This phenomenon has been studied in a broad range of countries with different traditions, income levels, macroeconomic outlooks, religions, and levels of urbanization and industrial activity. The difficulties in securing loans with movable property have

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been observed in Africa, Asia, Eastern Europe, and Latin America—in countries with legal and regulatory systems modeled after the civil codes of continental European countries, as well as in African and Asian countries whose systems are modeled after British common law.

What prevents the use of movable property as collateral in developing and transition countries? Three obstacles stand out:

- The *creation* of security interests is difficult, expensive, and uncertain.
- The *perfection* of security interests—the public demonstration of their existence and the establishment of their priority—is not effectively possible.
- The *enforcement* of security interests is slow and expensive.

These abstract notions can be understood more easily with an example. Compare the financing available to farmers raising cattle in Uruguay with that available to their counterparts in Kansas, in the United States. Uruguay and Kansas have similar topographies and well-educated populations interested in advanced technologies and able to apply them, and both are world-class exporters of beef cattle. In Kansas, private banks view cattle as one of the best forms of loan collateral; this is also the view of the bank examiners at the Federal Reserve Bank of Kansas City. Banks with "cattle paper" are seen as solid whereas banks with "exposure to farm real estate" are seen as risky. By contrast, in Uruguay, because of flaws in the legal framework governing secured transactions, private banks and bank examiners prefer real estate as collateral for loans; they consider a pledge on cattle worthless as collateral. The unacceptability of cattle as collateral applies to all types of transactions, including sales of cattle on credit, sales of cattle financed by third-party lenders like banks or finance companies, or working capital loans for other purposes that might be secured by cattle.

Creating security interests. First, it is difficult to create a security interest in Uruguay. Suppose a private bank in Uruguay were to lend against 100 cattle worth $200,000. Uruguayan law calls for a specific description of the property that is pledged. A pledge against cattle might identify the individual cows pledged by name (Bessie, Elmer, etc.) or by the numbers tattooed on them. The need to identify the collateral so specifically undermines the secured transaction because the bank must ensure that the cattle designated in the pledge are available to be seized in the event of nonpayment—the lender is not allowed to repossess a different group of cows.

As a result, the supervision of such loans is costly. It would not be enough, as it is in Canada and the United States, for example, to verify simply that there are enough cattle in the farmer's field; in Uruguay, the loan officer would have to verify that the cattle in the field are the ones specifically identified in the pledge. The Uruguayan bank might try to get around this problem by using a more general description of the collateral in the pledge contract—say, "100 calves." But, with a loan of one year's maturity, the calves would become cows, bulls, or steers, and the enforceability of the contract would be clouded. In Canada and the United States, however, a binding agreement can be written with a floating security interest in "$200,000 worth of cattle." Moreover, in Uruguay, the bank would have to worry that the farmer might sell the cattle without notifying the bank, whereas a Canadian or US bank would have a continuing security interest in the proceeds of the sale and could automatically attach the proceeds—whether they were placed in another bank or used to buy a tractor.

Perfecting security interests. Second, Uruguayan lenders cannot easily find out whether prior and superior claims exist on their security interest. In Canada, Norway, and the United States, for example, all security interests against property are registered; the registries are public and indexed by borrower, by description of security interest, and by other relevant information. Lenders can easily conduct a thorough search to ensure that they have identified any outstanding security interests; security interests that are not registered have no legal standing. By contrast, the registry in Uruguay files security interests in chronological order and does not index them. The only way lenders can find out whether a security interest exists is if borrowers inform them.

Enforcing security interests. Finally, repossession and sale of collateral takes longer in Uruguay than in Kansas. In Kansas, repossession and sale of cattle takes one to five days and can be contracted between private parties. Typically, judicial intervention or the action of government officials is unnecessary. In Uruguay, the process requires six months to two years. In the case of cattle, there is a risk that the collateral will die, disappear, or get sick. Not surprisingly, under these conditions, lenders demand collateral that is sure to outlast a lengthy adjudication process—in other words, real estate.

Economic impact

In Kansas, the ease of creating a security interest, the inexpensiveness and high degree of confidence that can be attached to the perfection of a security interest, and the speed and low cost of enforcement explain why farmers can get private loans for a large fraction of the value of their cattle at interest rates close to the prime rate. The difficulty of using cattle as collateral in Uruguay explains why Uruguayan farmers cannot get any financing for cattle. However, although both rich and poor farmers are affected, rich farmers own land and have access to some credit by virtue of their real estate holdings; poor farmers, who are often tenants, have to use their own savings to finance the additional investment required to raise their incomes. But neither rich nor poor farmers have the easy access to credit enjoyed by their Canadian and US counterparts (and competitors in the world beef markets).

With minor adjustments, the same story can be told for Argentina, Bangladesh, Bolivia, Bulgaria, Mexico, and other developing and transition economies, both urban and rural, regardless of whether their legal systems are based on civil or common law. And the same story can be told, with slight variations, for lending against all movable property in developing countries, except for loans and leases secured by automobiles or loans secured by goods stored—under the control of lenders—in warehouses and pawnshops. Barriers to using movable property as collateral block access to credit and make it difficult to obtain term financing for investment. They also make it difficult to reform banking systems burdened by risky, unsecured loans. Lacking usable collateral, developing countries do not enjoy the major benefit of financial markets—the transfer of funds from savers with limited investment opportunities to investors with insufficient savings to finance profitable projects.

Access to credit. Even in the best of circumstances, poor people do not often go to banks for loans to finance small equipment purchases. But, in industrial countries, small-scale farmers and entrepreneurs can usually purchase equipment, livestock, or inventory on credit from merchants. In developing countries, however, merchants willing to sell on credit to poor customers whose reputation is good have their own problems gaining access to credit: legal constraints on collateral prevent merchants from getting financing secured by their inventories or accounts receivable. If merchants want to extend credit to microenterprises and small and medium-sized businesses, they typically must do so out of their own capital.

Term finance. Although operators of small industrial operations may find it possible to finance "plant"—real estate—with a mortgage, it may be impossible for them to get medium-term loans for working capital or equipment. The reason is not the loan maturities—the same lenders happily make longer-term loans secured by real estate—but the underlying collateral (equipment and inventory) that is unacceptable to lenders. In the United States, movable property accounts for half of the nonresidential capital stock and two-thirds of corresponding gross investment. The difficulty of financing this investment in developing countries greatly hampers industrial and agricultural development.

Bank reform. In developing countries, well-regulated banks typically only make loans secured by real estate or make unsecured loans to those who give evidence of owning real estate. Because the costs of mortgaging property are usually quite high, most bank loans are actually unsecured but made to borrowers who own real estate on the theory that, in the event of default, banks can file a lien against the real estate.

Most bank loans in industrial countries are secured—70 percent in the United States, for example. The difference between industrial and developing countries is striking—nearly 90 percent of bank loans in Argentina are unsecured, and the figure is similar for Bulgaria. Unsecured banking systems are necessarily more risky and prone to failure. And, because mortgages are unregistered, a lender has no idea how many times a borrower has used the same property to indirectly back up a loan. If the borrower defaults, only the bank that files a lien the fastest will be able to back up the loan. Inability to use anything else as collateral means that about half of the nonresidential private capital stock is inaccessible to banks as security for loans.

Capital markets. The World Bank has supported capital market reforms that encourage the securitization of equipment loans, real estate mortgages, and credit card accounts receivable. Such mechanisms can change the conduits through which financing takes place, improve the allocation of capital, and promote competition in the financial sector. However, their effectiveness is limited by the difficulty of creating, perfecting, and enforcing the underlying secured transactions. At the most rudimentary level, the easiest securitization is one where an enforceable security interest is given in the underlying paper. Successful securitizations in Canada and the United States are based on predictable collection rates for underlying mortgages, chattel paper, leases, and accounts receivable. In countries where the underlying loans cannot be collected or leases enforced, securitization offers only limited actuarial benefits. And, if a government guarantees such securitizations, it risks accumulating large uncollectible debts.

Leasing, a type of secured transaction, may facilitate repossession by not requiring proof of ownership. Even so, repossession can be a lengthy process. Leasing is also subject to problems of creation and perfection. When these problems are not addressed, leasing primarily benefits those who can already borrow.

Seeking solutions

Some analysts have concluded that, if the private sector is unwilling to provide credit, market imperfections justify the creation of state agencies that make loans. However, this strategy has severe limitations. First, state lenders are no more able to collect these loans than are private lenders. The main difference is that state lenders are willing to make loans despite the risk of losing money. Not surprisingly, they have lost a great deal. Second, because borrowers know that these loans are hard to collect, such lenders tend to attract a different type of client—one who specializes in getting loans from the government, not one who specializes in investments with high returns. What typically takes place with state agency lending programs is a great deal of lending, little repayment, and not much positive impact on economic growth.

To get around the difficulties of repossession and sale of collateral, some lenders simply seize and sell the collateral without the sanction of law. Some leasing operations disguise their underlying financial nature and pretend that their seizures are not repossessions, hoping that the judicial system will not uncover the equivalence of the transactions. For large and valuable pieces of equipment, dealers in every developing country tell tales of dispatching armed men and bribing police to recover machinery at gunpoint.

In some countries, lenders use a postdated check to convert the civil offense of nonpayment into a criminal act. They may demand a postdated check in the amount of both the loan and the interest. On the date the loan is due, the lender requests payment. If the borrower cannot pay, the lender deposits the check in a bank. If the check is returned unpaid, the lender can take the check, stamped "check without funds," to the police station. In Bolivia, for example, writing a check without funds is prima facie evidence of a criminal act of fraud. The borrower may be arrested. If he or she fails to raise the funds, conviction is certain. (The sentence in Bolivia for writing bad checks is about four years.)

Lenders in the formal sector, obviously, cannot use such collection techniques; the risk of civil and criminal damages is too great. Therefore, the resources of the formal sector are not tapped for credit, and movable property remains the province of lending techniques in the informal sector. This is costly for developing economies—faced with the prospect of jail if they are unable to repay, business people tend to borrow less and borrow only for operations with very high returns—and costly for society, because incarcerating risk-taking entrepreneurs stifles development.

Governments can implement a number of legal reforms to address the fundamental problems in credit markets that make it so difficult to secure loans with movable property:

- Changing the law to permit a greater variety of security interests in a wider range of transactions by a broader group of people.
- Making registry records public, reforming state-operated registries, restructuring public registries to permit competition, and privatizing registry services or allowing private registry services to compete with public ones.
- Speeding up enforcement and making it cheaper, changing the law to permit private parties to contract for nonjudicial repossession and sale, and, when possible, allowing private parties to contract for repossession and sale without government intervention. F&D

This article draws on the work of several lawyers and economists who have advised the World Bank on a variety of issues related to the Bank's lending activity and economic and sector work in the area of secured transactions.

C E A L
Center for the Economic Analysis of Law
WASHINGTON, DC

CEAL Issues Brief, No. 6 January 2003

Should the Bank and the Fund Support the Reform of Secured Transactions?

Heywood Fleisig, CEAL
Nuria de la Peña, CEAL

What is the Legal Framework for Secured Transactions?

The legal framework for secured transactions governs the use of collateral for loans. It sets out the rules for creating security interests; for determining the priority among lenders; for sanctioning a system (registry, filing archive) for publicizing the existence of such a security interest; and for enforcing such security interests, by specifying the procedures for seizing collateral or evicting tenants from real estate and selling for selling collateral. With these four steps, the framework for secured transactions of a country sets out the unique legal and institutional system that permits using personal or real property to secure the payment of loans, or secure the performance of other obligations or transactions.

Economic Impact of a Good Framework

A good legal framework for secured transactions permits using more property as collateral, permits the use of collateral by more lenders and borrowers, and permits designing more transactions that use collateral.

Improves access to credit

Expanding the use of collateral, in turn, improves access to credit. A complex and abstract economic literature documents this. However, a visit to the credit union of the staff of the Bank and the Fund can verify this claim. Posted there are the loan terms for members who borrow without giving collateral -- unsecured loans. Relative to those terms, the same posting indicates that a borrower who offers real estate as collateral can get a loan nine times larger, take eleven times longer to repay, and pay an interest rate only half as high. The terms for loans secured by personal (movable or intangible) property -- cars, boats, and recreational vehicles -- fall in between. Any nearby commercial bank will offer similar terms. That is, the very same borrower gets a larger loan at lower rates with a long repayment period when the borrower offers collateral.

That is the power of collateral. A good legal framework for collateral can improve access to credit more than any other social institution.

Aggregate country data reflect these firm-level results. Financial systems with well-developed frameworks for secured lending supply five to ten times more private credit relative to GDP than do their unreformed counterparts. These systems supply credit at

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interest rates close to the government borrowing rate for loans secured by a wide range of property -- real estate, apartments in cooperatives, condominiums, leases of public land, equipment, building improvements, portfolios of unsecured loans, inventories, accounts receivables, and livestock.

The problem

Few Bank and Fund borrowing member countries have such legal systems. Why? Briefly, their laws do not support the creation of a wide range of security interests over a full spectrum of property in ways that include most agents and transactions; their laws have no logically consistent system for assigning priority to security interests; their registries that give publicity to these priorities are expensive and ridden with fraud and error; and their systems of enforcement are slow, expensive, and uncertain. Such legal systems ensure that even property with a high market value has no economic value as collateral for loans.

Recent Policy Background

Multilateral development bank focus[1] on reforming ineffective systems of secured transactions began in the early 1990s with the about simultaneous efforts of the European Bank for Reconstruction and Development, as an institution, and by individual staff of the World Bank and the Inter-American Development Bank.

In the mid-1990s the question of whether the World Bank and the International Monetary Fund should play a larger role in limiting international financial disturbances was raised in a series of preliminary G-5 reports. It arose more formally at the 1995 Halifax meetings of the G-7 in response, largely, to events in Mexico. This concern took more concrete and specific form in the G-7 meetings in Washington in April of 1998 concerning the spreading financial crises in developing countries.

G-22, Working Party 3

These G-7 consultations produced the meeting of the G-22, Working Party 3, which issued the "Report of the Working Group on International Financial Crises". That report was signed by representatives of the finance ministries of all G-7 shareholders in the Bank and the Fund, as well as those of several borrowing country members: Mexico, Argentina, Brazil, South Africa, Thailand, and Korea.

"Immediate Steps"

The report concludes with recommendations for "Immediate Steps". The first of these recommendations "endorses the key principles and features of effective insolvency and debtor-creditor regimes contained in Annexes A and B." Annex B goes on to describe, briefly and accurately, how effective debt collection laws require effective systems for creation, priority, publicity, and enforcement of security interests.

In this report, WP3 of the G-22, acting for the shareholders, instructs the Bank and Fund to act as agents in this reform.

Was this good advice? What have the Bank and Fund done? The remainder of this note answers those questions in the context of the economic impact of secured transactions reform on important classes of Bank and Fund operations.

Secured Transactions -- Links to Bank and Fund Programs

The legal framework for secured transactions underlies, in key ways, the effectiveness of many reforms proposed by the Bank and the Fund.

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Microcredit

The Bank has taken an important lead in developing microcredit lending, an innovation in unsecured lending that has proven an effective conduit for credit in many countries, especially for reaching the poor and women.

However, where do microcredit lenders get the funds that they lend? As the deposits of their largely impoverished members are usually insufficient, these lenders remain perilously dependent on government grants and donor resources.

A good framework for secured transactions could solve this problem, however. Such a framework would permit microlenders to offer their often-excellent portfolios as collateral for loans. Then large formal sector lenders could create a security interest in the loan portfolios of the microcredit institution. Refinanced with such loans, microcredit lenders could reduce dependency on fickle donors, fiscally-strapped governments, and expensive deposit-mobilization. Instead, they could finance their operations in the same way as do unsecured lenders such as American Express, MBNA, and Diners Club. These companies, operating in the framework of modern U.S. laws, readily finance their portfolios of small unsecured loans at rates close to bank wholesale lending rates.

However, in every country where the Bank has supported microcredit operations, the current legal framework makes this transaction economically impossible. Sometimes, the law does not recognize taking loan portfolios as collateral. Sometime, the law permits the transaction in a way that makes it too costly or does not adequately address risk. Often, unreformed law requires a transfer of the portfolio to the formal sector lender under the laws on the assignment of rights. However, then the formal sector lender must take a position directly against the individual small borrower; most large lenders do not want this. Government officials responsible for laws and the microlenders themselves are typically unaware of how the law prevents this transaction. Microcredit literature rants about conservative banks that want collateral and will not refinance them, rarely recognizing that banks are bound by the same laws as the microcreditors -- laws that do not envision exactly the transaction sought by the microcredit lenders.

Nonetheless, no Bank microcredit operation has supported the reform of this legal framework; or supported even the research on what legal changes would be needed in a borrowing member's law to permit financing small portfolios of unsecured loans with legal security and in an economically feasible way. In Bangladesh and Bolivia, the countries most often cited for developing microfinance, the Bank has produced reports carefully analyzing how their laws prevent such portfolios from serving as collateral. But the Bank has designed no subsequent operations to address that problem in either country. Nor, in either country, has the Fund included the desirability of such a reform in its Article IV consultation or made such a reform a condition on any drawing on Fund resources.

Microenterprise and SMEs

The World Bank strongly supports microenterprises and SMEs. It has supported billions of dollars in credit lines and technical support operations aimed at stimulating the development of these enterprises and promoting loans to them by the private sector

However, firms of that size typically have only movable property as assets: for example, tools, restaurant equipment, shelves for stores, inventories, accounts receivables, or equipment for construction and manufacturing. These small enterprises often operate out of rented real estate. They have no real estate assets at all on their balance sheets.

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Firms that own no real estate, however, obviously cannot offer anything as collateral in legal systems that, effectively, envision using only real estate as collateral. The persistent complaint that private lenders demand collateral that these borrowers cannot offer is not surprising: rather, their unreformed laws guarantee this outcome. Though these Bank-funded credit lines aim at creating sustained private sector lending support for these enterprises, they cannot succeed. The private sector will never willingly make such loans because the law determines that the collateral underlying those loans has no economic value.

Despite this, no Bank microenterprise or SME credit line operation has supported a change in these laws, or provided for preparing a strategy for ultimately passing such a law that could be drawn on by other Bank and Fund operations, donors, or the citizens and governments of the borrowing member countries themselves.

Privatization

Privatization of state-owned enterprises represents a major source of improvement in efficiency in most developing countries. In the countries of Eastern Europe and the Former Soviet Union, and other socialist countries, of course, privatization has revolutionary economic and political implications. Bank and Fund operations have lent billions of dollars supporting privatization.

Such programs are studded with financial peril. No longer owned by the state, these production units can no longer automatically offer sovereign guarantees for their loans. At the same time, the unreformed legal framework in which they operate ensures that their movable property cannot serve as collateral for private sector loans and that they cannot purchase equipment from the private sector on credit. Even where their real estate can serve as collateral, their demand for credit for movable property may represent 80 percent or more of their overall financial needs. Their real estate will not suffice. And, of course, in the countries in transition, most of their real estate cannot serve as collateral for loans either.

Despite this, no Bank privatization program has proposed a legal reform that would permit the property owned by these firms to serve as collateral for private loans. Bank operations that identify funding as a problem repeatedly fund "transitional" state-run loan or loan-guarantee systems, aggravating the problem of the "soft budget constraint." Bank operations that do not address funding at all simply leave these firms struggling for investment funds to stay alive. Those that save themselves typically do so by establishing close personal ties with commercial banks. These ties permit larger amounts of, effectively, unsecured lending. These close relations between borrower and lender, however, undermine attempts by bank supervision and regulation operations to control related-party lending.

Land titling

Land titling can give land occupants more certain rights to land. More certain rights to the use of land encourage occupants to invest more in improvements and lose less time guarding their property. Drawing on its pioneering work in Thailand, the World Bank has supported billions of dollars in land titling projects.

However, most land titling projects have little impact on access to credit. Many important land-use rights and systems do not rest on title: examples include private and state-run cooperatives, customary land systems common in non-Western cultures, or leased land, whether private or public. Moreover, the secured transactions system, not the land titling system, governs the use of land as collateral for loans.

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Nonetheless, no Bank-supported land titling project has supported expanding the range of transferable land rights to include cooperatively-owned land, land leased from governments or private owners; or land in non-traditional holdings like state-run cooperatives or communal lands in the altiplano of the Andes. None has proposed fundamental reform of the mortgage law so that even titled land could better serve as collateral. At most, Bank projects computerize existing registries and import an American-model mortgage or trust law, with all the defects that system now contains. As a result, little of the real estate in these countries serves any better as collateral after the reform than before. The impact of the expensive land-titling project on access to credit is minimal. In a recent project in Ukraine, for example, the Bank remains committed to a western-type fee-simple-title/mortgage system, even though virtually none of the real estate in Ukraine would qualify at present as collateral for a loan under such a system. Bank-supported land titling projects in Guatemala, Romania, Central America, Bolivia and Viet Nam ignore the advantages of Civil Code concepts of property rights in land and reproduce, at enormous expense, complex land mapping and titling systems imported from common law countries. Many of these systems are considered unaffordable even in wealthy US jurisdictions. No Bank-supported land titling project responds to these issues. The Fund, despite often-expressed concerns about the inflation of real estate collateral values in credit expansions in borrowing member countries, has never expressed in conditions or Article IV consultations support for programs to broaden the base of real estate collateral.

Housing and housing rehabilitation

About 1/3 of the world's capital stock is residential housing. Its creation and maintenance have a major bearing on the standard of living of a country. These arrangements immediately affect the welfare of the poor, a key target group for Bank and, increasingly, Fund programs. To improve housing, the Bank has lent billions.

A poor framework for secured lending, however, severely undermines efforts to improve the housing stock. Under most legal systems, small properties cannot serve as collateral because of the high costs of creating a mortgage or other security interest. Consequently, these properties cannot be purchased on credit and they cannot serve as collateral for improvements to the property. Primitive legal systems restrict security interests in land to the mortgage, which, in turn restricts security interests to titled land. Other property -- leasehold, cooperatively owned property, other use rights -- cannot serve as collateral in these systems. Modern low-cost housing techniques, such as prefabricated housing and mobile homes, cannot be financed under traditional legal systems. In some systems they cannot serve as collateral at all. In other systems, the law sets out inconsistent provisions for the priority of claims against such collateral once it is affixed to the land. Bank-funded projects for renovation of housing suffer because the law treats property improvements -- fixtures such as furnaces, air conditioners, elevators -- as part of the real estate and subject to encumbrances on the underlying real estate. This makes private financing of improvements to housing impossible or very expensive, as it involves refinancing of the first mortgage.

Despite this, no World Bank-supported housing operation has proposed changes in the laws governing private lending for these investments; or provided for a study of such laws to give a government, concerned NGOs or other Bank task managers a road map or strategy for future required reform.

Technology and training

The World Bank has the world's leading program for improving intellectual property rights and expanding computer and Internet literacy. It has supported many innovative programs in this area.

However, the assets of a modern information technology company are nearly entirely personal (movable or intangible) property: patents, copyrights, computers, communication equipment, intellectual property, or accounts receivable. Real estate counts for little in the assets of these firms.

Unfortunately, none of this personal property can serve as collateral under the legal frameworks for most developing countries. Companies like Amazon or Yahoo could never be financed in Bank borrowing-member countries.

Nonetheless, no Bank lending operation supporting these technologies has ever recommended the appropriate change in laws; or supported creation of a roadmap to proper reform. No Bank document would inform an interested government or a local organizations such as a Chamber of Commerce about what changes in laws are necessary to permit the financing of activities key to building modern private information services in their economy.

Financial sector regulation

The financial sector is the economic brain of a country. When it functions well, it moves resources from savers to the investors with the best and, therefore, the most growth enhancing investment opportunities. When it functions badly, banking systems become decapitalized, asset price bubbles create huge risks in credit expansion, and state-run banks and guarantee programs run up losses sometimes in double digit shares of GDP. All this leads to misallocation of lending and long periods of low growth that jeopardize international financial stability and aggravate poverty.

Not surprisingly, the Bank has lent billions of dollars to support financial sector reform. The Fund typically places conditions on financial sector reform on multi-billion dollar drawings on the Funds resources. For many countries, the Bank and the Fund collaborate on Financial Sector Assessment Plans (FSAPS) to spell out key problems and discuss options for reform.

A good framework for secured transactions plays a key role in developing an effective financial sector.

✍ *Bank supervision and regulation*

Reform of the law of secured transactions is central to building sound bank supervision and regulation. A bank is an engine for transforming deposits into loans. How do you supervise a banking system where the legal framework does not support debt collection? The supervision manual could be very short, one line perhaps: "Don't lend." In such legal systems, a good Sup&Reg operation will usually reduce access to credit. Of course, these reform operations can create the appearance of good supervision and regulation system. They can do this by writing up the equivalent of the Federal Reserve Commercial Bank Examination Manual. But it is not possible to read even ten pages of that 1238 page document without seeing a reference to "collateral": its proper treatment, its proper valuation, how the loan officer should inspect it, and the collateral requirements for asset-backed finance, to name a few.

Such a supervision and regulation system has little relevance in countries where an inadequate legal framework prevents most property from serving as collateral. In most unreformed economies, none of its the movable property (about 1/3 of the capital stock) can serve as collateral and only a fraction of the real estate (about 2/3 of the capital stock) can serve as collateral. In some of these countries, bank supervisors classify "personal guarantees" as a third type of collateral, even though well-regulated systems would correctly discard this classification and treat loans with a personal guarantee as just another name for an unsecured loan and so classify them.

Real estate bubbles

Most recent financial crises have included extraordinary asset price inflation – real estate prices driven to fantastic heights by credit expansion. The cases of Korea, Japan, Thailand, Indonesia, and the Philippines have been studied extensively in the "bubble literature". These reports document the cycle of how rises in property values fuel further increases in mortgage-based lending. This lending further drives up property values.

The problem of asset inflation is enormously aggravated by a poor legal framework for secured transactions. Where that legal framework is good, movable property, trading typically at world market prices, also serves as collateral. Domestic credit expansion will not drive up these asset prices because their prices are set in world markets too large to be influenced by one country's credit policies. Similarly, in a well-designed legal framework, all the real estate can serve as collateral, not just large pieces of titled urban real estate.

Real estate is the most untradeable good a country possesses. If only part of it can serve as collateral -- titled urban real estate -- it is no surprise that its price in domestic currency moves up and down sharply with changes in domestic credit.

State banks and state loan guarantee systems.

Attempting to solve the problem of enormous unmet needs for credit, government-run banks and loan guarantee systems were set up in most developing countries between 1960 and 1990. These state-run programs face two broad problems. First, as government institutions, their incentives to collect their loans are weakened by political interference and inefficiency. Second, these public banks face a weak framework for collecting debts but, nonetheless, accept collateral that most private lenders refuse. Whatever the books said, most of the loans they made were effectively unsecured.

These ventures, supported with World Bank loans, lost billions of dollars. Covering these losses became a burden on state budgets, sometimes absorbing double-digit shares of GDP.

Commendably, World Bank and Fund programs now aim at closing down these institutions and transferring this lending task to the more vigilant private sector.

Unfortunately, the private sector will not lend to the groups previously served by the state lenders. The weak framework for debt collection makes such loans uncollectable. This leaves developing country governments in an enormous policy conundrum. While these state-run programs made most of the bad loans, they also accounted for most of the credit reaching to key political groups with enormous credit needs -- farmers, small businesses, and industry. These needs could have been met by the private sector had the legal framework for secured lending worked. However, the legal framework was not reformed. The consequence? Governments face constant political pressure to reinstitute these unsustainable state-run banks and state guarantee programs.

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Despite this, few Bank or Fund financial sector operations support the reform of the laws of secured transactions and related laws and infrastructure necessary to end this dependence of key sectors on state-run banks. Insolvent state banks and state guarantee funds, therefore, emerge every few years as major budgetary problems, undermining Bank and Fund proposed macroeconomic adjustment programs. In Uruguay, Brazil, and Argentina recent Bank operations refinanced bankrupt state lenders without suggesting changing the laws that make it impossible for them to collect their loans. In Bolivia, Bank-supported operations refinance a bankrupt banking system without supporting changing laws identified more than ten years ago in Bank reports as blocking debt collection. For Argentina and Uruguay, the Bank has had for years reports documenting the failures in the debt collection system and explaining the links between the law and the failures of the state and the private banking system. These same publications are available to the Fund. Yet Fund conditionality and consultations bless refinancing the state lenders and suggest no alternative path for these countries.

✍ Structure of the financial sector

A good framework for secured transactions improves the overall stability of the financial sector in several ways. First, it reduces dependence on banks. Non-bank financial intermediaries can expand because the reformed framework provides a way to raise funds even though they do not take deposits. By using their accounts receivable and chattel paper as collateral for loans, they can refinance and expand. Non-bank financial intermediaries account for about 60 percent of US credit. In most developing countries, such intermediaries account for less than 5 percent of total credit. Financial sector stability improves because the larger non-bank sector reduces reliance on the ever-fragile banking systems. Moreover, this diversification in credit suppliers -- both financial and non-financial -- allows specialized lenders to supply credit at lower risk, especially to target Bank borrowers such as the poor or those in rural areas.

A good framework for secured transactions also plays a large role in developing capital markets, as all securitizations depend in key ways on the legal framework for collateral. "Asset backed financing" literally means using assets as collateral for financial instruments.

Bottom Line

The G-5 and, ultimately, the G-22 thought the reform of secured transactions was a fundamental reform -- necessary for the success of key Bank and Fund operations and essential for advancing world financial stabilization. The G-22 instructed the Bank and the Fund to implement such a reform. We now approach the fifth anniversary of that instruction. Where do we stand?

The heavy lifting in the Bank and the Fund is done through their operations -- loans and negotiated agreements -- not through their short notes, research papers, conferences, statements of principles, or publicity documents. The strongest support the Bank can give to a reform of the law of secured transactions arises when it makes passage of the law a condition of tranche release on an adjustment operation. The Bank has done this on adjustment operations for Romania, Ukraine, and Slovakia. For the Fund, conditionality on drawings plays a similar role. A condition on the reform of secured transactions has been set for Bulgaria and, with reservations, Mexico. IMF Article IV consultations set out important but not binding actions in their Letters of Intent and Memoranda of Understanding. In these IMF documents, the reform of secured transactions

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is mentioned as desirable for Honduras, Bosnia-Herzegovina, and Armenia.

Bank-supported reports have documented problems in the frameworks for secured transactions in Viet Nam, Jamaica, Bangladesh, Argentina, Colombia, Uruguay, Bolivia, Peru, Uzbekistan, and Bulgaria. In these countries the Bank has supported no further work in reforming the laws identified as responsible for these problems. In a few other countries, such as Guatemala and Nicaragua, the Bank has supported drafting laws of secured transactions and then supported no further work in the reform.

In a closely related area, Bank and Fund-supported banking laws, with no particular pattern, sometimes regulate deposit-taking institution and sometimes regulate all lending institutions. When poorly drafted, the latter strategy can cripple the growth of the non-bank financial sector. In Ukraine, Bank-proposed legislation needlessly controls non-bank leasing operations; in Romania, until derogated by the Bank-supported secured transactions law, the Fund-supported banking legislation subjected agents such as fertilizer vendors and tractor dealers to the norms of the bank Superintendency when they sold on credit.

Students of bureaucracy will see in the odd mosaic of countries -- never representing an entire division or department -- and in the large amount of dropped work, evidence that this reform enjoys no support in the Bank or the Fund at the Division Chief or Department Director level. That certain topical areas and regions completely ignore this reform shows that this reform lacks support in Bank and Fund topical central units, such as those for research, financial sector, microcredit and infrastructure. That the Bank and the Fund set conditions on completely different counties and mention them in almost-random Letters of Intent, FSAPs and Country Strategy Papers shows that this reform is not supported or coordinated at any high level in either the Bank or the Fund.

Supporters of this reform, therefore, owe great thanks to these few task managers in the Bank and the Fund who sponsored the work set out above: nothing is so lonely in the Bank and the Fund as pushing forward a reform that senior management finds unworthy of including in the program of any other country or any other sector.

In the end, however, this management inattention by the Bank and the Fund management has worsened performance in a wide range of otherwise useful Bank and Fund-supported programs. It has needlessly endangered the guarantees and funds of lending-member shareholders. This inattention has left unreformed the basic debt collection systems of every important country in the world that has had a financial crisis: Argentina, Mexico[2], Brazil, Thailand, Indonesia, Philippines, Korea and Russia. It has left unreformed the basic systems of smaller financial hot spots and larger impending problems: Guatemala, Bolivia, Jamaica, China, India, and Pakistan. It has left Africa untouched.

Next Steps?

Gathered here, as we are, in this enormous and elegant building complex, and supplied as we are with copious publications from these institutions together with public comment on that information, it is easy to misjudge the size and importance of different agents. The Bank's annual gross disbursements range between \$10 billion and \$20 billion and those of the IMF typically fall just short of \$35 billion. Their net disbursements are less.

These large numbers, however, pale beside the Gross Domestic Investment of the world's developing countries: about \$2 trillion. This investment is required annually to achieve the unambitious objective of maintaining, relative to advanced countries, their present low

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incomes and standards of living. Large as the Bank and the Fund loom in the public's perception of the development community, therefore, their resources cover less than one percent of the investment needs of developing countries.

Such small amounts of resource transfer by the Bank and the Fund can only have an important effect when they are linked with well-designed programs that change fundamentally the underlying laws and institutions that face the private sector. Only private sector credit can finance these investment needs, and the private sector needs an effective framework for secured transactions. Private lenders who cannot collect will not lend.

The G-22 was right to instruct the Bank and the Fund to address these problems in the world's legal frameworks for secured lending. This reform is now long overdue.

Heywood Fleisig is Director of Research at CEAL; Nuria de la Peña is Director of Legal Operations. These remarks were presented at the Global Forum on Insolvency Risk Management sponsored by the World Bank, January 28-29, 2003. The views expressed here need not reflect the views of other staff of the Center for the Economic Analysis of Law or of its Research Associates.

References: Bank and Fund documents referenced here are available at the following sites. IMF programs: http://www.imf.org/external/work.htm. IMF documents by country: http://www.imf.org/external/country/index.htm. IMF/World Bank Financial Sector Assessment Programs: http://www.imf.org/external/np/fsap/fsap.asp. World Bank documents and reports by country: http://www-wds.worldbank.org/navigation.jsp?pcont=browcon. World Bank loans and credits by country: http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,menuPK:34471~pagePK:34396~piPK:34442~theSitePK:4607,00.html. The Federal Reserve Commercial Bank Examination Manual: http://www.federalreserve.gov/boarddocs/supmanual/cbem/0211cbem.pdf. The paper by the former President of the Federal Reserve Bank of New York discusses the "myth" of reforming bank supervision and regulation without fixing the underlying laws and legal institutions. See Gerald Corrigan, Building Effective Banking Systems in Latin America and the Caribbean (Washington, DC: Inter-American Development Bank, May 1997). http://www.iadb.org/sds/doc/ifm%2D107e.pdf. This paper had strong influence on the early G-5 deliberations (Draghi Committee) and G-7 recommendations for further action. The New York Federal Reserve District has more supervisory responsibilities than do most countries. The G-22 report, **Report of the Working Group on International Financial Crises** can be found, among other places, on the IMF's website: http://www.imf.org/external/np/g22/ifcrep.pdf. Publications setting out a variety of issues concerning legal reform for secured transactions and its economic impact can be found at www.ceal.org.

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[1] Improving the system for using property as collateral has preoccupied policymakers and scholars for several thousand years. Hundreds of articles appear in law journals concerning aspects of this system. Their number rises sharply after the US reform of the 1950s. The economic literature begins in the 1960s and builds in the 1980s and 1990s.

[2] Mexico reappears on this list because the Article IV consultation that discusses Mexico specifies a legal reform that, by the logic described therein, could have no economic effect. The economic ineffectiveness of the Mexican reform was confirmed in the public presentation of the supervisor of that reform at the Inter-American Development Bank's Microcredit Summit in Rio de Janeiro, September 2002. Finally, according to the 2001 report to Congress of the US Executive Director to the Fund, the condition on Mexico was placed specifically at his request.

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Breakout Session:

Economic Governance in Post-Conflict States: Lessons from Afghanistan and Iraq

Over the last decade, USAID has been deeply involved in helping post-conflict states such as Kosovo, East Timor, Afghanistan, and Iraq rebuild basic systems of economic governance. This session will feature lessons learned from efforts to re-establish the laws, regulations, and institutions needed for viable financial, fiscal, and trade sectors, and for successful microfinance operations. Hear first hand about the challenges of restoring systems of economic governance in Afghanistan and Iraq from some of the key players in these efforts.

Presenters:

- Steve Lewarne, The Services Group
- Fran Greaney, BearingPoint
- Mayada El-Zoghbi, Global Microenterprise Initiatives LLC

June 28, 2004

The Role of Economic Governance in Post Conflict Economies: Iraq and the CPA

Stephen Lewarne, Senior Vice-President
The Services Group

- Brief overview of the Iraqi Economy
- Basic Economic Governance Issues in a War-Torn Economy
- What will the CPA leave the New Iraqi Government on June 30
- Evaluation of the CPA structure for Good Economic Governance and a stable Investment Environment
- The New Iraqi Regime and Investor Confidence
- Avoiding the Dutch Disease

Brief Overview of the Iraqi Economy

- Baathist Seized Power between 1968-1979
  - –Nationalized the Oil Sector (Iraqi National Oil Company)
  - –Nationalized the Financial Sector
- 1979 Iraq Reported the Highest Per Capita GDP in the Region
- 1980-1988 Iran-Iraq War
- 1989 Year of Reconstruction and "Nominal" Privatization
- 1990-Mid-2003 Gulf War and Sanctions
- 1996 Oil for Food UN Program Begins
- 1997 Iraq reports living standards well below pre-Gulf War levels
- March 2003 Coalition Provisional Authority Takes Over

- Iraq is a national entity, with established membership in international organizations (IMF, WB, UN)
- Unlike Kosovo, Bosnia, East Timor, or Afghanistan, Iraq has had a nationwide civil administration that administered an economy roughly on par with the rest of the oil rich Middle East
- The Civil Administration needs some rebuilding but not a major reconstruction (as it did in Kosovo, Bosnia, Afghanistan and East Timor)
- Human capital is qualitatively above that of other post-conflict economies and on a par with the rest of the middle east
- The Humanitarian crisis in Iraq (housing and food shortages) due to its linkages to the UN and other international agencies have largely been avoided—unlike Kosovo's large refugee problem and Afghanistan's inaccessibility issues
- However there was little to no time to engage the NGOs and UN network prior to invasion—weakening the initial rebuilding effort

- Current production of 2 million bpd (back to pre-war levels). Pre-1991 production capacity was 3.5 million bpd
- 112 billion barrels in proven reserves (second to Saudi Arabia) 45-100 billion in potential reserves
- Very low production costs (when it's safe to go to the oil field)
- 110 trillion cubic feet of gas (which is on a par with Turkmenistan)
- Iraq's upstream and downstream oil and gas infrastructure is outdated and requires a sizable investment in repair, rehabilitation, and upgrading (this will be the main destination of FDI).
- In addition, large-scale investment is required to develop dozens of oil fields that have been identified and appraised, but are as yet undeveloped
- Oil sales have already established a large reserve at the Central Bank of Iraq and in the Development Fund
- Budget revenue estimates for 2004 were calculated to 2006 assuming a $21/bbl – oil prices appear to be double that for now –we note that the oil price is volatile

- Labor force is approximately 6.5 million
- Unemployment is around 50% or at a level of 3.25 million people.
- GDP growth is probably negative offset only slightly by an increase in trade.
- GDP per capita, while difficult to measure at this point is probably around $700-900
- Agricultural production used to be 25% of GDP but has crashed
- OFF (which is a subsidy to foreign food producers) has crushed domestic production incentives
- The CPA Budget estimates that $3.3 billion will be required for recovery in Agriculture alone—there is only $2.4 billion available for Agriculture (largely from oil sales)
- The World Bank will have make up the $1.2 billion difference

- Poor FDI performance is a function of economic governance and its institutions—having oil helps but less than you might think
- The Economic and Social Commission for Western Asia (ESCWA) figures show that the region's small share of world FDI diminished to 0.16% in 2001
- The region's share of FDI to developing countries has also shrunk to just 0.58%.
- The causes of the region's poor performance in attracting FDI are widely attributed to:
  - Unpredictable macroeconomic conditions and public policy choices
  - Regional instability and the structural weaknesses of regional economies
  - Inadequate availability of a skilled and flexible workforce
  - Weak institutions
  - High administrative barriers
  - Inadequate infrastructure
  - Underdeveloped financial sectors

- In the next 3-5 years, the main determinant of a good investment environment in Iraq will be the economic Governance regime it adopts after June 30 and the way in which the new Iraqi regime conducts its economic governance
- Establishing a sound economic governance regime will encompass the obvious investment climate issue of a foreign investment law, low administrative barriers, comprehensive commercial law system, and open trade
- However, in addition especially in the initial phase during reconstruction serious attention will have to be paid to the institutions of fiscal and monetary policy, as well as the legal and regulatory regime and trade
- Central to this will be both the comprehensiveness of the regime left in place after June 30/04 as well as the credibility of the transitional and new regime to uphold these new or reformed institutions

Basic Economic Governance Issues in a War-Torn Economy

- Monetary Reforms and Standards implemented or supported
- Fiscal Policy (Budget preparation and execution, treasury management, public procurement mechanism etc.) need to be started early and comprehensively
- Administrative, legal and regulatory reforms need to be started immediately
- Trade Reform: International integration started early
- Privatization, while nearly always necessary, needs to be considered carefully so as to obtain the proper mix and pace of reforms (i.e. just because its "public" does not mean i) its bad ii) cannot benefit from foreign investment)
- Dutch Disease Issues: Attention must be given to long-term implications if the economy will rely on the export of oil (or other natural wealth)

- Establish or immediately support a Central Bank Structure (or Banking and Payments Authority)
- Introduce a stable currency
  - –This allows households to focus on productive activity and lower search costs.
    - [illegible]
    - [illegible]
- Introduce an intervention mechanism to sterilize the inflow of donor monies and control inflation
  - –This was done very effectively in Afghanistan and in Iraq, in both places it was crucial to maintaining purchasing power during the introduction of a new currency
- Soon after central bank functions established, undertake commercial banking operations diagnostics followed by bank supervision and regulation capacity—encourage the application of foreign banks if politically feasible

- **Establish or support the Ministry of Finance immediately to show the Donor community a transparent use of funds**
  - For many reconstructing economies transparency in the use of funds is the only way to guarantee a smooth review by Donors
- **Set up the ability to prepare and execute a budget—focus on budget execution as much as preparation**
  - execution is usually much more problematic than preparation in war-torn economies
  - This was done well in Kosovo, Montenegro, and Afghanistan. Iraq focused more on budget preparation immediately to the detriment of the process
- **Set up a Financial Management Information System (FMIS)**
  - This was an immediate strength in the Afghan reforms learned from the Kosovo reconstruction
- **Insist that any capital construction programs pushed by individual donors be run through the Fiscal Authority so that there is not a separation of the current and capital budget**
  - This was one of the main mistakes made by the European Agency for Reconstructions (EAR) and UNMIK in Kosovo and one of the strengths of the National Development Framework (NDF) in Afghanistan under Minister Ghani
- **Immediately tackle the internal and external debt issue (particularly what will be honored how and when)**

- **Focus Immediately on the Problem of Administrative Barriers (either to remove existing barriers or start off correctly)**
  - This will allow both internal and external trade to flow to its best uses and lower the implicit costs of investment
- **Establish a Legal and Regulatory Regime that emphasizes international standards. Specifically the introduction of:**
  - Bankruptcy Legislation
  - Labor Law
  - Company Law
  - Competition Law
  - Consumer Protection Law
  - Securities Law
  - Foreign Investment Law
  - Property Rights Laws

- **Strengthen capacity at the Ministry of Trade to formulate WTO Compliant trade policy**
- **Revive or put in place bilateral and multilateral trade agreements to provide market access for exporters**
- **Resolve Administrative Barriers that relate to inward investment and allow for smooth functioning of businesses**
- **Establish industrial Zones to promote trade and investment**
- **Trade promotion, business service centers and create business associations**

Coalition Provisional Authority

What the CPA Will Leave the Iraqi Government on June 30

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- **The Coalition Provisional Authority put in place or revived several key institutions essential to recovery:**

  Monetary Stability
  - Rebuilt the Central Bank of Iraq
  - Introduced a new currency
  - Managed its introduction well (learning from mistakes made in Afghanistan)
  - Introduced the currency auctions to intervene in the currency market to stabilize the exchange rate and maintain purchasing power
  - Announced a managed float, trained CBI personnel to operate the exchange and intervened appropriately
- **Iraqi Bank Law issued 09/03**
- **The Central Bank of Iraq (CBI) announced that on March 1, 2004, it would fully liberalize interest rates on deposits, loans, credits, securities, and all other domestic financial instruments**

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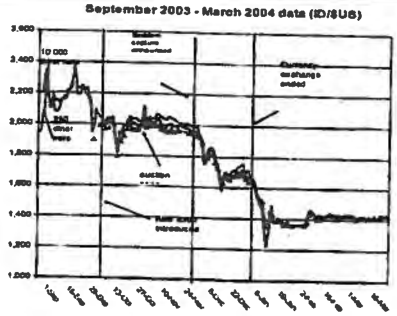
September 2003 - March 2004 data (ID/$US)



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- **Budget Planning.** A Budget passed by the CPA announcing both current and capital spending. A program that integrates all public revenues and expenditures has been started
- **Budget Execution**. A Financial Management Information System (FMIS) has been established
- **Tax Policy and Administration**. Tax Administration–particularly customs administration—has started, as has capacity building in administration
- **Intergovernmental Finance**. A municipal, regional and national financial framework established. This is still in process, but a plan has been submitted to the CPA based on international standards

- **Full consideration has been given to revenue sources:**
  - –Oil revenue is recognized to be some $20 billion by 2006 composing about 97% of revenues
  - –Reconstruction Levy is in place and will be phased out in 2005
  - –Personal income tax has been established at a low 15% maximum marginal rate
  - –Corporate income tax the same
  - –User Pay Charges have been introduced
  - –As have Excise Taxes, a "Hotel" Tax, Land Tax and others
- **Recognition is made in the Budget Documents of the danger of over-reliance on oil revenues.**

- **Expenditures are documented well but most importantly:**
  - –Capital Projects are included in the budget and detailed by Ministerial demands
  - –Contingency reserves are set aside (this will cover such things as underestimation of the real size of the subsidy represented by the Oil for Food Program, among other things)
  - –Foreign Obligations are also recognized, the original budget only has reparations to Kuwait—there are also a host of other domestic and international debt obligations which when honored will throw off large expenses
  - –However, Paris Club countries working with James Baker have reduced the total debt burden from $116 billion to $39 billion
  - –Local and regional government finance is built in.
  - –It has a policy on decreasing support for SOEs which employ over 500,000 people on an employed population of 3.25 million in a workforce of 6.5 million
  - –Special nation building capital expenses are recognized as are special economic reconstruction programs

- The CPA has completed or is completing the full complement of Commercial Legislation
  - Foreign Investment Law
  - Bankruptcy Legislation
  - Labor Law
  - Company Law
  - Competition Law
  - Consumer Protection Law
  - Securities Law
  - Property Rights Laws
- The way the laws are being issued may be an issue
- Some are done with appropriate consultation (bankruptcy—see below) others are likely to be imported model laws (competition policy)
- Imported model laws are not bad but they are only a starting point and require substantial domestic buy-in which is not guaranteed
- In addition a law requires implementing instructions and precedent—meaning the task of legal and regulatory reform is an iterative process—before investors believe them credible

- **Preparation of Bankruptcy Legislation**
  - This was gone about in a consultative and thoughtful way for Iraq
  - A group of Iraqi lawyers and foreign consultants worked on the amendments to the old bankruptcy law and circulated them among domestic and foreign agencies, including Iraqi bankers, judges and the World Bank.
  - One of the most important amendments to the law is a clarification that secured creditors will rank first in the distribution of assets of a bankrupt company.
  - Other amendments include softening punishments for managers of bankrupt companies -- which included imprisonment and prohibition from holding various jobs -- and encouraging negotiated work-outs between a debtor and its creditors.
  - A troubled company will have protection from its creditors while it negotiates a reorganization plan which the creditors can then vote on -- a process generally similar to the U.S. Chapter 11 bankruptcy procedure.
  - Under other amendments, Iraqi courts will be authorized to recognize cross-border bankruptcy procedures, for instance when a multinational company working in Iraq gets into financial trouble.

- **1984 Customs Law is upheld with revisions**
- **CPA Order No. 54 on Trade Liberalization issued 02/04:**
  - Customs, tariffs, duties and import taxes suspended until the new Iraqi Government comes into effect (this extends the original June/03 Policy)
  - Updates parts of the 1984 Customs Law—particularly in customs valuation (largely to accommodate the Reconstruction Levy)
- **Trade Bank of Iraq set up to facilitate the import and export of goods and services (CPA Order No. 20)**
  - The Trade Bank of Iraq has issued over $175 million in letters of credit to international suppliers in order for ministries to import essential goods and equipment. There are over $120 million more in letters of credit pending issuance. [To put this in perspective $295 million is roughly half the value of the 2004 budget deficit or double the needs for housing reconstruction]
- **WTO Approved Iraq's request for observer status in February/04**

Evaluation of the CPA Structure for Good Economic Governance and a Stable Investment Environment

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- **Monetary Policy—Good**
- **Fiscal Regime—Good but some concerns**
  - Need better assurance that the current and capital budget will be run through the Ministry of Finance
  - All Donor Money has to go through one conduit that is part of the budget construction process
  - Iraq, despite its oil wealth will not have the luxury of a current budget being able to finance large white elephant capital projects
  - It is not clear the 15% maximum marginal rate will be kept in place by a new regime
  - Has a full accounting for the unfunded pension liabilities been undertaken and do we know the extent of the all the social safety net requirements in war-torn Iraq? To not have a grasp on this soon will erode confidence in a sound fiscal budget over the long-run
- **Conservative estimates of the oil price going forward was used to draw up revenue projections**

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- **The legal regime appears consistent and comprehensive (i.e. they have not left anything glaring out) but judicial enforcement is the real issue going forward**
- **An investor Roadmap to "look behind" the reality of and the traction gained of the CPA Legal Regime will be necessary after June 30**
- **Trade Regime will need to be enhanced to meet WTO Accession Standards—this is not impossible but it will take time and considerable capacity building**

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The New Iraqi Regime and Investor Confidence

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- A Transitional Government will come into effect June 30
- This will be replaced by a "permanent" government January 2005
- Will the transitional and the permanent government maintain the same economic governance and investment laws and regulations the CPA has introduced?
- How long will it be before private investors have confidence the economic and investment environment is stable?

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- This matters crucially in the next 5-10 years as Iraq gets its petroleum and agricultural sectors back up and running
- Importantly FDI into the oil sector will not likely be an issue (Angola's FDI remained very high at around $1.1 billion in the middle of its civil war) but the oil sector is not labor intensive
- The stability of the economic governance regime will depend also on the health of the non-oil sector – since it is much more labor intensive than the oil sector
- Thus if confidence in what the CPA has left in place is not instilled quickly then unemployment could remain at around 50%—meaning continued problems

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Avoiding the Dutch Disease

Huge oil wealth brings with it large foreign exchange earnings and the majority of economic activity in the capital intensive oil sector. This raises the value of the exchange rate making manufactured and agricultural goods for export less competitive with other nations—stifling job creation in the manufacturing and agriculture sectors. This in turn raises imports stifling the creation of jobs in import substituting activities. The non-oil sector then is unable to absorb the excess labor and so we are left with a very wealthy country that is no where near its full employment level. Governments tend to react by overly subsidizing the unemployed making it more difficult to lure them into the workforce which also stifles non-oil business formation. When there is a shock such as a decline in the oil price the pain of adjustment can be severe and for some time high unemployment and high inflation persist together (stagflation), as the lowering of subsidies (because the government has less income) force people into the workforce, and the relative costs of imports (which makes up much of the consumption basket) rise.

- Petroleum will dominate GDP for several years
- Petroleum will receive most of the FDI in years to come, and the industry has a steady cash flow to reinvest in its own capital reconstruction needs
- Agriculture on the other hand requires relatively more assistance for its reconstruction and has to contend with:
  - A decade of deterioration due to the Hussein regime's neglect, as well as property displacement among farmers that needs to be legally resolved
  - And more importantly, the presence of the OFF program has ruined domestic production incentives and artificially lowered prices
- It is going to take a substantial effort and considerable time to replace depreciated agricultural capital as well as settle land disputes.
- And it is taking more time than was originally anticipated by the CPA to monetize the OFF program converting it first from a subsidy to foreign food producers to domestic producers and then eliminating the need for subsidy through agricultural reconstruction

---

- The OFF program also covered non-agricultural production and procurement (some 75% was actually non-food) with similar incentive dampening and distortionary effects
- The manufacturing and services sectors are equally affected, and like agriculture, but unlike petroleum do not have a large and steady cash flow for their reconstruction
- Iraq therefore for the next 5-10 years will be a "one-crop" economy (in petroleum) while it attempts to rebuild the infrastructure in the other sectors

- The level of reconstruction required in Iraq will absorb nearly all of the foreign exchange—as they import substantial capital reconstruction materials to replace deteriorated industries and replace war damaged infrastructure
- If the reconstruction program is managed properly, the non-oil and gas sector will absorb substantial labor involved in the reconstruction process
- There will not be a great incentive in the initial years to misspend the money since its application to labor intensive reconstruction projects will be more or less obvious

- The problem will be in the out years
- What we must do now is insure that Iraq does not walk into Dutch Disease after reconstruction projects are completed and labor starts to seek alternative employment
- A program must be designed now for the education of the workforce such that it is more highly trained to provide services and possess up to date manufacturing skills
- The legal and regulatory environment must accommodate business formation and foreign investment
- Privatization must occur so that business entities exist to absorb labor as it comes off of reconstruction projects
- The Government must be disciplined enough to not spend the oil revenue on subsidies to the "unemployed"
- An Oil Fund should be created that will gradually receive increased contributions as reconstruction needs decline
- This will force fiscal discipline on the Iraqi government which will not receive funds directly from the sale of oil but from an income stream created by the oil fund.
- The Central Bank must learn to manage its reserves conservatively and be prepared to intervene on the currency markets to avoid any dramatic currency appreciation

Pro-Poor Growth

Thursday, July 1, 2004
9:00-10:30

Plenary Session

Pro-Poor Economic Growth and Key Interventions

Aart C. Kraay, Presenter
Umberto Lopez, Presenter
Don Sillers, Moderator

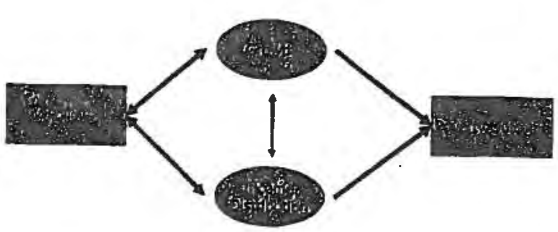
Pro poor growth: A review of what we know (...and of what we don't)

Humberto Lopez
(The World Bank, PRMPR)

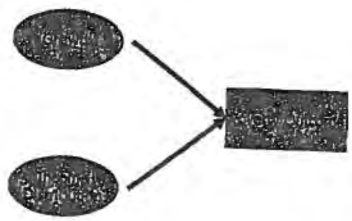
Plan of the presentation

- Poverty, growth and inequality
  - What is the relative importance of growth and inequality for poverty reduction?
  - What do we know about the sensitivity of poverty to growth?
- The relationship between growth and inequality
  - Does faster growth "per se" lead to more inequality?
  - Does less inequality "per se" lead to less growth?
- Policies and poverty
  - Is a pro growth strategy the best pro poor strategy?
  - Are there policies that present growth poverty trade offs?

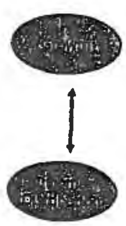
From policies to poverty...



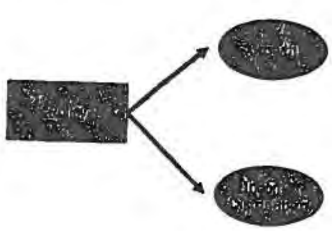
Some papers focus on the growth & distribution - poverty relationship



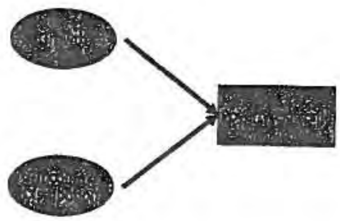
Others on the growth - inequality relationship



Finally, others on the impact of policies on growth and inequality



Poverty, growth and inequality



Poverty, growth and inequality

- We know that growth is good for poverty reduction
- We also know that growth accompanied by progressive distributional change is even better (at least if pc income is above the PL).
- But...
  - In practice, how important is each of these elements for poverty reduction?
  - What do we know about their determinants?
    - Impact of lower inequality on the growth elasticity of poverty

Relative importance of potential sources of poverty reduction

- Kraay (M 03) finds that:
  - About 40 percent in short-run changes in (HC) poverty can be explained by growth in average incomes.
  - In the medium- to long-run about 75 percent in (HC) poverty is due to growth in average incomes.
  - Cross country differences in the sensitivity of poverty to growth in average incomes (i.e. in the elasticity) are very small.
- This would suggest that
  - A policy package focusing on growth should be at the center of any pro poor growth strategy (at least if we adopt a long-run horizon)

The sensitivity of poverty to growth

- Ravallion (EL 97) focuses on how the growth elasticity of poverty is related to inequality:
  - **Changes in (HC) poverty=k(1-Gini)*growth**
- Ravallion (M 04) improves this (empirical) model but the basic message remains the same.
- This implies that the poverty reduction associated to a given growth rate is negatively related to the existing level of inequality:
  - For a given growth rate, more unequal countries will find it harder to reduce poverty.
  - Reducing poverty fast will require paying attention to distributional issues.

Do initial conditions matter?

- So far..
  - Growth matters (Kraay)
  - Inequality matters (Ravallion)
- But do each of them matter in some countries more than in others?
  - To answer this we assume that income follows a log-normal distribution (Bourguignon (M 02) finds that -at least for P0- this approximation seems to be extremely precise)
  - This assumption permits identifying precisely the contribution of growth and distributional change for poverty reduction as a function of level of development and initial inequality.

The sensitivity of poverty to growth (under log-normality)

		Growth	Elasticity	
PL* / Gini	0.3	0.4	0.5	0.6
0.16	-6.2	-3.3	-2	-1.2
0.33	-4	-2.2	-1.3	-0.9
0.5	-2.8	-1.6	-1	-0.7
0.66	-2.1	-1.2	-0.8	-0.5
0.9	-1.4	-0.9	-0.6	-0.4
1.1	-1	-0.7	-0.5	-0.4

		Inequality	Elasticity	
PL* / Gini	0.3	0.4	0.5	0.6
0.16	12.9	7.7	5.3	4
0.33	5.2	3.3	2.4	2
0.5	2.5	1.7	1.4	1.2
0.66	1.2	0.9	0.8	0.8
0.9	0.4	0.4	0.4	0.4
1.1	0.1	0.1	0.2	0.3

The importance of growth for poverty reduction

	Gini			
'ov. Line :	0.3	0.4	0.5	0.6
0.16	0.19	0.16	0.12	0.08
0.33	0.37	0.31	0.23	0.17
0.5	0.56	0.47	0.34	0.25
0.66	0.75	0.64	0.5	0.28
0.9	0.92	0.84	0.69	0.5
1.1	0.99	0.98	0.86	0.64

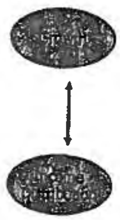
Some simulations...

	Scenario 1[a]			
PL[a] / Gini	0.3	0.4	0.5	0.6
16	-5.7	-2.2	-0.7	0.4
33	-6.8	-3.3	-1.5	-0.7
50	-5.9	-3.1	-1 6	-0.9
66	-5.1	-2.7	-1.6	-0.7
90	-3.8	-2.3	-1.4	-0.8
110	-2.9	-2	-1.3	-0.9
	Scenario 2[a]			
	0.3	0.4	0.5	0.6
16	-12.4	-6.6	-4	-2.4
33	-8	-4.4	-2.6	-1.8
50	-5.6	-3.2	-2	-1.4
66	-4.2	-2.4	-1.6	-1
90	-2.8	-1.8	-1.2	-0.8
110	-2	-1.4	-1	-0.8
	Difference			
	0.3	0.4	0.5	0.6
16	-6.7	-4.4	-3.3	-2.8
33	-1.2	-1.1	-1.1	-1.1
50	0.3	-0.1	-0.4	-0.5
66	0.9	0.3	0	-0.3
90	1	0.5	0.2	0
110	0.9	0.6	0.3	0.1

All in all...

- Growth is crucial for poverty reduction, but distributional change also matters.
- On the balance of pro growth and pro poor policies:
  - In countries with very low income, it will be difficult to achieve poverty reduction only through distributional change.
  - In contrast, in richer countries, redistribution can be effective.
  - In very unequal countries, the impact of a given growth rate on poverty reduction will be small.
  - In contrast in more equal countries, the impact of a given growth rate on poverty reduction will be more effective.
  - Finally, in very poor and very unequal countries..

The relationship between growth and income distribution



The relationship between growth and income distribution

- Impact of growth on income distribution
  - Technological change may lead to a rise in inequality through a shift in relative labor demand towards skilled labor.
  - But growth can also lead to an increase in the pool of skilled workers and therefore reduce inequality.
- Impact of inequality on growth
  - Investment indivisibilities or higher propensity to save in the rich may imply that inequality is good for growth.
  - Political economy, crime, or incentives to increase human capital considerations may imply that equality enhances growth.
- Impact of redistribution on growth
  - Incentive considerations may imply that redistribution negatively affects growth.
  - Capital markets imperfections considerations may however imply that redistribution positively affect growth.

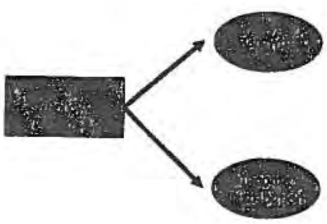
The relationship between growth and income distribution

- Impact of growth on income distribution
  - Dollar and Kraay (JEG 02) -no impact
  - Easterly (JEG 99) -no impact
  - Chen and Ravallion (WBER 97) -no impact
  - Deininger and Squire (WBER96) -no impact
- Impact of inequality on growth
  - Forbes (AER 00) -positive
  - Li and Zhou (RDE 98) -positive
  - Barro (JEG 00) -no impact
  - Alesina and Rodrik (QJE94) -negative
  - Perotti (JEG 96) -negative
- Impact of redistribution on growth
  - Easterly and Rebelo (JME 93) -pos tive
  - Perotti (JEG 96) -positive

Some implications...

- Lack of a trade off between growth and income distribution:
  - Standard growth enhancing policies should be at the center of poverty reduction strategies.
- Impact of inequality/redistribution and growth
  - We need to investigate this issue much more with theoretical and empirical work that evaluates the channels through which these variables are related
    - Political economy
    - Incentives
    - Capital market imperfections
    - Education and skills

Policies/institutions and poverty



Policies/institutions and poverty

- Probably the most interesting part of this debate both for policy makers and for operational staff.
- Unfortunately it is the weakest strand of the literature.
- Usually based on cross country regressions that have produced mixed results. Focus has been on:
  - Potential impact of policies/outcomes on growth and inequality.
  - Potential conflicts between the growth and the poverty impact of some policies.
  - Potential dynamics in poverty (different short and long run effects).

Policies and poverty

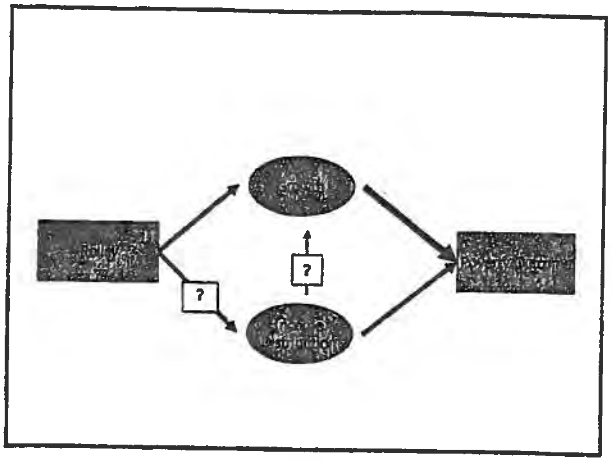
- Dollar and Kraay (JEG 02) and Kraay (M 03)
  - Find little evidence that relative incomes are correlated with standard explanatory variables used in the literature.
    - Implication: Adopt a pro growth package
- Barro (JEG 00), Li and Zhou (AEF 02), Lundberg and Squire (EJ 03) and Lopez (M 03)
  - Find some evidence (still weak) that some pro growth policies may negatively affect inequality (potential trade offs)
    - Implication: When adopting a pro growth package keep an eye on the possible impact on inequality (at least in the short run).

Policies and inequality

	B(2000)	D&K(200	L&Z(2002	K(2003)	L&S(2003	L(2004)
Better Education	+		+		+	+
More Trade	-	+	0	0	-	-
More Financial. Devel.		-	+		0	-
Less Government Spending		+	-	0		-
Better Rule of Law	+	+		0		
Lower Inflation		+	+		+	+

Summing up...

- There seems to be some consensus in a few areas:
  - Growth is fundamental for poverty reduction, and in principle growth "as such" does not affect inequality.
  - Growth accompanied by progressive distributional change is even better than growth alone.
  - The level of development and the level of inequality of a given country should be taken into account when designing poverty reduction strategies.
  - Better education and lower inflation are typically associated with lower poverty.
- But beyond that there seems to be little else:
  - The role of inequality seems more significant in the short run.
  - We know very little about the potential impact of initial inequality levels and redistribution on growth
  - There may be some policies that present growth-inequality trade offs, but admittedly we know very little regarding about the potential impact of policies on inequality



Thursday, July 1, 2004
10:45-12:15

Plenary Session

Role of Agriculture in Poverty Reduction & Growth

John Mellor, Presenter
Thomas, Moderator

A Mixed Blessing: natural resources and development

USAID Workshop:
Promoting Economic Growth in a New Era
July 1, 2004

Open Society Institute

What some call "black gold", others have called...

- The resource curse
- The paradox of plenty
- Flawed prosperity
- Economic indigestion
- The devil's excrement

The record of oil exporting countries

- Lower economic growth
- Poor performance on human development
- Poor governance and corruption
- Militarization, human rights abuses, violent conflict

Economic Causes of the "Resource Curse"

- Dutch Disease
- Underemployment
- Commodity Price Shocks
- Deplete-able source of wealth

Political Causes of the "Resource Curse"

Legitimacy gained not by votes but by spending

→ *Resource windfalls prompt spending sprees:*

- Spending guided by patronage, not profitability
- Corruption
- Waste and delays
- Inflation
- Debt

Opportunities for USAID engagement

- Timing: outside influence wanes as resource revenues grow
- Encourage and assist countries to report their petroleum/mining revenues
- TA on best practices in expenditure planning and oversight
- Educate civil society on budgets

Fiscal Management in Oil-Producing Countries

Presentation to USAID Workshop
"Promoting Economic Growth in a New Era"
Washington, D.C.—July 2004

Rolando Ossowski
Fiscal Affairs Department
International Monetary Fund

Outline

- Challenges posed by oil revenue in oil-producing countries.
- The nonoil balance and the overall balance
- The need to avoid a procyclical fiscal policy
- Sustainability and accumulation of financial assets
- Some institutional mechanisms
- Conclusions

Introduction

- Some stylyzed facts for many developing oil-producing countries:
  - disappointing growth and continued poverty
  - generally weak economic performance
- Some suggested explanations:
  - Dutch disease
  - Enclave nature of the (mature) oil industry
  - Oil-financed postponement of growth-enhancing reform
  - Competition for oil rents from fiscal pressure groups/rent seeking
  - Institutional quality issues
  - ***Characteristics of fiscal policy***

Oil-Producing Countries are not the Same

- Importance of oil
- Development of nonoil economy
- Maturity of the oil industry
- Ownership of oil industry and fiscal regime
- Financial position of the government (net debt, liquidity)

Challenges Posed by Oil Revenues

- The revenue stream from oil:
  - *is uncertain and volatile*
  - *originates abroad*
  - *will eventually dry up*
- Governments must decide
  - how expenditure can be planned and insulated from revenue shocks–how to inject oil resources into the domestic economy (stabilization)
  - to what extent resources should be saved for future generations (saving)

The Nonoil Balance

- The fiscal nonoil balance is a key fiscal indicator in oil-producing countries. It should figure prominently in the budget and fiscal analysis.
- Why is the nonoil balance important?
  - Indicator of government demand
  - Measure of injection of oil revenue into the domestic economy
  - Measure of fiscal effort and underlying policy stance
  - Important input into the analysis of fiscal sustainability
- Scaling factors: GDP, nonoil GDP, nominal, real terms. Sometimes what you see is not what you get.

The Nonoil Balance (2)

- Is the nonoil balance presented and discussed in the budget?
- Does the nonoil balance figure prominently in public discussion of fiscal policy?
- Do not confuse improving overall balances due to higher oil revenue with "fiscal consolidation" or "fiscal adjustment".
- With rising oil revenues, a fiscal expansion (deterioration in the nonoil balance) can be masked by an improving overall balance, making everybody happy for a while—until the next downturn occurs.

The Nonoil Balance and Transparency

- Countries should be encouraged to highlight the nonoil balance in budget documents used in parliamentary and public discussion.
- A clear presentation of the nonoil balance would help:
  - Make the use of oil revenue more transparent
  - Delineate policy choices more clearly
- A greater focus on the nonoil balance would help develop constituencies in support of prudent policies, thereby contributing to a less procyclical and more long term-oriented fiscal policy.

The Overall Balance

- The overall fiscal balance is the relevant indicator for assessing the government's net financing requirement and provides information on fiscal vulnerability.
- How is the overall balance financed?
  - Domestic financing
  - External financing
- May not be a good pointer for the impact of fiscal policy on domestic demand or the government's adjustment effort.

Need to Avoid a Procyclical Fiscal Policy

- If a country behaves procyclically during oil upturns, it will probably be forced to be procyclical during oil downturns—because it may not be able to finance the "bad times".
- Do oil producers avoid the temptation of increasing expenditure during the upswing?
- Fiscal policy should be adjusted smoothly in the upswing—and in the downturn if feasible.
  - Smoothness applies to the nonoil balance, particularly expenditure.
- There are macroeconomic and fiscal benefits to be derived from fiscal prudence and smooth adjustment.

Macroeconomic Considerations

- There is a strong macroeconomic case for smoothing fiscal expenditure and minimizing the transmission of oil price volatility to the nonoil economy.
  - Impact of fiscal volatility → volatile aggregate demand.
  - The costs of large and unpredictable changes in fiscal spending and the nonoil deficit include:
    - The need to reallocate resources to accommodate changes in demand and relative prices.
    - Real exchange rate volatility.
    - Increased risks faced by investors in the nonoil sector, with adverse effects on growth, poverty reduction, and the creation of jobs.

Fiscal Policy Should Support the Broader Macroeconomic Objectives

- Need to foster an environment conducive to nonoil growth and development
  - Economic policy should help minimize real appreciation of the currency, fight inflation, and seek to achieve low interest rates.
- Example: fiscal policy (nonoil deficit) may need to be tightened during an oil boom—no need for fiscal policy to add to the fire during oil upswings.
  - Oil income comes onshore
  - Procyclicality of oil prices and the *nonoil* economy
  - Monetary policy may be inadequate, costly, or self-defeating
  - Fiscal policy can help the sterilization process

Fiscal Considerations

- It is costly and inefficient to adjust spending rapidly and abruptly.
- The level of spending should be determined in light of its likely quality and the capacity to execute it efficiently.
  - The sudden creation or enlargement of spending programs is risky.
    - Increases in spending may exceed the government's planning, implementation, and management capacity → waste.
    - Spending should not rise faster than transparent and careful procurement practices will allow.
- Spending typically proves difficult to contain or streamline following expansions. Expenditure becomes entrenched and takes a life of its own. Drastic spending cuts may lead to social instability, discouraging investment and reducing future growth.

Size of the Nonoil Deficit

- How large can the nonoil deficit be?
- Factors to take into account:
  - macroeconomic objectives
  - short-run vulnerability
  - government wealth, including oil in the ground and net accumulated financial assets
- While in some countries relatively large nonoil deficits may be sustainable, in other countries there is a need to reduce the nonoil deficit due to vulnerability and sustainability considerations.

Sustainability and Accumulation of Financial Assets During the Period of Oil Production

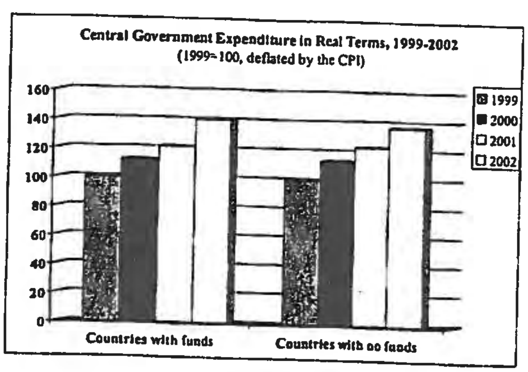
- Sustainability
  - Oil revenue will run out
  - Permanent income: annuity value of oil
  - Intergenerational issues
- Portfolio transaction
  - Swap oil assets for financial assets
  - Oil revenue is akin to financing
- Net financial liabilities and sovereign premiums

Oil Funds (1)

- Most important types of funds:
  - Contingent
  - Revenue-share
  - Financing fund
- The operational rules of funds can be flawed—the fund will not necessarily deliver the fiscal benefits hoped for, but may hamper fiscal policy and asset and liability management.
- Oil funds should not have the authority to spend. Avoid dual budgets: all spending should be transparently on budget.
- Oil revenues should not be earmarked—there should be genuine competition for fiscal resources.
- Governance and transparency (including performance evaluation, audit, and disclosure) are critical.

Oil Funds (2)

- Operational and institutional design matters a lot.
- Do not confuse oil funds with fiscal rules.
- Oil funds are not a panacea—international experience is mixed.
- Norwegian Oil Fund: transparency objectives; does not hamper fiscal policy or asset management.



Medium-Term Expenditure Frameworks

- MTEFs can help limit the extent of short-run spending responses to rapidly-changing oil revenues.
- They can allow a better appreciation of future spending implications of current policy decisions—including future recurrent costs of capital spending.

Fiscal Rules

- Attempt to insulate fiscal policy from political pressures.
  - By placing restrictions or limits on fiscal variables (such as deficits, expenditure, debt), rules seek to constrain fiscal policy.
- The design of fiscal rules in oil-producing countries must take into account their specific fiscal characteristics.
- Rules should aim at decoupling expenditure and the nonoil deficit from the short-term volatility of oil revenues. But many oil-producers are liquidity-constrained.
- A sound fiscal management framework is a necessary (not sufficient) condition for the success of a fiscal rule.
- Fiscal rules are no stronger than the will of the political class to abide by them.

Conclusion: Prudent Fiscal Policy is Crucial for Good Economic Performance

- Put in place fiscal strategies to break the procyclicality between oil prices and expenditures.
- Pay attention to the nonoil balance.
- Target prudent and relatively stable nonoil deficits.
- If necessary, pursue fiscal consolidation to reduce vulnerability and strengthen fiscal sustainability.
- Establish sound budgetary systems.
- Develop medium-term budgetary frameworks.
- Have a long-term horizon.
- Enhance fiscal transparency, so that everybody can see how oil revenue is used (or misused)

Session Title: Applying New Institutional Economics

Session Themes

A. After decades of flirtation with pure formalism, economics over the past few decades has brought institutions back into the center of economic analysis. Legal, political and even social institutions are now focal points. With this recognition comes the need for a new approach to assess the institutional environment and design reform initiatives. It is not enough to simply add new variables into standard analysis. This presentation briefly summarizes the contributions that an understanding of an institutional perspective can make to the practice of development and then presents two applications drawing on a new methodology that fits this perspective, with illustrations from the field. The first addresses the importance of recognizing a disconnect between the *de facto* (unofficial) and *de jure* (official) rules which govern the economic life of the individuals within a given society. The implication being that only those reforms that reach the actual behavior of the individuals within a reform environment, rather than the behavior described by the laws of a country, have a chance to succeed. This is illustrated by an examination of the institutional conditions in which entrepreneurial activity occurs, within a property rights regime. The second application demonstrates a method for uncovering the political economy of a reform environment and discusses the implications of this undertaking for the success of a reform initiative. These applications are intended to provide development practitioners with the tools to improve the design, targeting, and sustainability of reforms, increasing the chances of success.

B. It has now become common wisdom in the policy community that institutions—both formal and informal—create and perpetuate incentives so that institutional design must be commensurate with the goals of economic development. However the practice of identifying the underlying institutions at play and the incentives they create, as well as the importance of monitoring and measuring outcomes, is still in its infancy. This presentation summarizes three attempts to redress this situation. The first borrows the practice of clinical trials from the pharmaceutical industry and introduces a methodology to statistically evaluate whether and why a donor intervention was successful or a failure, thereby allowing rigorous lessons to be learned regardless of project outcomes. The second introduces a methodology to test alternative institutional arrangements to see whether the incentives they create lead to behavioral responses in the target population that are consistent with what is required for a proposed donor intervention to be successful. Both of these were developed under EGAT sponsorship during the "Forums" Project and tested in The Philippines. The third application, funded by the Investment Promotion Office of UNIDO/Bologna and underway in Morocco, uses the concept of inter-jurisdictional competition to create a "game" for municipalities to play in which fulfillment of commitments to improve the business and investment environment by strengthening local governance "wins" substantial financial and technical rewards for their SME firms. This technique both allows donors to identify serious reformers as well as multiplies the amount of reform a given technical assistance budget can generate.

Presenters

Peter Boettke, Deputy Director of the James M. Buchanan Center for Political Economy, a Senior Research Fellow at the Mercatus Center, and a professor in the economics department at George Mason University.

Clifford Zinnes, Director of Research Coordination at the IRIS Center and Affiliate Faculty at the School of Public Policy, both at the University of Maryland

Improving Development Assistance in Light of New Institutional Economics

Peter J. Boettke, *Director of Research*
Global Prosperity Initiative
Mercatus Center
George Mason University
July 1, 2004

Economics as the study of institutions

- NIE is about paying attention to the exchange relationships that emerge among people and the <u>institutions</u> within which those exchanges take place
- Institutions are the set of rules which govern social intercourse in a particular context and the enforcement of those rules in that context

Role of institutions

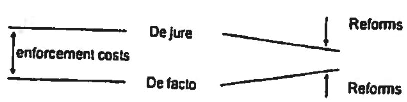
- Institutions provide the <u>incentive structure</u> that individuals face in their social intercourse
- Three games in development economics:
  - Incentives that actors in developing world face
  - Incentives that the decision makers in both the donor and recipient nation face
  - Incentives that the actors within development agencies face in deciding on development priorities and ideas to utilize in pursuing those priorities

De jure and *de facto*

- Distinction between the *de jure* (official) and *de facto* (unofficial) rules that constitute institutions
- The closer the tie between the *de jure* and the *de facto* rules, the lower the enforcement costs
- Vice-versa, the looser the tie, the higher the enforcement costs
- Important to understand the nature of the tie between *de jure* and *de facto*

Reform process

- Successful reform process will:
  - Strengthen the tie
  - lower the cost of operating within the de jure
  - raise the cost of operating outside it



Crucial issues of the reform process

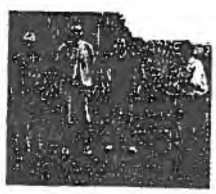
- Conflicts between the *de jure* and *de facto* often revolve around rules of property:
  - Lead to alternative enforcement devices, and greater costs of realizing gains from exchange
  - Affects entrepreneurial activity
- Entrepreneurial Environment:
  - "Betting on Ideas" and finding the finance to bring those "bets" to life
  - Need strong tie between *de jure* and *de facto*

Crucial issues of the reform process

- Political economy mapping:
  - Understand political interests
  - Identify who could benefit and who could be made worse off by the reforms
  - Facilitate local ownership of the reforms
  - Align interests in order to build winning coalitions

Getting 'Dirty' in Order to Address Institutions

- To understand the *de facto* rules which govern social and political intercourse
- One must get "dirty": on-the-ground data gathering, historical reading, and familiarizing oneself with the culture and way of life of the people



- www.mercatus.org/pdf/materials/435.pdf

Thursday, July 1, 2004
1:30-3:00

Breakout Session:

Financial Deepening and Access to Credit

Chris Barltrop, Presenter & Moderator

Thursday, July 1, 2004
3:30-5:00

Breakout Session:

Developing Value Chains for Microenterprise

Hubert Schmitz, Presenter
Downing, Moderator

Thursday, July 1, 2004
3:30-5:00

Breakout Session:

USAID, the IMF, and Fiscal Crises for the Poor

Alex Segura-Ubiergo, Presenter
Robert Aten, Presenter
David Dod, Moderator

INDEPENDENT EVALUATION OFFICE
of the IMF

EVALUATION OF FISCAL ADJUSTMENT IN IMF-SUPPORTED PROGRAMS

http://www.imf.org/external/np/ieo/2003/fis/index.htm

Objectives in view of IEO mandate

- Derive operational recommendations to improve the fiscal design in IMF-supported programs
- Examine areas of controversy
  - The quantitative dimension
  - The qualitative dimension

2

Issues in two dimensions

- **Quantitative dimension.** Fiscal adjustment as "one size fits all" leading to excessive adjustment. Why?

1. Unnecessary reduction in programmed public spending in countries relying on concessional flows
2. Overly optimistic projections of private demand leads to premature concerns about crowding out and tigh fiscal stance

3

- **Qualitative dimension.** Efficiency, sustainability, and equity of fiscal adjustment
  - Trade-offs:
    - Between quality and quantity
    - Between quality and speed/expediency
  - Mismatch of Timeframes
    - "High quality" fiscal reforms require time—beyond the horizon of typical SBAs

Methodology and Database

- 133 arrangements in 1993-2001 containing program projections of basic macro variables
- 15 in-depth case studies of programs including:
  - Surveillance activity for the prior 3 years
  - Analysis of the implementation of 153 specific fiscal reform measures
- Ad hoc samples
  - 20 concessional programs in Sub-Saharan Africa
  - Social spending in years with and without programs in 140 countries in 1985-2000

Quantitative Findings Re Fiscal Targets

- No support for "one size fits all" criticism (significant variability)
- No evidence that programs always involve austerity
- Variability systematically related to initial conditions and financing prospects
- But program documents do not clearly explain how the pace and magnitude of adjustment is determined (lack of "story line")

Quantitative Findings, cont'd

- Are fiscal targets flexible?
  - Yes. 2/3 of programs revise (T+1) targets by the 2nd review
  - Revisions are linked to revisions in growth prospects
  - Asymmetry: Targets are revised downward when growth is below expectations; less often the other way around
  - Rationale for revision is not clearly brought out in documentation

7

Quantitative Findings, cont'd

- Did programs achieve fiscal targets?
  - On average, programs achieved ½ of targets in a 2-year period
  - Almost all achieved by the first year
  - Significant variability: 60% of programs underperformed
  - Features of programs that underperformed
    - No improvement in fiscal balances
    - Shortfalls reflect weak performance, not ambitious targets
  - Growth overoptimism explains adjustment optimism (expenditures are sticky, expenditure ratios increase)
  - However, in episodes of large fiscal adjustment (>3% of GDP) revenue shortfalls explain most fiscal shortfalls

8

Quantitative Findings, cont'd

- What happens to economic recovery under programs?
  - On average, growth rates do not decline during program years*
  - But significant variability; capital account cases had the worst performance
  - However, significant optimism (private activity and growth), particularly when the program commences in an adverse situation

**Before/after comparison Cannot be attributed to IMF presence*

9

Is there a contractionary bias on the demand side?

- Overoptimism regarding private demand may prevent considering a countercyclical fiscal impulse
- Evidence of over performance on the external side (CA and reserves)—financing available at the margin
- This may signal an understatement of the countercyclical component of the fiscal stance
- However, the fiscal stance cannot be determined solely by short-term countercyclical considerations. We need also to consider market reactions and debt sustainability concerns--particularly in emerging markets
- Thus, to make a judgment on the appropriateness of the overall fiscal stance of a program we need to consider how all these factors interact with each other.

10

Quantitative Findings, cont'd

- The problem, however, is that program documents do not explicitly discuss these factors
  - Linking fiscal stance to private sector recovery
  - Basis for private sector recovery assumptions
  - Tradeoffs between aggregate demand and market response/debt sustainability

More explicit discussion would:

- Reduce overoptimism in projections
- Provide a framework for sensitivity analysis
- Alert staff early on corrective actions

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Social Spending: Three Issues

1. Do aid projections "taper out" too quickly relative to what donors provide, forcing an unnecessary cut in social expenditures?
   - Cross section of PRGF programs shows tapering out of projections
   - In-depth analysis of 20 programs in Africa does not show that projections underestimate actual flows in the outer years

12

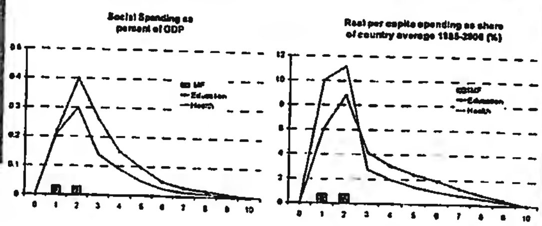
Social Spending, cont'd

2. What is the net impact of an IMF program on public sector social spending? (controlling for other factors and the endogeneity of IMF presence)

- No reduction in health and education spending as a share of GDP or of total expenditures
- In fact, expenditures temporarily increased by 0.3-0.4 percentage points of GDP

Social Spending, cont'd

Estimated Impact of a Two-Year IMF-Supported Program



Social Spending, cont'd

3. Social Concerns in Program Design

- Non-PRGF programs follow 1997 Guidelines: to track health and education spending and monitor basic social indicators, and encourage authorities to incorporate spending targets in LOIs.
- Guidelines are broad in scope and the staff is uncertain how to apply them given the new initiatives on streamlining
- A detailed examination of 15 programs shows significant variability. A review of 8 more recent programs finds only limited improvement in this area.

Social Spending, cont'd

Findings from case studies:

- Specific spending categories/programs critical to the most vulnerable come under pressure during shocks or budgetary retrenchments
- Preempted by personal expenditures
- Case study. How hospitals in Ecuador adjusted during the 1999-2000 crisis

- IMF needs to move from tracking long-term/aggregate trends to assisting countries in protecting these expenditures under shocks (true role of the IMF given its mandate)
- These budgetary and tracking systems need to be in place early. But this takes time.
  - Initiatives must come from countries
  - IMF does not have the comparative advantage (key role of World Bank)
  - New agreements on PEM provide opportunities

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Fiscal Reforms

Three aspects of fiscal reforms under IMF-supported programs:

1. Balance among policy measures, eg: do programs tilt toward specific areas while neglecting others?
2. Progress in implementation
3. Learning from the past and the role of surveillance in supporting reform

Methodology: For 1 and 2 we identified and tracked 153 specific fiscal-related reforms in the 15 programs. For 3, we examined 33 pre-program Article IV documents

17

Fiscal Reforms, cont'd

1. Balance among policy measures

- Programs focus more on the revenue side than the expenditure side
- Accent on the VAT, particularly on increasing VAT rates
- Less attention to other taxes and efforts aimed at reducing evasion in customs, income and corporate taxes
- Not forceful enough in collecting from well-known tax payers with arrears, particularly if they are powerful (actions here will increase support for the overall reform agenda of programs)
- Tax administration has focused more on the technology side than on politically difficult actions to empower tax agencies and make them less prone to political interference
- Expenditure side: Programs have focused on short-term quantitative targets to reduce the wage bill rather than on a reorientation of public spending or medium-term civil service reform. Hence, progress has been easily reversed

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Fiscal Reforms, cont'd

2. Progress in implementation during programs

- In no reform area was implementation satisfactory in more than 40% of cases
- Most difficult areas: Measures to reduce the wage bill, achieve civil service reform, and social security systems
- Limited progress results from an emphasis in short-term qualitative targets relative to institutional reforms that may require time beyond the horizon of the program
- Critical: Unbundle reforms into several steps
  - Those that can be implemented in the short run with enough determination of the executive
  - Those that require more time, e.g. legislation
  - Those that may require even more time, e.g. improving implementation capacity of agencies
- Surveillance should provide such a road map. But does it?

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Fiscal Reforms (contd.)

3. Learning and the surveillance process

- Program documents often fail to evaluate past fiscal performance, and to an even lesser extent, policy failures under the previous arrangement
- Link between surveillance and programs:
  - Surveillance is not forceful enough in flagging the need to accelerate reform where implementation was lagging
  - A large share of policy measures included in programs were not previously flagged by surveillance
  - This is also true in self-standing surveillance, e.g. surveillance not associated with a program
- In summary, surveillance is not effective enough in providing a clear road map of structural reforms to be followed, with or without a program

20

Recommendations

1. Documents should provide a clear justification for the magnitude and pace of the envisaged fiscal adjustment
2. The internal review process should focus more on early brainstorming
3. Programs should give greater emphasis to institutional reforms in the fiscal area
4. The surveillance process should be used more explicitly to provide a longer term road map for fiscal reforms and to assess progress
5. The IMF should focus on assisting countries in preparing systems to protect the most vulnerable in case of crisis
   - Invite countries to identify critical programs under surveillance
   - Formulate a work program with the World Bank on budgetary systems able to protect these programs in real time in case it is needed

21

Breakout Session:

Public-Private Alliances as Enablers of Economic Growth: The private sector perspective

Alliances are an effective mechanism for improving a country's enabling environment for economic growth. The Global Development Alliance business model underscores the importance of joint planning to solve complex development problems as well as leverage significant resources to better combat the problems. Representatives from the private sector will relate their experiences working in partnership with USAID and the alliances contribution to economic growth.

Presenters:

Mark Gellerson
Allen Eisendrath

Friday, July 2, 2004
9:00-10:30

Plenary Session

Free Trade Agreements & Lessons from NAFTA

Guillermo Perry, Presenter
Raul Urteaga Trani, Presenter
James Fox, Presenter
Charles Mohan, Moderator

Globalization

Making Trade Work for the World's Poor

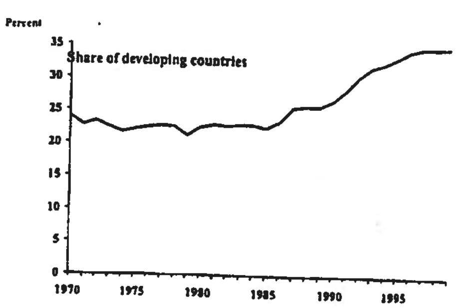
Richard Newfarmer
World Bank

July 2, 2004

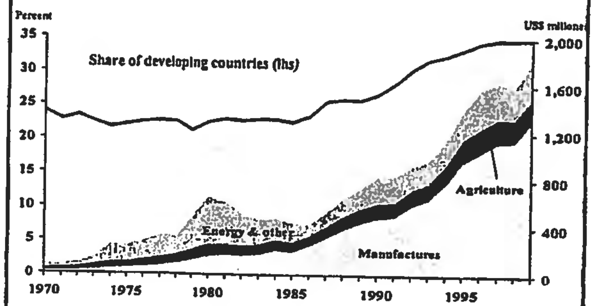
Main messages...

- Many developing countries have done well in the 1990s, but poorest countries have lagged.
- The Doha Agenda has the potential to speed growth, raise incomes, and reduce poverty, and all countries have an interest in its success.
- But to realize this potential, governments have to tackle inequities in the world trading system – and to forge an agreement than benefits the poor.

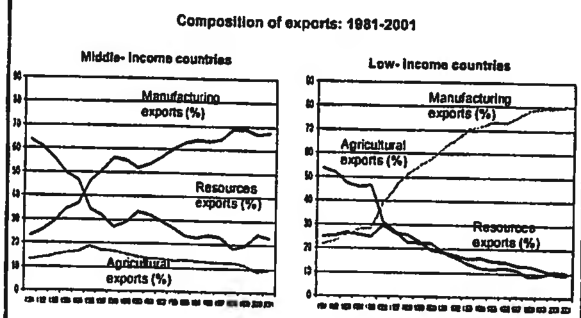
Developing countries have increased their share of the global market...



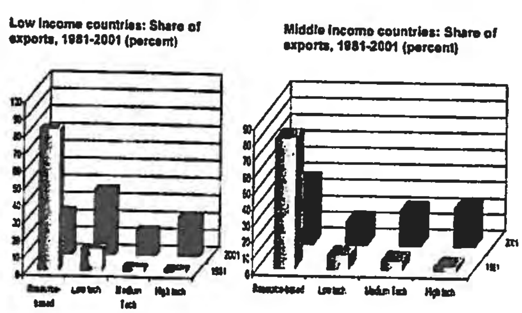
Developing countries have increased their share of the global market...



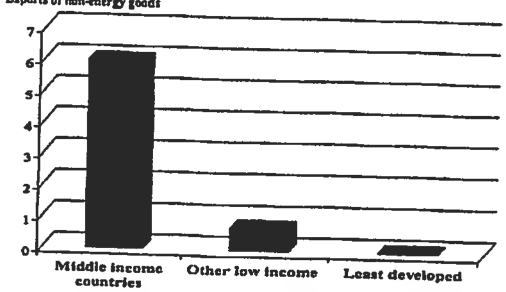
Developing countries are exporting more manufactures...



...and they are moving up the technology ladder



...but the poorest countries have fared badly

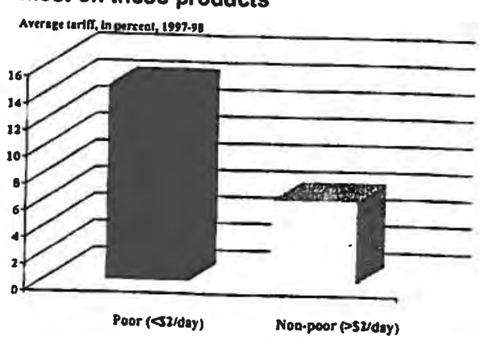


In fact, 1/3 of developing countries have not benefited significantly from growth in international trade.

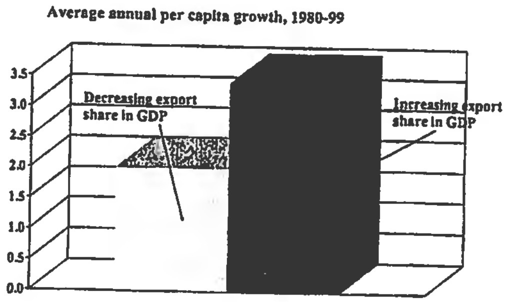
Reasons for poor performance vary...

- Dependence on primary commodities and/or persistent conflicts.
- Domestic trade policies and trade-related institutions, macroeconomic instability, and poor governance.
- Obstacles and inequities in world trading system.

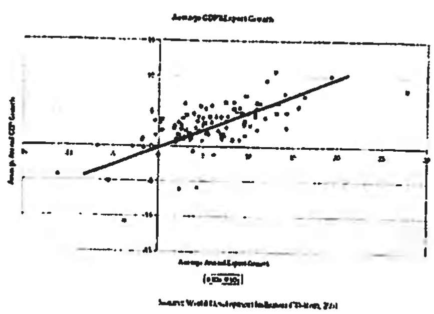
...which penalizes the poor who depend most on these products



Why does it matter? Integration with global markets is associated with faster growth



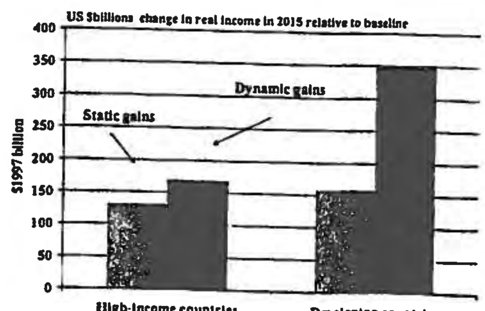
Export growth is associated with rapid income growth



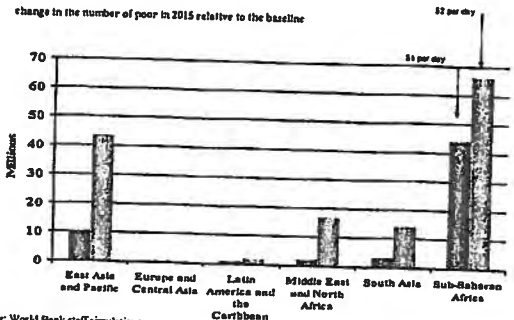
Source: Cline, 2003, from WB data

The Doha Agenda could redress some inequities and accelerate growth

A "good" agreement could boost incomes $270-520 b.



More people would be lifted above the poverty line...140 million...many in Africa

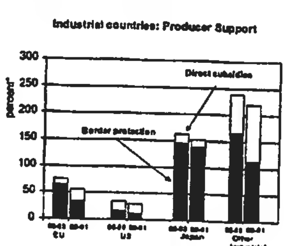


Source: World Bank staff simulations

But to realize development promise, an agreement has to reduce barriers to the products the poor produce

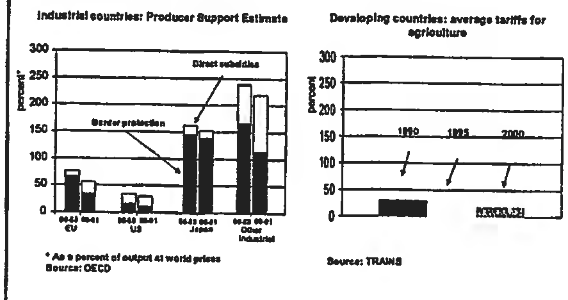
- Agriculture is a priority, particularly reducing border protection and subsidies in rich countries
- Reducing protection on manufactures and services, particularly in the South
- Helping low-income countries reduce reliance on trade preferences, increase competitiveness, and reform insitutions to facilitate trade

Protection in rich countries is high and unchanged since the Uruguay round...

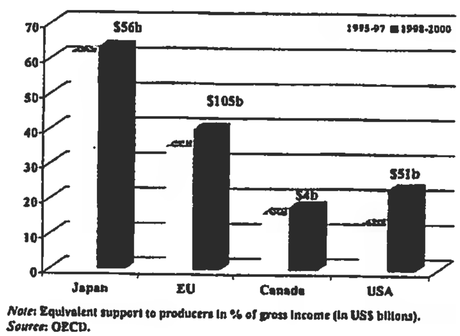


* As a percent of output at world prices
Source: OECD

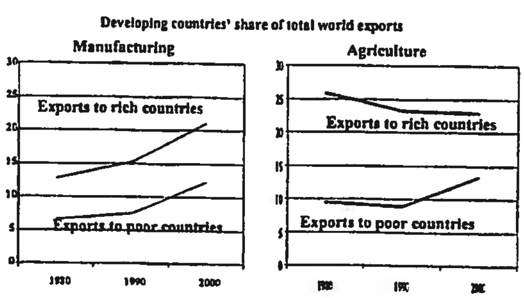
Protection in rich countries is high and unchanged since the Uruguay round...and developing countries have reduced barriers only slightly



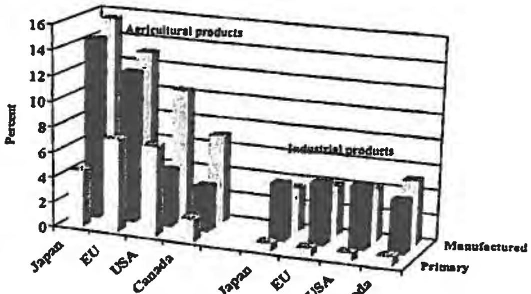
Growing agricultural subsidies in the Quad also limit market access for poor countries



Developing countries have failed to penetrate agricultural markets of rich countries



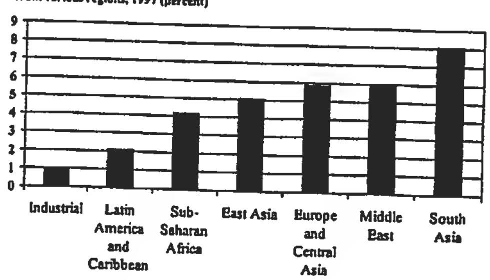
...and efforts to add "upstream" value added in agriculture are hurt by escalating tariffs



Note: Average unweighted tariffs (1998-1999).
Source: World Bank, based on WTO data.

Also progress in manufactures market access discussions...important because rich countries charge poor countries more

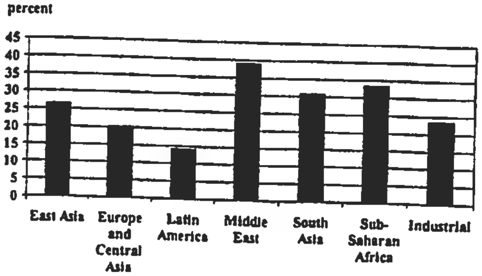
Av tariffs of industrial countries charged to exporters from various regions, 1997 (percent)



...and their own barriers also hurt other developing countries

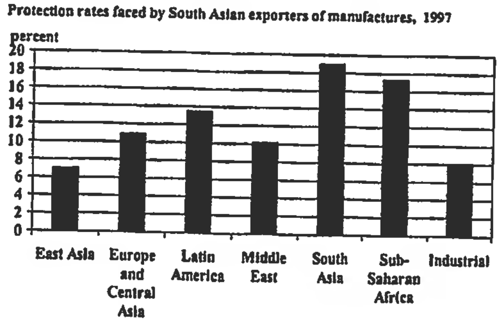
Protection faced by African exporters of agricultural goods, 1997

percent



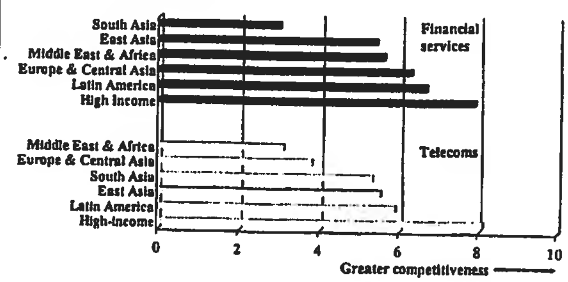
...and so do other developing countries

Protection rates faced by South Asian exporters of manufactures, 1997



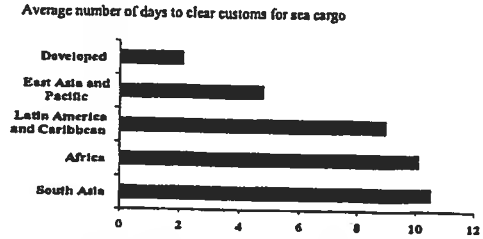
Trading market access for liberalization of services may be key to Doha success

Services liberalization index



Improving trade facilitation can be as important as cutting tariffs...ports, customs, transport

Average number of days to clear customs for sea cargo



...including trade facilitation in the Doha Agenda could have development benefits

Source: International Exhibition Logistics Associates, based on a sample of countries in each region

Moving forward on Doha Development Agenda is urgent...because collapse would mean:

- Impetus to bilateral and regional agreements...
  - But these produce small market access
  - Puts developing countries in weakest negotiating positions with big players
  - Many countries excluded
  - No way to discipline most injurious practices that hurt poor people... e.g., agricultural subsidies or antidumping
- Upsurge in protectionism...anti-dumping
- Lost opportunity to accelerate growth and poverty reduction

...so all countries have to take responsibility and work hard to avoid this fate

For the development promise of the Doha agenda to be realized, all countries have to take responsibility

- Rich countries have to lead in agriculture, labor-intensive manufactures, and development assistance
- Middle-income countries have to be willing to lower high external tariffs—benefiting themselves and their neighbors- to get better access and lock in services access
- Low-income countries have to rely less on preferences and reform trade-related institutions.

Making Trade Work for the World's Poor

Richard Newfarmer

World Bank

July 2, 2004

Friday, July 2, 2004
10:45-12:15

Plenary Session

Gains, Pains, and Risks of Globalized Trade and Investment

Richard Newfarmer, Presenter
Kishore Rao, Presenter
Stephen Parker, Presenter
Paul Deuster, Moderator

1

Thinking Global, Acting Local: A Country-Level Perspective on Globalism and Poverty

Steve Parker
Senior Economist, DAI
Chief of Party, *STAR-Vietnam* Project

Development Alternatives, Inc

2

Overview

- Perspectives on globalism
- Characteristics of poverty
- Links between trade/investment and poverty
- Country-level considerations – each country has its own context
- The increasing importance of international agreements – the WTO and the proliferation of plurilateral trade agreements
- Perspectives on USAID projects to implement USG trade agreements

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Perspectives on Globalism

- Globalism has become a catch-all for the positive and negative impacts of international influences on domestic activity
- In terms of economic dynamics at the country level, globalism encompasses cross-border trade in goods and services, investment and capital flows, transfers of technology and information flows
- Globalism involves new strategies for production, marketing and financial management by multinational corporations and NGOs that focus explicitly on global rather than national objectives
  - e.g. regional and increasingly global production networks supplying parts and services from many countries to produce final goods; NGOs and labor groups follow the trade and capital flows
- As communication and transportation costs decline, the impact of globalism on domestic activity intensifies
- Globalism spurs advances in international governance, as governments organize to facilitate and/or manage international influences

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Characteristics of Poverty

- **Demand-constrained poverty:**
  - excess supply of low-skilled labor leads to low labor income resulting from underemployment and depressed wages
  - poor people rely heavily on labor income
  - low labor income implies high poverty levels

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Remedies for Demand-Constrained Poverty → Increase Demand for Low-Skilled Labor

- Deregulate policies and improve market institutions in local economies, encouraging private sector and enterprise development as the foundation of industrialization
- Encourage export growth
- Gradually but steadily liberalize import protection, recognizing adjustment costs

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Characteristics of Poverty (2)

- **Supply-constrained poverty:**
  - Poor workers and farmers constrained by limited education, poor health, living in isolated areas, discrimination
  - Poor who do not benefit from greater labor demand
  - Poor with a limited political voice

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Remedies for Supply-Constrained Poverty

- Target income transfers to the poor in the short-run
- Improve education and health, and poor-intensive infrastructure in the medium-term

7

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Links Between Trade/Investment and Poverty

- Rapid export growth and inflows of foreign investment increase demand for able-bodied, low-skilled workers and farmers in developing economies → rising labor income key to helping demand-constrained poor grow out of poverty
- Greater international integration introduces risks and adjustment costs that can be borne significantly by the poor and near poor
- Trade and investment have a limited affect on supply-constrained poor
- Trade always involves winner and losers, which requires a viable domestic political economic process to resolve distributional trade-offs
- Resolving distributional trade-offs is always easier when there is strong growth → a positive rather than zero sum game

8

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Trade and Poverty Links Are Country Specific

- No cookie-cutter pro-poor development strategy – each country is different, with different resource endowments, levels of development, governance and political will, legal and market institutions, and geography
- A strong pro-poor development strategy should include a systematic set of policies dealing with both demand and supply constrained poverty
- Greater integration into the world market, through higher exports, imports and investment flows, should be an important element of a broader, systematic development strategy
- Sustained export growth is positively correlated with lower poverty levels – export growth is one of the fastest and most effective ways to increase demand for low-skilled labor, which in turn increases labor income for demand-constrained poor

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The Evolving Context for Shifting to Export-Led Growth

- Traditionally the shift to an export-led growth strategy was done on a unilateral basis or as part of a WB/IMF restructuring effort
- Increasingly economic integration is advancing in the context of a stronger WTO, strict WTO accession requirements, and/or preferential bilateral and regional trade agreements
- Other international agreements are increasingly important, including the WIPO conventions for IPR, the Kyoto Agreement on Customs, and the ILO for labor
- Private standards monitored and enforced by private companies and NGOs are increasingly important, including voluntary labor and environmental standards, and internet protocols

10

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The Evolving Context for Shifting to Export-Led Growth (2)

- Preferential trade agreements enhance market access to trading partners, but also require major commitments to legal and administrative reform and liberalization of market access
- Such trade agreements limit the use of policy instruments for industrialization strategies – binding lower tariffs, elimination of import quotas, market access for services, improved IPR enforcement, and liberalization of foreign investment
- Preferential trade agreements create different legal and policy regimes for members of each agreement relative to non-members, which places great pressure on countries with limited administrative capabilities and creates incentives for corruption

11

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The U.S. is Increasingly Entering into Preferential Trade Agreements with Developing Countries

- U.S. bilateral/regional trade agreements typically build upon a NAFTA base, which is WTO plus and monitored and enforced strongly
- U.S. trade agreements provide preferential access into the U.S. market
- Similarly strong commitments, without as strong tariff reductions, are required for countries acceding to the WTO or normalizing trade relations with the US

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U.S. Trade Agreements Typically Require Parties to Improve Systematically:

1) market access for trade in goods and services
2) protection of intellectual property rights
3) liberalization of investment flows (typically WTO plus)
4) commercial laws and dispute settlement processes that presume a strong court system
5) transparency of laws and regulations, and the right to comment on draft laws
6) the establishment of administrative law procedures with due process and court review to appeal government decisions
7) the Jordon FTA includes labor requirements, and there is pressure to include environment requirements as well – will this trend continue?
8) unlike NAFTA and the WTO, most FTAs with developing economies do not include a binding dispute settlement process among parties to the agreement

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Considerations for USAID Projects to Support Trade Agreements

- Once a trade agreement is signed, domestically laws and regulations need to be adjusted to confirm to the treaty commitments
- Assistance to developing country negotiators and implementers of U.S. trade agreements raises sensitivities with U.S. negotiators – **USAID coordination with USTR and the Embassy is likely to be required**
- U.S. trade agreements usually require major changes in laws and regulations, with demands to develop a strong court system to adjudicate commercial disputes – **a USAID project to support implementation of a trade agreement becomes in large part a legal development project**

14

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Some Considerations for USAID Projects to Support Trade Agreements (2)

- U.S. trade agreements usually include strong requirements for trade in goods and also for opening trade in services, for protecting IPR and for liberalizing investment policies -- parties required by the treaty to improve market access, but cost-benefit analysis to show net welfare benefits and to evaluate adjustment costs can support the reform process
- In many cases, countries are expected to start or complete implementation of key commitments before the agreement is formally approved (commitments due upon entry into force) – a **USAID project supporting negotiations should also focus on implementation**
- Entering into trade agreements raises political sensitivities in the developing country, requiring careful positioning of USAID assistance and issues of "firewalls" between USAID-supported TA and USTR/Embassy officials who are ultimately responsible for implementation of the agreement

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Thank you and comments are welcome.

Journal

Promoting Economic Growth in a New Era

Journal

Introduction

- The purpose of this five-day Workshop is to provide USAID Economic Growth Officers and partners with knowledge, tools, and contacts to better implement programs and activities that promote economic growth in developing and transition countries.

- Use this journal in whatever way will enhance your learning and help you to capture and retain possible take-home applications.

Day 1: A New Era

Monday's sessions included:

- **Overview of Global Trends, Growth Determinants & Aid Effectiveness**
- **Millennium Challenge Account**
- **Regional Break-out Discussions**
- **USAID Priorities**

- What key ideas did you find most important from today's discussions?

- Based on the sessions, what do you now better understand?

- What 1 or 2 Take-Away ideas do you have from today's sessions that might be useful now or in future assignments?

- Whom did you meet today with whom you would like to stay in touch?

Day 2: Challenges

Tuesday morning's sessions included:

- **Challenges of HIV/AIDS**
- **Microeconomic Constraints to Business**

- What key ideas did you find most important from today's discussions?

- Based on the sessions, what do you now better understand?

- What 1 or 2 Take-Away ideas do you have from today's sessions that might be useful now or in future assignments?

- Whom did you meet today with whom you would like to stay in touch?

Day 3: Governance

Wednesday morning's sessions included:

- **New USAID Strategies (Dealing with Fragile States and Anti-Corruption Strategy)**
- **Assessing and Controlling Corruption**

- What key ideas did you find most important from today's discussions?

- Based on the sessions, what do you now better understand?

- What 1 or 2 Take-Away ideas do you have from today's sessions that might be useful now or in future assignments?

- Whom did you meet today with whom you would like to stay in touch?

Day 4:
Pro-Poor Growth

Thursday morning's sessions included:

- **Pro-Poor Economic Growth & Key Interventions**
- **Role of Agriculture in Poverty Reduction and Growth**

- What key ideas did you find most important from today's discussions?

- Based on the sessions, what do you now better understand?

- What 1 or 2 Take-Away ideas do you have from today's sessions that might be useful now or in future assignments?

- Whom did you meet today with whom you would like to stay in touch?

Day 5 - Globalization

Friday morning's sessions included:

- **Free Trade Agreements & Lessons from NAFTA**
- **Gains, Pains, and Risks of Globalized Trade & Investment**

- What key ideas did you find most important from today's discussions?
- Based on the sessions, what do you now better understand?
- What 1 or 2 Take-Away ideas do you have from today's sessions that might be useful now or in future assignments?
- Whom did you meet today with whom you would like to stay in touch?

Take-Away Ideas

Please Review your journal notes.

- What key ideas did you think were most important from this week's sessions?

- What are 2-3 immediate actions you plan to take to follow-up on the workshop?

- How do you plan to network with the key contacts you met during the workshop?

- Who are the key players you plan to brief about the results of this workshop when you get back to your work?

  - What are the key messages you want to convey to each of them?