3 The international dimension: corruption in a globalising and diverse economy

The contributions in this chapter extend the analysis to key issues in a global economic perspective. Georg Huber-Grabenwarter and Frédéric Boehm explore specific challenges for corporate integrity in developing economies that may be characterised by weak governance systems and a large informal sector. Gavin Hayman adds to this analysis by outlining corruption risks in the extractive industries, which are of particular importance for many developing countries as they are home to large stocks of natural resources. Transparency International examines whether and to what extent foreign direct investment and global supply chains make a contribution to enhancing corporate integrity across the world. Ayesha Barenblat and Tara Rangarajan expand this discussion and propose some promising ways to strengthen the integrity of supply chains, while Deborah A. Bräutigam broaches the question of whether China's rise as an important global investor bodes ill or well for tackling corruption in business.

Sol Piciotto in his contribution looks at the important issue of transfer pricing, and directs attention to corruption risks that arise when companies operate globally while their taxes are to be determined and paid at country level. Finally, John Nellis discusses corruption in the context of privatisation programmes, which continue to play an important role in many economies around the world.

Laying the foundations for sound and sustainable development: strengthening corporate integrity in weak governance zones

Georg Huber-Grabenwarter and Frédéric Boehm[1]

Strengthening corporate integrity in least developed countries with limited basic governance structures in place poses a set of distinctive challenges. For businesses, aligning corporate activities with company values and principles of corporate integrity is more difficult when the institutional environment is weak and inefficient. For governments, strengthening the rule of law and sectoral integrity is particularly taxing when a large portion of economic activity takes place in the informal sector. For donors, corruption in the business sector is a cross-cutting concern for aid programming.

1 Georg Huber-Grabenwarter and Frédéric Boehm are project staff at the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ). The ideas expressed constitute the personal opinion of the authors and do not necessarily comprise the position of the organisations associated with them.

Building and asserting corporate integrity when the rules are weak

About 900 million people live in so-called 'weak governance' zones, particularly in sub-Saharan Africa, where governments struggle to provide essential services and to assume their responsibilities with regard to public administration and human rights.[2] Doing business in countries with weak institutions and possibly high levels of corruption poses enormous challenges to the integrity of domestic and foreign businesses alike.

When local rules are incomplete, ill enforced or blatantly manipulated, simply playing by those rules is not sufficient. When laws and their enforcement fail to place reasonable boundaries on corporate behaviour, companies need to ensure that their actions do not undermine the protection and fulfilment of human rights and general principles of responsible business conduct. A lack of basic legal guidance therefore mandates more due diligence and individual responsibility for businesses, both domestic and foreign.

Weak institutions not only fail to provide guidance for responsible corporate behaviour, they also tend actively to undermine it. Weak institutions very often mean that property rights are poorly protected, contracts are difficult to enforce and companies are faced with arbitrary and excessive regulations (red tape).

As a result, companies may be tempted to use bribery and other corrupt practices as a political 'risk insurance' to protect investments. Similarly, they may be lured to manipulate rules in their favour, avoid the enforcement of regulations, gain lucrative contracts or resource extraction permits, or simply to cut through red tape and administrative hold-ups.

Resorting to corruption in weak institutional settings undermines the very business opportunities companies seek to exploit or protect, however, in addition to creating significant reputational and material risks for foreign companies. The willingness to bribe makes unaccountable rule-making, arbitrary rule enforcement, hold-ups and extortion lucrative propositions for corrupt office-holders, and thereby reinforces the very system it is trying to overcome. Using corrupt means to outflank competitors further amplifies market uncertainty, by destroying fair competition and predictable regulation, with adverse implications for the cost of capital and business planning. Resorting to high-level influence-peddling and patronage to protect investments ties the future of a business venture to the often uncertain fate of a specific political power broker. In Indonesia, for example, the valuation of firms connected to the late President Suharto fluctuated significantly in line with rumours about his health, and firms that had staked their future on ties to Suharto continued to under-perform after regime change.[3]

What can companies do to protect their corporate integrity in such a challenging environment and act as positive agents of change?

2 OECD, *Risk Awareness Tool for Multinational Enterprises in Weak Governance Zones* (Paris: OECD, 2006).

3 R. Fisman, 'Estimating the Value of Political Connections', *American Economic Review*, vol. 91, no. 4 (2001); F. Oberholzer-Gee and C. Leuz, 'Political Relationships, Global Financing and Corporate Transparency: Evidence from Indonesia', *Journal of Financial Economics*, vol. 81, no. 2 (2003).

First, awareness and preparedness are important. Mapping the risks specific to a company's operations and developing a tailored compliance and anti-corruption training programme should ensure clear ground rules and operating procedures on how to respond to demands for corrupt payments. A variety of tools and templates are at hand to help companies craft business strategies and compliance programmes for institutionally weak environments.[4]

Second, clean business requires clean business partners. Extra-managerial care and due diligence in vetting business associates, contractors and agents are a prerequisite to avoid the outsourcing of corruption.[5] Screening out unreliable partners and establishing deeper, long-term relationships with trusted ones, known as relational contracting, can help enforce contracts even when formal institutions are still weak and corrupt.[6]

Companies can also join and lend support to initiatives that seek to mitigate problems of collective action and instil trust in fair competition and the integrity of public contract awards. The Extractive Industries Transparency Initiative commits business and host governments in more than twenty countries to enhanced transparency in revenue-sharing arrangements. Sectoral agreements and integrity pacts demand explicit no-bribery commitments from competing companies and public sector clients. Such agreements raise the costs and consequences of non-compliance. Once they reach a critical mass of buy-in, they can make it very difficult for non-signatories to stand on the sidelines.[7]

Finally, foreign companies can also help strengthen business integrity in a host country without unduly interfering with domestic political affairs by extending support to business associations or chambers of commerce that pledge to promulgate corporate integrity.[8]

As the rise of Infosys in India shows, asserting corporate integrity in a high-corruption environment is both feasible and good business. Infosys has grown from a small software company in 1981 to a multinational information technology service provider while steering clear of corruption in a setting infamous for red tape and high corruption risks.[9]

The complex role of the informal sector

Many developing nations are characterised by well-established informal sectors.[10] While exact definitions vary, the informal sector or shadow economy usually refers to economic activity

4 OECD, *Investments in Weak Governance Zones. Summary of Consultations* (Paris: OECD, 2005).

5 J. Bray, 'The Use of Intermediaries', in J. G. Lambsdorff, M. Taube and M. Schramm (eds.), *The New Institutional Economics of Corruption* (London and New York: Routledge, 2005).

6 D. Rodrik, 'Second-best Institutions', *American Economic Review, Papers and Proceedings*, May 2008.

7 For an example in Colombia, see V. Lencina, L. Polzinetti and A. R. Balcázar, 'Pipe Manufacturers in Colombia and Argentina Take the Anti-corruption Pledge', in TI, *Global Corruption Report 2008* (Cambridge: Cambridge University Press, 2008).

8 M. Weimer, *Anti-corruption and the Role of Chambers of Commerce and Business Associations*, U4 Brief no. 12 (Bergen: Chr. Michelsen Institute, 2007).

9 R. Abdelal, R. DiTella and P. Kothanandaraman, *Infosys in India: Building a Software Giant in a Corrupt Environment*, Case Study no. 9-707-030 (Boston: Harvard Business School, 2007).

10 F. Schneider, 'Shadow Economies and Corruption all over the World: New Estimates for 145 Countries', *Economics: The Open-Access, Open-Assessment E-Journal*, vol. 1, no. 2007-9 (2007).

that is not illegal *per se* but carried out at least partly below the radar of official statistics and regulations.[11]

The size, economic importance and persistence of the informal economy in developing countries is particularly striking. For 2005 it was estimated that the shadow economy (excluding household production) equalled almost a third of the official GDP across Asia. In Africa and Latin America this share amounts to more than 40 per cent, and it reaches well over 50 per cent in countries as diverse as Azerbaijan, Bolivia, Cambodia, Georgia, Nigeria, Peru, Tanzania and Thailand. Strong growth of the formal economy has hardly put a dent into these numbers. In addition to providing income and employment to many on the lower rungs of the economic ladder, the informal sector often complements formal economic activities and serves vital bridging functions in sectors such as waste management and water provision.[12]

Tackling corruption and strengthening business integrity when large parts of important economic activity are carried out outside officially regulated structures is vexing for governments, especially since the relationship between corruption and the informal sector is ambivalent. Corruption nurtures informality. Excessive regulation and the entry points for corruption that it provides further exacerbate arbitrariness in regulation and entry costs and drives economic activity into informality. At the same time, the lack of legal protection and the desire to dodge regulations makes the informal sector a particularly easy prey for extortion and solicitation of bribes by corrupt officials, thereby helping to sustain petty corruption among tax collectors, local police, environmental inspectors and other officials. Where the informal sector competes with formal businesses, this also may encourage others to follow suit in order to reduce regulatory burdens and compete on an equal footing.[13]

Several strategies can help break these vicious circles.

- Reducing red tape, which has been significantly related to higher corruption and larger unofficial economies,[14] can make the switch to formality easier. The burden of red tape is as well documented as it is striking. In countries such as Botswana, Brazil, Indonesia and Venezuela, registering a business takes more than seventy-five days. The overall procedure costs more than the average per capita income in countries such as Angola, Bolivia, Cambodia, Cameroon, Malawi, Nicaragua and Uganda, putting formal status well beyond the means of many informal entrepreneurs.[15] Improvements are feasible and can be effective. After reducing the minimum capital requirements for companies, Georgia and Saudi Arabia saw registrations increase by 55 and 81 per cent, respectively.[16] Egypt undertook sweeping reforms in 2006 and 2007, reducing minimum capital requirements for a new

11 Please note that some definitions of the informal sector may include elements of illegal activities – an approach not adopted for the purpose of this article.

12 See TI, 2008.

13 E. Lavallée, 'Corruption, Concurrence et Développement: Une Analyse Econométrique à l'Echelle des Entreprises', *European Journal of Development Research*, vol.19, no. 2 (2007).

14 S. Djankov, R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'The Regulation of Entry', *Quarterly Journal of Economics*, vol. 117, no. 1 (2002). For a classic study, see H. De Soto, *The Other Path* (New York: I. B. Tauris, 1989).

15 World Bank, *Doing Business 2009* (Washington, DC: World Bank, 2008).

16 World Bank, 2008.

business by 98 per cent, cutting the start-up times and costs for new businesses in half and significantly reducing property registration fees. After cutting the time required to establish a business from fifty-eight to twenty-seven days, Mexico saw the number of registered businesses rise by nearly 6 per cent.[17] Improving knowledge on how to register, and supporting informal business in these processes may thus help in reducing corruption. For example, after Ghana began facilitating and promoting registration, entrepreneurs reported being exposed to less corruption.[18]

- Enhancing access to capital, social insurance schemes, formal training and self-organisation can help informal workers and businesses regularise more of their business relations and reduce their vulnerability to extortion and bribe-paying. In many countries microfinance schemes have already brought credit and saving services to the rural and urban poor, long shunned by conventional banks.[19] In Malawi, workers from the informal economy can obtain formal qualifications for their skills and receive further vocational training in areas ranging from carpentry and tailoring to bricklaying, electrical installation and motor vehicle repair.[20] In India, the Self-Employed Women's Association (SEWA) has successfully organised informal workers and helped them enforce their basic rights since 1971. SEWA has grown to more than 400,000 members and the model is being copied in other countries.[21]
- Recognising and facilitating the informal sector's contributions to the formal economy and public service provision can improve precarious working conditions and reduce exposure to abuse. Countries such as Ghana, Senegal and Vietnam have licensed or are considering licensing informal water vendors, and have established guidelines for tanker operators and independent entrepreneurs.[22] Another example is informal waste-pickers, who assume a vital role for waste collection and recycling in many urban areas in developing countries such as Egypt and India. Solid waste management schemes can foster these activities by registering informal waste-pickers, designating waste transfer points and clarifying interaction with formal procedures.[23]

Taken together, these strategies can bring more informal economic activities into the legal fold, reduce exposure to extortion and other forms of corruption, and strengthen access to legal recourse in cases of abuse. These steps can ensure that informality and corruption do not feed on each other and taint prospects for tackling corruption in the broader economy.

17 World Bank, *Doing Business 2008* (Washington, DC: World Bank, 2007).
18 A. Darkwa-Amanor, 'Corruption, Registration of MSMEs, and Their Linkages: New Evidence and Recommendations from Ghana', paper presented at the Africa Regional Consultative Conference, Accra, Ghana, 5 November 2007.
19 M. Pagura and M. Kirsten, 'Formal–informal financial linkages: lessons from developing countries', *Small Enterprise Development,* vol. 17, no.1 (2006).
20 J. Chafa, 'Informal Sector Programmes in Teveta', paper presented at 'Training for Survival and Development in Southern Africa' seminar, Oslo, 15 November 2002.
21 M. A. Chen, N. Mirani and M. Parikh, *Self-employed Women. A Profile of SEWA's Membership* (Oxford: Oxford University Press, 2006); E. Crowley, S. Baas, P. Termine and G. Dionne, 'Organizations of the Poor: Conditions for Success', paper prepared for the International Conference on Membership-Based Organizations of the Poor, Ahmedabad, India, 17–21 January 2005.
22 TI, 2008.
23 K. Sandhu, 'Role of Informal Solid Waste Management Sector and Possibilities of Integration: The Case of Amritsar City, India', paper presented at International Conference on Sustainable Sanitation, Dongsheng, China, 28 August 2007.

Activities of donors on private sector corruption in developing countries

By the 1970s donors had recognised private sector development as a major engine for both economic growth and poverty reduction. Corruption remained an untouchable issue, however.[24] It was only in the 1990s that donors acknowledged corruption's tremendous negative consequences for the investment climate in developing countries and began to tackle corruption, mostly through public sector reforms.

While the private sector was understood primarily as a 'partner and an important driver'[25] for these reforms, donors also acknowledged that companies are not just victims of corrupt public officials but, rather, often actively resort to corrupt practices in order to gain contracts, or influence or evade laws and regulations. As a result, donors realised that tackling private sector corruption and strengthening corporate integrity are prerequisites for sound and sustainable development.

Today both bilateral and multilateral donors, as well as export credit agencies, are placing a stronger focus on fighting corruption not only in the public but also in the private sector. Initiatives to tackle the supply side of corruption include: (1) anti-corruption measures in donor operations; (2) support for home country and international anti-corruption instruments; (3) cooperation with the private sector to strengthen corporate integrity; and (4) helping developing countries establish sound investment climates.

Anti-corruption provisions in donor operations

Almost all donors today have integrated anti-corruption clauses into their agreements with project partners and contractors. Corruption awareness and reporting obligations for donor staff have been found wanting for several donors,[26] however, and facilitation payments are still regarded as permissible by some donor agencies.[27] Sanctions in cases of breach of such agreements include revoking contracts, penalties or debarment from future contracts. The World Bank, for example, established such a debarment system in 1996 and continues to refine it, for instance with provisions for voluntary disclosure and the use of independent compliance monitors.[28]

24 See W. Easterly, *The Elusive Quest for Growth* (Cambridge, MA/London: MIT Press, 2001).

25 H. Mathisen and M. Weimer, *Assessing Donor Anti-corruption Initiatives in Support of Private Sector Development: A Mapping Study* (Bergen: Chr. Michelsen Institute, 2007).

26 OECD, *Mid-term Study of Phase 2 Reports: Application of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* (Paris: OECD, 2006).

27 This mirrors a comparably reluctant approach to criminalising facilitation payments in several donor countries. See article starting on page 116.

28 S. Williams, 'The Debarment of Corrupt Contractors from World Bank-financed Contracts', *Public Contract Law Journal,* vol. 36, no. 3 (2007).

Other mechanisms established to monitor compliance include hotlines (e.g. at DANIDA, the Danish public donor),[29] ombudspersons (e.g. at Germany's GTZ) and the World Bank's Department of Institutional Integrity, which investigates allegations of fraud, corruption and staff misconduct in bank operations.

Export credit agencies (ECAs) can also make a major contribution to incentivise corporate integrity. They underwrite an estimated 10 per cent of global exports by large industrialised countries and provide loans that exceed the lending of multilateral development banks.[30] ECAs can help tackle corruption in foreign investment projects by including strong due diligence and anti-corruption measures in their guarantee and loan schemes. In order to get a guarantee from the Norwegian Export Credit Agency (*Garanti-Instituttet for Eksport Kreditt*), for example, companies must sign a statement declaring that they will refrain from any illegal bribes.

The 2006 OECD recommendations to deter bribery in officially supported export credits provide an updated guiding framework for good anti-corruption practices. The challenge is to ensure more widespread and effective implementation of many important provisions, such as the requirement for the applying exporters to disclose the use of agents and commission fees, and to induce the ECAs of non-OECD countries to adopt the same principles.[31]

Addressing the global supply side of corruption

Ring-fencing donor projects is not enough. For a sustained impact on corporate integrity in developing countries, donors must address the global supply side of corruption. A major step forward is the OECD's Principles of Donor Action in Anti-Corruption.[32] Principle 2 provides a clear mandate for donors to address proactively the supply side of corruption, stating: 'Donors recognise that corruption is a two-way street [and that] action is needed in donor countries to bear down on corrupt practices by home-based companies doing business internationally.'

In this context, donors aim at influencing national and international processes and instruments that address the supply side of corruption. At the national level, the GTZ and BMZ (Federal Ministry for Economic Cooperation and Development), for example, are currently engaging in a reform of the German National Contact Point that monitors the OECD Guidelines for Multinational Enterprises.

At the international level, donors support the further development of private sector anti-corruption instruments, such as the OECD Anti-Bribery Convention and the UN Convention against Corruption (UNCAC).

29 Ministry of Foreign Affairs of Denmark, *Help Us to Fight Corruption* (Copenhagen: Ministry of Foreign Affairs of Denmark, 2005).

30 'Exporting Corruption: How Rich Country Export Credit Agencies Facilitate Corruption in the Global South', An interview with The Corner House, *Multinational Monitor*, vol. 27, no. 3 (2006).

31 OECD, *OECD Council Recommendation on Bribery and Officially Supported Export Credits* (Paris: OECD, 2006); OECD, *Export Credits and Bribery* (Paris: OECD, 2008); S. Hawley, *Experience and Practice of Combating Bribery in Officially Supported Export Credits* (Sturminster Newton, UK: Corner House, 2006).

32 The principles are annexed to the *Policy Paper and Principles on Anti-Corruption: Setting an Agenda for Collective Action* (Paris: OECD, 2007) elaborated by the OECD–DAC–GOVNET Anti-Corruption Task Team.

Cooperating with the private sector in fighting corruption

Donors are also working directly with the private sector to address corruption risks. Initiatives include:[33]

- sector-specific initiatives that bring together governments, industry and civil society to raise transparency and accountability in key economic development sectors, beginning with extractive industries in 2002 and followed by health, construction and development aid;[34] and
- the donor-supported Business Anti-Corruption Portal, an online database that provides information and resources to help small and medium enterprises avoid corruption when operating in developing countries.

Helping developing countries establish sound investment climates

Donors' key strategy to fight private sector corruption is fostering a sound investment climate and supporting good governance in developing countries through institutional reforms and administrative capacity-building. This includes assistance in drafting policies and regulatory frameworks, enhancing the integrity of the judiciary and state bureaucracies and incorporating a business climate perspective in national development plans and poverty reduction strategies.[35] The World Bank, for example, has spent US$3.8 billion, or more than 15 per cent of total group lending, on supporting governance and the rule of law.[36]

As an analysis of more than 400 private sector anti-corruption projects by major donors shows, most of these initiatives target corruption implicitly.[37] In addition, most efforts to support sound investment climates focus rather narrowly on curbing corruption that affects day-to-day business operations, but otherwise give rather short shrift to high-level corruption at the business–government nexus that can lead to policy or state capture. Measures to tackle such higher-level corruption more directly, such as transparency initiatives for political decision-making and political party-financing reforms, go beyond a narrow focus on economic affairs. Diplomatic considerations and concerns about overstepping their mandate make many official donors hesitant to engage too explicitly in this area.

Solutions depend on a broad base

Strengthening corporate integrity in developing countries requires commitment and action by a large band of stakeholders. Corporations need to step up their due diligence and compliance efforts, especially in institutionally weak environments that are particularly vulnerable to

33 J. Brüggemann, *Preventing Corruption in Government-to-Business Interaction*, working paper (Eschborn, Germany: GTZ, 2007).

34 Extractive Industries Transparency Initiative (see article starting on page 54), Construction Sector Transparency Initiative (COST), Medicines Transparency Alliance (MeTA) and International Aid Transparency Initiative.

35 H. Mathisen and M. Weimer, 2007.

36 World Bank, *Improving Development Outcomes: Fiscal Year 2007 Annual Integrity Report* (Washington, DC: World Bank, 2007).

37 H. Mathisen and M. Weimer, 2007.

corruption. Governments need to help the informal economy and ensure that it becomes a positive force in fostering business integrity.

Donors can also play their part. Ensuring effective anti-corruption compliance in their own programming means leading by example, setting important integrity incentives for local as well as international contractors. Working with governments and the private sector to address corruption risks proactively in key industries and sectors helps build and expand islands of integrity in the broader economy. Importantly, these strategies can unfold their full potential only if there is support for overall good governance reforms to raise regulatory quality and institutional accountability, and efforts to tackle corruption in international trade continue apace. Finally, for maximum efficacy, donors should place more emphasis on grand corruption and encourage new and increasingly important donors from non-OECD countries to join all these efforts.

Corruption and bribery in the extractive industries

Gavin Hayman[1]

The recent commodities boom created an unprecedented transfer of wealth from rich nations that consume natural resources to poorer countries that produce them. In 2006 exports of oil and minerals from Africa were worth roughly US$249 billion, nearly eight times the value of exported farm products (US$32 billion) and nearly six times the value of international aid (US$43 billion).[2] A similar story is apparent in much of the rest of the developing world.

If used properly, this money could be one of the best chances in a generation to lift many of the world's poorest and most dispossessed citizens out of poverty. History shows, however, that countries relying on oil and mining revenues tend, with surprisingly few exceptions, to be poor, badly run and prone to violent instability: the infamous 'resource curse' is now a well-documented phenomenon. To give just one example: from 1970 to 2000 the Nigerian government received over US$300 billion from oil sales while the percentage of citizens living in extreme poverty (on less than US$1 per day) increased from 36 per cent to around 70 per cent.[3]

The mechanisms behind the curse

The political structures that accrete around resource-rich 'bonanza' economies rarely bring about the social and cultural changes that lead to long-term investment in social development. Governments typically depend on taxes to run their affairs and have to justify to their citizens

1 Gavin Hayman is campaigns director at Global Witness.

2 World Trade Organization, *International Trade Statistics 2007* (Geneva: WTO, 2007); OECD, 'Query Wizard for International Development Statistics' (online database).

3 X. Sala-i-Martin and A. Subramanian, *Addressing the Natural Resource Curse: An Illustration from Nigeria*, Working Paper no. WP/03/139 (Washington, DC: IMF, 2003).

how much and how they spend the money they appropriate from them. In countries rich in natural resources, this principal accountability relation is broken. Governments can rely on natural resource revenues to fund their activities and focus their efforts on controlling these resource rents. The end result is 'crony capitalism', widespread patronage takes the place of meritocracy in government. The state becomes less of a rational manager of resources and behaves more like a 'protection racket'.

A recent example demonstrates how corruption is at the core of this pernicious system. In 2003 one of the largest ever foreign corruption investigations in US legal history uncovered what is alleged to be a major international corruption scandal that, in the words of an indictment by US prosecutors, 'defrauded the Government of Kazakhstan of funds to which it was entitled from oil transactions and defrauded the people of Kazakhstan of the right to the honest services of their elected and appointed officials'.[4]

The alleged scheme was based on the Kazakh president and oil minister demanding that international oil companies pay fees to a middleman. This arrangement, the indictment alleges, helped the middleman to skim money from the deals and send some US$78 million in gifts and kickbacks to the Kazakh president and others through dozens of overseas bank accounts in Switzerland, Liechtenstein and the British Virgin Islands.[5] One 'gift' was matching 'his and hers' snowmobiles for the president and his wife.[6] The case has yet to go to trial.

A lacklustre response

The international response to corruption in oil and mining has generally been weak and fragmented, not least because of geopolitical competition for influence and access to vital natural resources. Governments and companies alike have been slow to recognise that the short-term benefits of indulging in corruption, or turning a blind eye to it, are far outweighed by the damage.

Although foreign bribery has been criminalised in the OECD countries – especially in its conventional manifestation of a businessman providing a 'suitcase full of cash' in return for largesse – new forms of interaction to win contracts and enjoy special advantages have arisen that are equally corrosive to the governance of the country concerned, but that may avoid prosecution under the laws of OECD member states.

These mostly involve sophisticated 'current pay-off and deferred gift' structures, in which a company enters into some sort of business relationship with state officials or their friends and relatives. These relationships can be structured to provide benefits to the official and his or her networks in lieu of direct bribe payments. Untangling such relationships is

4 United States Attorney Southern District of New York, Indictment against James H. Giffen. For further information, see United States Attorney Southern District of New York, press release, 2 April 2003.

5 Global Witness, *Time for Transparency. Coming Clean on Oil, Mining and Gas Revenues* (Washington, DC: Global Witness, 2004).

6 Ibid.

made doubly difficult by the hugely complex nature of many extractive investment agreements.[7]

In addition, the enforcement record of some OECD members is poor: the United Kingdom is a case in point. There has been only one successful prosecution for foreign bribery, ever, and the BAe Systems affair has left the impression that, if an inquiry were seen to threaten major commercial and strategic interests, the government would intervene to stop it. Some other OECD members, such as Switzerland, have been gradually improving the oversight of their home companies' behaviour abroad, but have been poor at recognising their domestic role as launderers of corrupt money flowing through the international system.

Collective action for more transparency

One promising new initiative, however, has been the Extractive Industries Transparency Initiative (EITI), which makes public the flow of revenue to governments from oil and mining companies. This information is secret in many countries, preventing citizens from asking their governments how the money has been used. EITI breaks new ground, by bringing together governments, the private sector and civil society groups from around the world. Some twenty-three countries are now candidates, implementing EITI, and about ten or so have published some sort of public report on their revenues.[8]

EITI also has shortcomings. It does not cover the allocation of oil and mining concessions, issues of money-laundering or the tracking of revenues once they reach government budgets, to ensure that the money is spent properly. The voluntary character of EITI also means that those likely to be the worst offenders are not compelled to take part.

A key challenge for the future is how to expand initiatives such as the EITI into a more comprehensive road map that will help countries to manage their natural resource revenues better and more fairly, starting from the award of concessions through to the drawing up of transparent public budgets. Such efforts would need the support of the wider international community, which means a diplomatic push to involve China and India too.

Another important development is the effort by the Publish What You Pay campaign[9] to ensure that securities markets require resource extraction companies to report publicly all payments made to foreign governments on a country-by-country basis, and that international accounting standards require the disclosure of such payments by companies in their financial statements. Various items of legislation or rule-making on this are pending. If passed, they will ensure better information about the international business dealings of countries that are not prepared to be more open by other means.

Lastly, we need to address the role of the global financial system in laundering stolen wealth; compare, for example, the seriousness with which banks pursue terrorist financing

7 T. H. Moran, *Combating Corrupt Payments in Foreign Investment Concessions: Closing the Loopholes, Extending the Tools* (Washington, DC: Center for Global Development, 2008).
8 As of November 2008. See www.eitransparency.org for the latest list.
9 Global Witness is a member of this campaign.

to that with which they pursue the proceeds of corruption. There is little point pouring aid into poor countries when equal amounts in stolen public money can flow straight out into banks and tax havens.

The transfer of natural resource wealth to poor countries offers an unprecedented opportunity for development. If the international community does not respond to it in a coherent and concerted way, however, we risk a chaotic scramble for resources, just as unedifying as that which took place in the colonial era, with corruption leaving the citizens of the affected countries as poor as, or poorer than, they were thirty years ago.

Foreign direct investment and global supply chains: do they spread or dilute corporate integrity?

Transparency International

Are foreign investment and the broader phenomenon of globalisation a force for good or bad? Do they help spread or undermine corporate integrity? No other questions have been as polarising and defining for political world views for such a long time, and they are questions whose answers have proved to be just as elusive and inconclusive. One thing for certain is that global interdependence is deepening, and it is here to stay.

The challenge is to map the specific features and implications of globalisation for a particular policy issue and devise strategies to manage it for the benefits of all. The impact of economic globalisation on corporate integrity and good governance around the world is one such issue, and, arguably, one of the most important. It is central to formulating trade policies and plotting a viable trajectory for political as well as economic development.

Two opposing claims drive the debate. On the one hand, foreign direct investment (FDI) and trade have been expected to bring advanced standards and practices of corporate governance and corporate responsibility to emerging economies with weaker governance frameworks. On the other hand, the practices of outsourcing and offshoring associated with globalisation are suspected to circumvent the very same standards for responsible corporate citizenship, and are believed to exploit and even aggravate weak and corrupt regulatory environments. Which scenario is closer to the truth? What do we know about the relationship between economic integration and corruption? Here are three insights.

(1) As global production networks continue to expand, deepen and involve new actors, the duty of major players to act with integrity and a sense of global responsibility is also growing

Global FDI reached an all-time peak of more than US$1.8 trillion in 2007. Flows into developing and least developed countries have also continued to grow sharply, reaching a record

US$500 billion and US$13 billion, respectively. All world regions posted record inflows, which in Africa and Latin America were driven mainly by booming demand for natural resources and other commodities.[1]

Likewise, cross-border mergers and acquisitions have also reached record highs. By 2007 the number of transnational corporations (TNCs) had grown to around 79,000. They are estimated to control some 790,000 foreign affiliates around the world, accounting for 11 per cent of global GDP, sales worth US$31 trillion and a workforce of more than 80 million people.[2]

The largest TNCs continue to grow and expand their economic footprints. At the same time, new players have begun to enter the scene. The 100 largest TNCs from developing countries posted growth rates of more than 20 per cent between 2005 and 2006 alone. By 2006 they controlled more than US$570 billion worth of foreign assets, led mainly by investors from China, South Korea, Brazil and Mexico.[3]

Direct ownership and growing economic footprints translate into direct accountability for enforcing corporate standards of integrity and responsible citizenship across subsidiaries around the globe. Even when cross-border business takes the form of outsourcing and trade rather than foreign ownership, however, corporate integrity does not stop at the factory door.

Global supply chains have grown ever more complex, integrated and concentrated. Producers in many key industries, from chemicals and pharmaceuticals to electric machinery, radio, TV, computing and medical equipment, source more than 30 per cent of their inputs from outside their countries.[4] The shift towards manufacturing in developing countries, in particular to Asia, continues unabated, and the trend is even more pronounced for key consumer goods. Asian production alone by now accounts for a half of world trade in clothing.[5]

These globalised supply chains are rarely networks among equals. A relatively small number of branded retailers, manufacturers and, increasingly, clients for offshore services from industrialised countries typically establish and lead far-flung global supply networks, with thousands of highly competitive input providers. Just-in-time-production, the flexible customisation of products and the need for reliable quality with sourced inputs and services require the global supply chain leaders to establish close relationships with their suppliers and get deeply involved in organisational, training and planning aspects.

Wal-Mart, for example, the world's largest retailer with sales of around US$375 billion in 2007,[6] maintains a global supply network of some 6,000 factories, more than 80 per cent of which are in China. In 2003 Wal-Mart spent US$15 billion on Chinese-made products, accounting for nearly one-eighth of all Chinese exports to the United States. If Wal-Mart were

1 United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (Geneva: UNCTAD, 2008).
2 Ibid.
3 Ibid.
4 World Trade Organization (WTO), *World Trade Report 2008: Trade in a Globalizing World* (Geneva: WTO, 2008).
5 WTO, 2008.
6 'Wal-Mart Reports Record Fourth Quarter Sales and Earnings', Wal-Mart Stores Inc., 19 February 2008.

a separate nation, it would rank as China's fifth largest export market, ahead of Germany and the United Kingdom.[7]

This leverage, created by dominant businesses' deep involvement in production processes, means that the responsibility of supply chain leaders to uphold standards of corporate integrity and responsible conduct also applies to the wider supply chain. Consumer boycotts and fair trade initiatives have already put enormous pressure on well-known branded retailers to live up to these responsibilities and guarantee ethical conduct across their supply networks. Other supply chain leaders outside the public spotlight of well-known consumer brands face the same moral responsibility to make their commitment to corporate integrity congruent with their spheres of influence throughout their global networks of suppliers.

(2) Corruption is bad for attracting foreign direct investment and maximising its contribution to sustainable development

Corruption makes it difficult to garner benefits from FDI. In a large survey conducted in 2008 by Transparency International, almost a half (45 per cent) of the multinational companies from OECD countries that were interviewed reported that personal and familiar relationships rather than competitive bidding are frequently used to win public contracts in the non-OECD countries where they operate.[8] In a different study, more than a third of international business managers estimated that corruption increases international project costs by more than 10 per cent, while one-sixth believed that corruption inflates costs by more than a quarter.[9]

The resulting deterrent effect of corruption on foreign investment is palpable. In a survey of more than 390 senior business executives, almost 45 per cent said that they had decided against entering a market or pursuing a business opportunity because of corruption risks.[10] Controlling for other factors that influence investment decisions, an increase in the corruption level from that of Singapore to Mexico has the same deterrent effect on foreign investment as a tax increase of more than twenty percentage points. An analysis of almost 5,000 cross-border mergers and takeovers shows that high corruption environments depress the valuation of domestic firms significantly, making them less attractive to investors.[11]

Corruption also discourages the most coveted future-orientated investors: knowledge-based and high-technology industries. High levels of corruption shift ownership structures towards joint ventures and short-term management contracts with local partners that can help navigate

7 G. Gereffi, *The New Offshoring of Jobs and Global Development* (Geneva: International Labour Organization, 2006).
8 TI, '2008 Bribe Payers Survey' (Berlin: TI, 2008).
9 Control Risks and Simmons & Simmons, *Facing up to Corruption 2007: A Practical Business Guide* (London: Control Risks, 2007).
10 PricewaterhouseCoopers, *Confronting Corruption: The Business Case for an Effective Anti-corruption Programme* (London: PricewaterhouseCoopers, 2008).
11 S.-J. Wei, 'How Taxing Is Corruption on International Investors?', *Review of Economics and Statistics*, vol. 82, no. 1 (2000); U. Weitzel and S. Berns, 'Cross-border Takeovers, Corruption, and Related Aspects of Governance', *Journal of International Business Studies*, vol. 37, no. 6 (2006).

the more challenging corrupt political terrain. Innovative high-tech companies are less likely to enter such relationships, since they are eager to protect their innovations and expertise.[12]

Finally, a lack of transparent governance also leads to less long-term and development-orientated portfolio investments, as it makes such funds more prone to sudden withdrawals in times of crisis. During the Asian and Russian financial crises of the late 1990s, for example, emerging market funds withdrew more strongly from countries that were less transparent.[13]

(3) Increased foreign direct investment and trade are not automatically benign; companies can and must do a lot more to live up to their responsibilities in host countries

The negative impact of corruption on foreign investment does not mean, however, that more FDI inevitably promotes good governance and helps reduce corruption.

In countries with weak and/or non-democratic structures, FDI appears to magnify the problems of state capture and procurement bribery.[14] It is unlikely to serve automatically as a beacon for better corporate governance, and the evidence available suggests that currently it does not export higher non-wage-related working standards abroad. In countries with more advanced governance structures, the outcome is more positive, as FDI has been found to support improvements in corporate and public governance.[15]

Many believe that strategic choice rather than coercion is behind this amplifying effect. As World Bank researchers have observed, 'FDI firms undertake those forms of corruption that suit their comparative advantages, generating substantial gains for them and challenging the premise that they are coerced.'[16] The use of local agents with essential connections and superior knowledge of the local marketplace is widespread, and sometimes even legally mandated, but it is problematic from a corruption perspective. The bribing of local business partners can be 'outsourced' to these agents, conveniently hidden in excessive service fees, thereby diluting legal and moral culpability for the corrupt act. One survey found that about three-quarters of managers from countries including the United States, United Kingdom and Germany believed that companies from their countries 'regularly' or 'occasionally' used intermediaries to circumvent anti-corruption laws.[17]

12 B. S. Javorcik and S.-J. Wei, *Corruption and Composition of Foreign Direct Investment: Firm-level Evidence*, Working Paper no. 7969 (Cambridge, MA: National Bureau of Economic Research [NBER], 2000).

13 R. G. Gelos and S.-J. Wei, *Transparency and International Investor Behavior*, Working Paper no. 9260 (Cambridge, MA: NBER, 2002).

14 J. S. Hellman, G. Jones and D. Kaufmann, 'Far From Home: Do Foreign Investors Import Higher Standards of Governance in Transition Economies?', draft paper, August 2002; P. M. Pinto and B. Zhu, *Fortune or Evil? The Effect of Inward Foreign Direct Investment on Corruption*, Salztman Working Paper no. 10 (New York: Columbia University, 2008).

15 B. Kogut and M. Macpherson, 'Direct Investment and Corporate Governance', in P. Cornelius and B. Kogut (eds.), *Corporate Governance and Capital Flows in a Global Economy* (Oxford: Oxford University Press, 2003); OECD, *Policy Brief: The Social Impact of Foreign Direct Investment* (Paris: OECD, 2008).

16 J. S. Hellman, G. Jones and D. Kaufmann, 2002.

17 Control Risks and Simmons & Simmons, *International Business Attitudes to Corruption: Survey 2006* (London: Control Risks, 2006).

Foreign investors and supply chain leaders acknowledge this corruption challenge and have begun to strengthen their compliance efforts. Much remains to be done, however, not only by new players on the international economic scene but also by the established and most advanced multinationals.

Ignorance about the illegality of foreign bribery continues to be widespread and persistent, while anti-corruption provisions and training remain inadequate. According to Transparency International's 2008 Bribe Payers Survey, nearly 75 per cent of more than 2,700 interviewed executives were not familiar with the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. In France, Germany, the United Kingdom and the United States, more than 80 per cent of surveyed executives admitted to 'not being familiar at all' with this legal framework. In Brazil, a new and growing player in FDI, this number reached 77 per cent.[18]

Similarly, a 2006 survey of 350 senior business executives in companies with foreign operations revealed the following.

- In Hong Kong, Germany, France and Brazil, fewer than half the surveyed companies reported having a specific procedure for vetting agents and suppliers before entering into a relationship with them. [19]
- Only a quarter to a third of companies in the construction, power and retail sectors had training programmes for executives on how to avoid corruption. In the information and communication technology, pharmaceutical, oil, gas, mining and defence sectors, fewer than 45 per cent of companies provided such training.[20]

A similar pattern of poor performance with regard to ensuring corporate integrity and compliance across supply chains emerges from an analysis of 280 companies with high or medium risk of exposure to potential labour rights violations in their international supply chains. Fewer than 30 per cent of companies from North America, Australia and New Zealand were found to have even basic systems for communicating, reporting and monitoring labour rights standards across their supply networks. In Europe, only slightly more than a half of companies appeared to have any kind of system in place, while in Japan and other parts of Asia this was the case for fewer than 10 per cent of companies.[21]

Frameworks for action: making global efforts work in the local setting

All this indicates that companies, both from industrialised and emerging economies, need to do much more to live up to their responsibilities as good corporate citizens on the global scene and make foreign business engagement a definite, positive force for stronger corporate integrity and good governance.

18 TI, 2008.
19 Control Risks and Simmons & Simmons, 2006.
20 Ibid.
21 B. Gordon, *The State of Responsible Business: Global Corporate Response to Environmental, Social and Governance (ESG) Challenges* (London: Ethical Investment Research Services, 2007).

A number of initiatives have sprung up over the last decade that facilitate such an engagement.

- At the international level, the United Nations Global Compact provides a guiding policy framework and an information-sharing platform for companies to help them align their global operations with established human rights, labour, environmental and anti-corruption norms. By 2008 more than 4,700 companies and stakeholders had signed up and committed to reporting on their performance. Although this high participation rate and explicit recognition of corporate responsibilities beyond compliance with local laws is encouraging, the important next step will be to monitor corporations effectively and hold them to account for their commitments.[22]
- Linking home-country and local host-country accountability, the OECD Guidelines for Multinational Enterprises formulate the expectations of mainly OECD and some supporting countries with regard to the responsible conduct of business abroad, including supply chain and anti-corruption issues. Governments are required to set up national contact points to facilitate adherence to these voluntary standards. These offices are increasingly being recognised as an important mechanism by which civil society can bring specific concerns about corporate conduct in host countries to public attention, and have them assessed and discussed in the home jurisdiction of the multinational corporation.[23]
- At the local level, a wide range of reporting and certification initiatives provide businesses with the opportunity to enhance transparency and integrity throughout their supply chains.[24] These tools have more recently been supplemented by innovative new frameworks for collective action, such as the Extractive Industries Transparency Initiative[25] and a strategic approach to enhancing public policy frameworks, ownership and worker participation at local level.[26]

The growing toolkit for supply chain integrity is encouraging and bodes well for making FDI and international supply chains a positive force for good governance, human rights and corporate integrity. The remaining challenges are many, however. Voluntary initiatives need to develop mechanisms for enforcement, independent assurance and monitoring in order to strengthen their legitimacy and effectiveness. Collective action needs to become more inclusive. Small and medium-sized companies and more multinational companies from emerging economies, which play an increasingly important role in foreign investment and global supply chains, need to be encouraged to make use of these integrity tools and join related initiatives for collective action.[27]

22 See www.unglobalcompact.org/; for a discussion of monitoring and enforcement challenges, see www.globalcompactcritics.net/.
23 See article starting on page 331.
24 See article starting on page 99.
25 See article starting on page 54.
26 See article starting on page 63.
27 Global Compact membership and compliance, for example, is concentrated in western Europe, while non-financial reporting by companies in emerging economies is found to be rather limited; see M. Palenberg, W. Reinicke and J. M. Witte, *Trends in Non-financial Reporting*, Research Paper no. 6 (Berlin: Global Public Policy Institute, 2006) and J. Bremer, 'How Global is the Global Compact?', *Business Ethics: A European Review*, vol. 17, no. 3 (2008).

The intensification of the global competition for fossil fuels, food and many other natural resources provides enormous opportunities for many developing countries to gain greater benefits from trade, investment and integration in global supply chains. At the same time, this race for resources presents a huge stress test for business integrity overseas, making more effective and inclusive collective commitments to responsible investment and supply chain management an urgent task.

Strengthening compliance and integrity in the supply chain: what comes next?

Ayesha Barenblat and Tara Rangarajan[1]

> I firmly believe that a company that cheats on overtime and on the age of its labour, that dumps its scraps and chemicals in our rivers, that does not pay its taxes or honour its contracts will ultimately cheat on the quality of its products. And cheating on the quality of products is the same as cheating on customers.
>
> Wal-Mart CEO Lee Scott, October 2008

Sustainability in supply chains: from sticks to carrots, partnerships and ownership

Fifteen years ago efforts to ensure supply chain integrity focused on labour and environmental issues, and relied mainly on risk mitigation and social audits as tools to assess such risks. This approach turned out not to be enough. Monitoring and the threat of sanctions alone were not effective in safeguarding compliance and integrity across supply chains.

Today, leading companies have moved beyond this narrow control-based approach. They are increasingly taking a hard look at how their own purchasing practices may have an impact on factory conditions and the sustainability of supply chains in a broader sense, including compliance with all applicable laws, not least those related to a country's anti-corruption stance. At the same time, these companies also seek to instil greater 'ownership' for improving conditions with the factories themselves.

Translating these lessons and new approaches into a strategic framework, Business for Social Responsibility, in partnership with some of its most innovative member companies, has identified four key pillars that must work in concert with one another to make supply chains effective and sustainable:

1 Ayesha Barenblat is a manager in Advisory Services at Business for Social Responsibility (BSR). Tara Rangarajan is the managing director of Advisory Services at BSR.

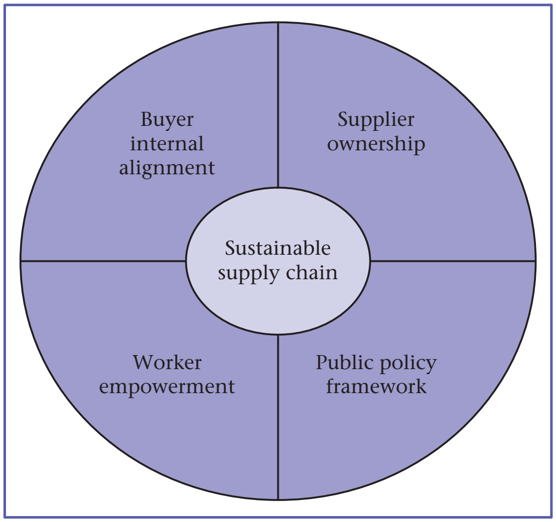

Figure 4: The four key pillars of the Business for Social Responsibility framework

- the internal alignment between the commercial and social objectives of buyers;
- the supplier ownership of labour and environmental conditions;
- the empowerment of workers to be informed and participating constituents; and
- public policy frameworks that foster public–private dialogue, partnerships and local solutions.[2]

Internal alignment requires that companies place sustainability on an equal footing with commercial objectives and organise their supply chain management accordingly. At a global textile retailer, for example, the firm's sustainable supply chain team helps to ensure sustainability integration and buy-in across the organisation. The company has also charged its senior vice-president in the sourcing unit with ensuring that suppliers deliver the products according to ethical standards.

In addition to this organisational alignment, buyers are paying considerable attention to changing the 'comply or die' model for suppliers and adjusting commercial incentives accordingly. That system, which led suppliers to falsify information and focus on beating the system, has been replaced by a more effective approach that emphasises a mutual commitment between brands and suppliers to identify and address the root causes of social and environmental challenges.

Towards partnerships and local ownership of supply chain integrity

Tackling the next generation of supply chain issues requires buyers and suppliers to begin operating as partners. A stronger sense of commitment by suppliers to good working and

2 BSR, *Beyond Monitoring: A New Vision for Sustainable Supply Chains* (San Francisco: BSR, 2007).

Box 1 Making compliance feasible rather than walking away

A multinational coffee chain purchased a bulk product from a supplier that in turn sourced the product from a third-party manufacturer. Through the factory assessment process, the coffee chain learnt that the third-party manufacturer was not paying workers the minimum wage and was exceeding acceptable overtime limits. The chain informed the supplier that no more orders would be placed until the situation improved. Rather than terminating the relationship, though, the chain asked whether the price it paid was sufficient to guarantee the minimum wage. When the supplier said it was not high enough a new price was set that would allow the minimum wage to be paid and other compliance issues to be remedied.

environmental conditions can be achieved through a basic bargain: suppliers assume greater responsibility in exchange for buyers providing greater security for business relations.

There is also a need for more information-sharing and dialogue, so as to create holistic, long-term solutions that truly improve the lives of vulnerable workers and our fragile environment.

Initially, many large buyers may seek to go it alone and set compliance standards for their own suppliers. This could lead to a confusing and costly proliferation of standards and compliance expectations for suppliers while forgoing the opportunity for a more systematic learning about good practices.

A good example of how buyers and suppliers are working together to help overcome these shortcomings is BSR's Apparel, Mills, and Sundries Working Group. Buyers and sellers have created one set of labour, health and safety, and environmental principles, and they have agreed on one audit with an emphasis on continuous improvement.

Empowering workers

It is broadly recognised today that the conventional reliance only on top-down auditing systems is flawed and needs to be supplemented by additional checks and balances. Empowering the workers most directly affected by lapses in corporate integrity to raise their concerns and actively participate in creating sound working conditions is key in this context.

Box 2 Engaging workers in supply chain integrity

Project Kaleidoscope is a multi-stakeholder effort of global corporations, organisations dedicated to advancing international labour issues, and a group of socially responsible investors. Participants have been working on a new approach to improve working conditions through a pilot project in ten factories in southern China. The focus is on moving beyond audit checklists to soliciting regular worker feedback, which has helped build trust and strengthen the overall worker–management relationship. In addition, suppliers were asked to provide regular performance data, which indicated the need for more robust management systems. The result has been a more proactive problem-solving attitude on the part of participating suppliers.

Supporting an enabling public policy framework

Buyer-initiated integrity initiatives for supply chains have arisen in response to the ineffective public enforcement of labour and environmental regulations in many developing countries. There is a growing recognition, however, that such private initiatives need to work in tandem with and support efforts to strengthen public policy frameworks. This has opened a wide array of new strategic engagement opportunities for supply chain leaders, including:

- support for a level playing field, by advocating for the recognition of integrity principles in international trade agreements;
- working with home governments to promote sustainable supply chains through appropriate design of procurement rules and aid programmes; and
- initiating a dialogue with suppliers, buyers and local governments on how to improve capabilities for local public enforcement.

A promising drive towards improvement

Credibility, transparency and a continuing commitment to improvement are the important principles needed to underpin this innovative approach to supply chain sustainability. There are reasons to be optimistic that standard-setting suppliers are moving in the right direction. Speaking in 2008 to leading advocacy groups, government officials and thousands of his company's top suppliers, Wal-Mart CEO Lee Scott announced far-reaching changes to the company's supply chain policies, including the following.

- *Certification:* A new supplier agreement requiring factories to certify compliance with local laws and regulations as well as 'rigorous' social and environmental standards. The agreement will be phased in by Chinese suppliers in 2009 and expanded to suppliers around the world by 2011.
- *Transparency:* By 2009 Wal-Mart will require all direct import suppliers, plus all suppliers of private label and non-branded products, to provide the name and location of every factory where their products are made.
- *Raising the bar:* By 2012 all direct suppliers will be required to source 95 per cent of their products from factories that receive the highest environmental and social ratings.[3]

Time will tell if these intentions can be effectively translated into activities on the ground. What is particularly significant, however, is that these commitments link supply chain sustainability to the core of the company's business model and business success – a recognition that no supply chain leader will be able to ignore any longer.

3 Wal-Mart Stores Inc., 'Wal-Mart Announces Global Responsibility Sourcing Initiative at China Summit', press release, 22 October 2008.

When China goes shopping abroad: new pressure for corporate integrity?

Deborah A. Bräutigam[1]

Chinese businesses have gone global – in a big way. Multibillion-dollar investments by Chinese companies in Angola (oil), South Africa (banking) and the Democratic Republic of Congo (minerals) have made headlines, but these are just the tip of the iceberg. Forty-nine Chinese contractors are listed among the world's top 225 firms, carrying out major construction projects from Dubai to Timbuktu.[2]

Turnover for Chinese companies involved in large construction projects overseas rose from US$8.4 billion in 2000 to US$40.6 billion in 2007.[3] China's telecommunications multinationals Huawei and ZTE have won dozens of major contracts with governments in the developing world. Manufacturers of consumer durables and pharmaceuticals have built factories in Nigeria, Pakistan and Tanzania. A portion of the country's enormous foreign currency reserves is channelled through the China Development Bank and the Export-Import (Exim) Bank of China, which help companies win business overseas. In 2007 alone the Exim Bank disbursed almost US$26 billion, making it among the world's largest export credit agencies.[4]

The corruption challenge that comes with this international expansion is imminent. Contracts involving construction, natural resources and land are areas in which the temptation for kickbacks and corrupt deals are ever-present.[5] This is true around the globe, but all the more so in the weak and conflict-prone states in which much recent Chinese business activity has taken place.

Tightening domestic rules

China's government has moved in recent years to clarify, tighten and enforce domestic anti-corruption laws and address widespread public disgust after a wave of bribery and embezzlement scandals. This has resulted in a series of high-profile prosecutions and convictions.[6] China's own criminal laws on bribery still contain many grey areas, however.

1 Deborah Bräutigam is Professor of International Development at the American University, Washington, DC.
2 P. Reina and G. J. Tulacz, 'The Top 225 International Contractors', *Engineering News-Record*, 13 August 2008.
3 Ministry of Foreign Economic Relations and Trade, *Almanac of China's Foreign Economic Relations and Trade* (Beijing: China Economic Publishing House, 2001); Ministry of Commerce, *China Commerce Yearbook 2008* (Beijing: China Commerce and Trade Press, 2008).
4 China Export-Import Bank, *Annual Report 2007* (Beijing: China Commerce and Trade Press, 2007).
5 More than 2,700 senior business executives from twenty-six countries polled in Transparency International's Bribe Payers Survey 2008 identified these sectors as particularly vulnerable to bribery. See article starting on page 402 and TI, *2008 Bribe Payers Index* (Berlin: TI, 2008).
6 *Caijing Magazine* (China), 24 September 2007.

Giving a bribe to a foreign official in China and bribing a foreign official overseas, for example, are not specifically criminalised, and the definition of what comprises a bribe is vague. China also lacks penalties for accounting practices that cover up kickbacks and bribes, and generous 'commissions' are still permitted as legitimate business expenses.[7]

The overseas corruption challenge

China's official pronouncements and practices are mixed when it comes to condemning bribery by its corporations overseas. On the one hand, while meeting with a large group of Chinese entrepreneurs in Africa in 2006, Premier Wen Jiabao laid down clear expectations: 'Our enterprises must conform to international rules when running businesses, must be open and transparent, should go through a bidding process for the big projects, forbid inappropriate deals and reject corruption and kickbacks.'[8] Wen's foremost concern was that corruption could sidestep healthy competition and condone products and work of inferior quality, inflicting long-term damage on China's commercial and political interests. In addition, China's Ministry of Commerce has promised to blacklist for at least two years companies implicated in bribery or collusion in the tendering for materials and equipment under China's foreign aid programme.[9]

On the other hand, the Exim Bank, which channels a large share of China's foreign aid as well as export credits, may still not have wholeheartedly adopted Wen Jiabao's call for transparency and may still not be fully averse to funding contracts awarded under the kind of no-bid arrangements Wen Jiabao warned against. When queried in 2007 about his bank's policies on transparency, Exim Bank president Li Ruogu commented: 'In China, we have a saying: "If the water is too clear, you don't catch any fish."'[10] In 2007 a political scandal broke in the Philippines over allegations of kickbacks connected to a contract awarded to Chinese telecoms firm ZTE and backed by a preferential export credit from the Exim Bank.[11]

To address corruption concerns, the Exim Bank is working to reduce embezzlement risks by not disbursing loans in some countries to the borrowing government itself but, rather, by keeping funds in a Chinese account under the country's name. Payments to Chinese companies that supply goods or build infrastructure are made directly from that account, after being authorised by the borrowing country. Additionally, Exim Bank loans for large infrastructure packages are sometimes repaid in oil or other natural resources. These practices make loans more secure, while also helping to ensure that receipts from natural resource exports are actually used for development.

7 *Caijing Magazine* (China), 19 September 2007; T. Ming. 'Jiejian haiwai jingyan, Jianquan fan shangye huiluo fagui' ['Learn from Overseas Experience, Improve Anti-commercial Bribery Laws and Regulations'], *Guoji Jingjifa Wang* [*International Economic Law*], 31 October 2006; *China Daily*, 20 October 2007.

8 *Nanfang Zhoumo* [*Nanfang Weekend*] (China), 2 November 2006.

9 Ministry of Commerce, 'Interim Measures for the Administration of Foreign Assistance Material Projects,' Decree no. 5, 1 September 2006.

10 Comment at the Center for Strategic and International Studies, Washington, DC, April 2007.

11 *Caijing Magazine* (China), 21 September 2007; *Philippines Today*, 16 February 2008.

Corporate conduct

Chinese companies are increasingly aware that adopting responsible business practices can be important for their international reputations. TI's 2008 Bribe Payers Index ranked Chinese companies twenty-first out of the twenty-two countries surveyed for their perceived propensity to bribe overseas.[12] At the same time, more than 180 Chinese companies, including Huawei, PetroChina and China Railway Engineering Corporation, have signed the UN Global Compact. Some, such as Huawei, have developed corporate codes of practice regarding corruption. Becoming a publicly listed company may further encourage this. In 2008 ZTE was sanctioned by Norway's national cellular operator Telenor for breaching its code of conduct in a business tender. ZTE admitted the breach but said it was the work of a rogue employee, commenting: 'ZTE has a very clear Code of Conduct and, as a listed company, our employees have to adhere to the highest business standards.'[13] As in other places, the increased exposure of corrupt practices is not always a sign of more corruption, but could be an indicator that control systems are functioning properly. It is then important, if and how such cases are sanctioned.

Promising legal reforms

Legal changes now under way may boost efforts to combat bribery by Chinese firms outside the country. China was a sponsor, and has signed and ratified, the UN Convention against Corruption (UNCAC), which stipulates that bribery overseas be made a crime. Chinese officials have repeatedly said that China will modify its laws to comply with all the convention's obligations.[14] In September 2007 China set up the National Corruption Prevention Bureau, tasked to improve international cooperation against corruption and fulfil China's responsibilities as an UNCAC signatory. The agency was not made autonomous, however. In June 2008 the Communist Party's Central Committee included the prohibition of commercial bribery overseas in its five-year anti-corruption work plan.[15]

Bad role models

China's reform efforts are taking place amid a new wave of bribery scandals involving well-known Western firms in China. In 2006 a Beijing consulting firm, Anbound, reported that 64 per cent of the nearly 100,000 corruption scandals investigated by China's government over the previous ten years had involved foreign companies.[16] China seems to have started up the steep road of reining in corporate corruption, but, with bad role models from the wealthy world so close at hand, we should not be surprised if these reforms proceed

12 TI, 2008, and see article starting on page 402.

13 Telecompaper.com (Netherlands), 14 October 2008.

14 Li Jinzhang, vice minister of foreign affairs, statement at the First Conference of the State Parties to the UN Convention against Corruption, Amman, Jordan, 10 December 2006; *Caijing Magazine* (China), 25 July 2007.

15 Central Committee of the Chinese Communist Party, 'Work Proposal of Establishing and Improving the Anti-corruption System 2008–2012', June 2008.

16 *People's Daily* (China), 17 November 2006.

slowly. The urgency of the challenge is clear, however. China's growing appetite for entrepreneurial risk-taking and its increasingly pivotal role in expanding foreign direct investment and trade to developing countries need to be matched by a strong commitment to anti-corruption standards when doing business abroad.

Risky interstices: transfer pricing and global tax management

Sol Picciotto[1]

Transfer pricing : a challenge for companies and the tax authorities

The term *transfer pricing* refers to the pricing of assets, products and services, usually when they are transferred between different units within a company. The term is also often used pejoratively, however, to mean the mispricing of cross-border transactions for an illegitimate purpose.

Under current accounting and taxation regimes, transfer pricing is an inevitable task for transnational corporations (TNCs) with branches or affiliates in many countries. Indeed, it is estimated that intra-firm flows of goods account for perhaps 40 to 50 per cent of world trade, although for OECD countries for which data is available the proportion varies widely, between 15 and 60 per cent.[2] Many other transfer payments within TNCs are made for services and finance. In addition, TNCs often dominate international supply chains, which, although they involve entities under different ownership, also provide flexibility in pricing transfers.[3] These enormous internal flows offer substantial opportunities to adjust prices to gain advantage for the firm. In particular, the prices used can have a significant impact on declared profits, and thus tax liability, in different jurisdictions.

The darker side and grey areas of transfer pricing

Transfer mispricing may be deliberate and at times fraudulent. The purposes may include reducing tax liability or import duties, evading currency controls and concealing the origins of funds transferred abroad, especially funds derived from criminal activity or corruption. When plastic buckets change hands for almost US$1,000 apiece, while a bulldozer is sold for a bargain US$1,700, it is clear that such egregious mispricing may be deliberate and fraudulent, involving collusion between exporters and importers.[4]

1 Sol Picciotto is an Emeritus Professor of Law at Lancaster University Law School.
2 OECD, *Measuring Globalisation: OECD Economic Globalisation Indicators* (Paris: OECD, 2005).
3 Ibid.
4 S. Pak and J. Zdanowicz, *US Trade with the World: An Estimate of 2001 Lost US Federal Income Tax Revenues Due to Over-invoiced Imports and Under-invoiced Exports*, working paper (Miami: Center for International Business Education and Research, Florida International University, 2005).

The complexity and often arbitrary nature of transfer pricing by TNCs also make it very difficult to know or prove that deliberate mispricing has taken place, however. Sometimes quite small and defensible adjustments to internal pricing can make a considerable difference to the profits a firm declares in different jurisdictions. This involves a legal grey zone.

The scale and scope of transfer mispricing are extremely difficult to establish, but the evidence suggests that it is being practised at levels that raise serious doubts about responsible tax management. Estimates based on trade databases of abnormal price deviations show likely levels of income-shifting due to under- and over-invoicing between the United States and other countries. These indicate mispricing generally ranging from 2 to 10 per cent of trade volumes, amounting to billions of dollars per year.[5] This contributes to a situation in which more than 60 per cent of US corporations reported no annual tax liabilities in any given year between 1998 and 2005.[6]

Europe faces similar issues. A detailed analysis of transfer pricing in Europe found many nations appear to gain revenues from intra-European profit-shifting by multinationals, largely at the expense of Germany.[7]

How to set the right price?

What is the norm for pricing between related parties operating within an integrated firm? Companies and tax authorities have long grappled with this problem, especially in relation to taxing income and profit. For corporate groups operating within a single tax jurisdiction, the usual approach is to require consolidated accounts, which simply eliminate intra-firm transactions and include as income the proceeds of sales only once made outside the group. This is obviously difficult for a single tax authority to apply to a TNC, and in the early twentieth century national tax authorities were given powers to adjust the accounts of companies within their jurisdiction to counteract any 'diversion' of profits to their foreign affiliates. Conflicting adjustments by different national authorities created a danger of international double taxation, however. This led to the adoption of internationally agreed principles for the allocation of income, to be embodied in bilateral tax treaties. [8]

The basic criterion for transfer pricing has been agreed to be the 'arm's-length' principle – that is to say, the price for equivalent transactions between independent entities, based on separate accounting by separate legal entities. This is inappropriate in principle, however, since TNCs by nature are globally integrated and derive much of their competitive advantage from

5 M. E. de Boyrie, S. Pak and J. Zdanowicz, 'Money Laundering and Income Tax Evasion: The Determination of Optimal Audits and Inspections to Detect Abnormal Prices in International Trade', *Journal of Financial Crime*, vol. 12, no. 2 (2004).

6 US Government Accountability Office (GAO), *Comparison of the Reported Tax Liabilities of Foreign and US-controlled Corporations, 1998–2005* (Washington, DC: GAO, 2008).

7 H. Huizinga and L. Laeven, *International Profit Shifting within European Multinationals*, Discussion Paper no. 6048 (London: Centre for Economic Policy Research, 2007).

8 S. Picciotto, *International Business Taxation* (London: Weidenfeld, 1992); M. B. Carroll, *Global Perspectives of an International Tax Lawyer* (Hicksville, NY: Exposition Press, 1978).

internal synergies and economies of scale and scope. This is especially so in today's knowledge economy, in which much added value depends on intangibles generated in the firm as a whole.

Although the OECD's Committee on Fiscal Affairs continues to maintain that separate accounts based on the arm's-length pricing of transactions should be the primary transfer pricing method, it has been obliged to accept alternatives based on allocating the overall profit earned according to the contribution made by each affiliate – an approach that is now often used.[9]

As a result, transfer pricing rules now applied by tax authorities are both complex and arbitrary. They result in frequent disputes, often involving negotiations between different authorities, to try to resolve double taxation resulting from inconsistent allocations that pose considerable problems for companies. Such cases may involve many millions of dollars and drag on for many years. In one notable transfer pricing case, the pharmaceutical company GlaxoSmithKline was assessed for US$5.2 billion in back taxes and interest by the US Internal Revenue Service in 2004 related to profits from its anti-ulcer drug Zantac. Glaxo claimed that this was arbitrary and appealed, arguing for a refund of US$1 billion. The dispute was finally settled for US$3.4 billion.[10]

Though extreme, the Glaxo case is far from unique, especially in globally integrated and knowledge-based industries such as pharmaceuticals. Conflicts emerge not only between firms and tax authorities but also between different tax authorities, since relatively small differences in transfer prices may affect the allocation of significant proportions of the tax base.

Inconsistent transfer-pricing adjustments between different national authorities are said to account for 80 per cent of bilateral double taxation disputes, although this cannot be verified, since the 'competent authority' procedure is secret and issues can take many years to resolve. To deal with this, the United States has introduced a procedure for advanced pricing agreements (APAs), which has also been adopted by other OECD countries. While this can provide firms with some certainty, it does not resolve the problems of arbitrariness or secrecy, as they are essentially private deals with each firm. Indeed, Glaxo's complaint of unfairness in the case above was based on a comparison with the treatment given by the US tax authorities in an APA with its then rival SmithKline. Glaxo discovered this differential treatment only after its merger with SmithKline in 2001.

A global challenge that hits developing countries particularly hard

In a survey of 850 multinational enterprises in twenty-four countries in 2007, a half said that they had undergone a transfer pricing examination since 2003, and a quarter said that

9 Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting, *Transfer Pricing Regulations and Transnational Corporation Practices: Guidance for Developing Countries* (Geneva: UN Conference on Trade and Development [UNCTAD], 1997).

10 M. A. Sullivan, 'With Billions at Stake, Glaxo Puts US APA Program on Trial', *Tax Notes International*, vol. 34 (2004); *The Economist* (UK), 31 January 2004; *Wall Street Journal* (Eastern edition), 12 September 2006.

the examination had led to adjustments. In addition, 87 per cent of respondents said they consider transfer pricing a risk issue in relation to their financial statements.[11]

Transfer pricing is not confined to a particular sector but plays an important role in all industries, from natural resource extraction and forestry to high-tech goods and services. Two-thirds of oil and gas multinationals considered transfer pricing issues as absolutely critical or very important. About a half of pharmaceuticals and telecommunications multinationals regarded transfer pricing as the largest risk issue for their financial statements.[12]

The scale and scope of transfer pricing, which may also involve transactions via tax havens for maximum tax avoidance, makes it an important issue for industrialised and developing countries alike. The former seek to protect their tax base and prevent legitimate tax competition between countries from becoming an unfair race to the bottom of special tax breaks, as well as ever lower corporate tax rates, such as those offered by international tax havens and offshore centres.

Developing countries face the additional challenge of ensuring that transfer pricing does not support capital flight or erode their revenues from what is, quite often, their single most important source of income: natural resources. In Papua New Guinea, transfer pricing on timber sales is estimated to cost the government tens of millions of dollars a year, and concerns about manipulative transfer pricing with regard to timber, other natural resources and a wide range of other trade transactions involving developing countries have been documented in many other parts of the world.[13]

Moreover, the tax authorities in developing countries are challenged to muster the expertise and resources to prevent transfer pricing abuses. As of this writing, only about forty countries are believed to have established some form of specific transfer pricing regulations.[14] Although in industrialised countries such as Australia and Denmark a half of multinational companies say they were challenged by the authorities when they adjusted their transfer prices, no such extra scrutiny was reported in Argentina, Brazil, India or Mexico.[15] As a result, the potential for abusive transfer pricing has emerged as an important concern on the international agenda for securing adequate financing for development.[16]

Two ideas for reform

The indeterminate or arbitrary criteria related to transfer pricing inevitably create opportunities and temptations for firms to adjust prices to gain tax advantages. Such practices may

11 Ernst & Young, *Precision under Pressure, Global Transfer Pricing Survey 2007–2008* (London: Ernst & Young, 2008).
12 Ibid.
13 *The Australian*, 19 July 2006; Bloomberg (US), 30 July 2008; I. Bannon and P. Collier, *Natural Resources and Violent Conflict: Options and Actions* (Washington, DC: World Bank, 2003); M. Grote, 'Tax Aspects of Domestic Resource Mobilisation: A Discussion of Enduring and Emerging Issues', presentation at UN Financing for Development and International Fund for Agricultural Development conference, Rome, 5 September 2007.
14 Ernst & Young, 2008.
15 Ibid.
16 See UNCTAD, *Draft Accra Accord* (Geneva: UNCTAD, 2008).

often be abusive. Both tax authorities and firms could do much to establish a better basis for preventing such abuse.

A common base for tax assessment

The tax authorities should reorientate their approach to transfer pricing by abandoning the chimera of the arm's-length principle. A new approach advocated by many specialists is a unitary or consolidated basis for the tax assessment of TNCs, with an allocation of the tax base based on formula apportionment.[17] This would sidestep the problem of transfer pricing by simply eliminating from the accounts internal transfers within the firm. It would also help to tackle other thorny problems of international tax avoidance related to intermediary entities formed in convenient jurisdictions or tax havens. This concept poses its own problems, however, especially the need for an international agreement on the formula for apportionment. This would not be easy to resolve, since much is at stake. Nevertheless, these issues should be faced and resolved openly, rather than having them shrouded in a fog of technical detail, imprecision and uncertainty, as under the present system.

Such solutions offer win-win opportunities. Firms and tax authorities alike would benefit from reduced compliance costs. This would be especially helpful for developing countries that lack the resources to operate complex anti-avoidance rules or check transfer prices. Greater effectiveness would mean higher revenues, which would provide the opportunity to reduce marginal corporate tax rates further.

Transparency of tax payments as an integral part of corporate citizenship

Firms should adopt clear and open guidelines for tax compliance, including a high degree of transparency about the amount of tax they actually pay broken down by jurisdiction. At present, companies usually report only a global figure, which is often misleading, because provisions made for tax are shown while the actual amounts paid in the end are often lower due to deferral. A promising approach that could serve as a template for disclosing how much tax companies pay, and how much tax governments receive, has been developed by the Extractive Industries Transparency Initiative and endorsed by the G8 group of developed countries.[18]

Furthermore, corporate codes of conduct should include a clear commitment to comply with both the letter and the spirit of tax rules, and reject overly aggressive tax planning and avoidance schemes. Surprisingly, such a commitment is ignored in most corporate codes of conduct. The Tax Justice Network's Code of Conduct for Taxation, which has basic principles applicable to both revenue authorities and firms, could provide a useful template.

As companies increasingly acknowledge their role as corporate citizens, they are reporting more information on their social and environmental impact. Tax payments, as the most direct and

17 K. A. Clausing and R. S. Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment* (Washington, DC: Brookings Institution, 2007).
18 See article starting on page 54.

fundamental way that companies contribute to society, should be central to a company's public disclosure. More transparency about tax payments is also a prerequisite for an informed debate on the fairness of specific tax management and transfer-pricing schemes. Opinions on what is considered appropriate will inevitably vary, but an informed debate as to whether a company is living up to its most fundamental commitments to society is essential and legitimate.

Such a combined constructive approach could establish a stronger basis of trust between the tax authorities and the private sector, which would greatly improve tax compliance and help strengthen the confidence of citizens in the legitimacy of taxation.

Where public and private merge: privatisation and corruption

John Nellis[1]

> Brazil, May 2003: Brazilian officials alleged collusion between American investors AES and Enron in the 1998 sale of an electricity utility in São Paulo. The authorities claimed that the two agreed in advance that AES would be the only bidder. In return, Enron would be given a contract to build a generation plant. The *Financial Times* reported that the AES representative came to the final meeting with two envelopes, the first containing a bid for US$1.78 billion, the second for US$2.28 billion. Once it was clear that Enron was not going to submit an offer, the lower bid was tendered. The Brazilian government investigated. All the parties denied any illegality. In 2007 collusion charges were dismissed for lack of evidence. That Enron (which underwent bankruptcy and dissolution in 2001) never built a power plant was a factor in the decision to drop the case.[2]

Worldwide, more than 100,000 large enterprises and firms have been privatised since 1980, along with an equal or larger number of small businesses.[3] Sales revenues are in the neighbourhood of US$700 billion. The total value of privatised assets is actually much higher than indicated by sales revenues, since many of the firms have literally been given away, particularly in former communist countries.

Ex post assessments conclude that privatisation generally results in declining production costs and increased returns to owners.[4] Efficiency and financial gains following privatisation have

1 John Nellis is a principal in the research and consulting firm International Analytics.
2 *Financial Times* (UK), 21 May 2003; see also 'AES in Latin America', at www.aes-latinamerica.com/tom-tribone-aes-enron/.
3 F. Schneider, *Privatization in Austria and Other EU Countries: Some Theoretical Reasons and First Results about the Privitization Proceeds* (Munich: CESifo, 2003).
4 W. L. Megginson and J. M. Netter, 'From State to Market: A Survey of Empirical Studies on Privatization', *Journal of Economic Literature*, vol. 39, no. 2 (2001).

been frequent and sizeable enough to impress many economists, financial analysts, finance ministers and international financial institutions.

Performance improvements stir technicians, but concerns about privatisation's unequal distributive effects have provoked criticisms. The complaint is that privatisation rewards the foreign, the wealthy, the agile and the corrupt at the expense of the local, the poor, the non-connected and the honest.[5] Opponents have made their points skilfully: privatisation has become the most widely criticised and popularly disliked of all economic liberalisation policies.

Rather than debating the merits of privatisation, the present task is to discuss the commonly asserted but little analysed linkage between privatisation and corruption. There is plenty of smoke around privatisation and how it fosters corruption, but determining if there is fire – and, if so, its nature, extent and how to put it out – is a complex matter.

Underachievement in Russia and eastern Europe

Privatisation has increased inequality, at least in the short run and particularly in former communist countries. Russia is the prime example. Despite a distribution of shares in privatised firms to the general public, as much as 90 percent of the prime assets were accumulated by a tiny group of entrepreneurs. Other countries using such a 'voucher privatisation' distribution scheme, such as the Czech Republic, Romania and the Ukraine, experienced similar if somewhat less dramatic results.

Methods of transferring ownership have varied. In Russia, former managers of state-owned firms transformed themselves into new owners and then persuaded or pressured worker-shareholders to support them, arguing that this would be a better arrangement than dealing with unknown, perhaps foreign, capitalists. In other cases, private Russian banks received shares in key firms as collateral for loans to the state that were never repaid, resulting in banks becoming owners of major assets for a relative pittance. Russia's Uneximbank obtained 38 per cent of the shares in Norilsk Nickel, a firm with reportedly US$2 billion in profits, in return for a US$170 million loan.[6] In the Czech Republic, investment fund managers accumulated vouchers and then 'tunnelled' resources by transferring decent assets to subsidiaries they personally owned or controlled, leaving the citizens to own liabilities in 'shell' companies.[7] Variations on these themes have occurred in most former communist countries, and also, belatedly, in China. In all instances, former members of the communist administrative *nomenklatura* transformed themselves into a property-owning bourgeoisie.

In retrospect, it can be seen that privatisation in 'transition' states was vastly oversold. Citizens were misled, and the expectations and promises of domestic reformers and international

5 S. Kahn and E. Minnich, *The Fox in the Henhouse: How Privatization Threatens Democracy* (San Francisco: Berrett-Koehler, 2005).

6 J. Nellis, 'The World Bank, Privatization, and Enterprise Reform in Transition Economies', *Transition Newsletter*, vol. 13, no. 1 (2002).

7 D. Ellerman, *Voucher Privatization with Investment Funds: An Institutional Analysis*, Policy Reseach Working Paper no. 1924 (Washington, DC: World Bank, 1998).

supporters alike were not met. These actions were seldom outright illegal, however, in the chaotic post-communist legal/institutional framework. Moreover, a large percentage of the privatised assets ended up in the hands of people who arguably made better use of them than the former state managers. These firms eventually contributed to recovery, growth and – through taxation – government revenues. Analysts of a *realpolitik* bent have thus concluded that privatisation in former socialist economies, while messy and unfair, was unavoidable, ultimately beneficial and superior to the only likely alternative: continued stagnation.[8]

Fifteen years on, however, most in the former Soviet states regard the privatisation exercise as having been unjust and fraudulent; they also regard it as largely over. Few think it worthwhile to try to correct or undo the process.

Some renationalisation has subsequently taken place in the incredibly lucrative Russian gas and oil sectors. This process appears to have been just as unfair as the original privatisations. In 2004, for example, the main assets of once private Yukos Oil were transferred by means of a rather dubious legal process 'at a minimal cost' to state-owned Rosneft. At least one very valuable Yukos unit was sold for a low price, which the then President Vladimir Putin's own economic adviser termed 'the scam of the year'.[9] Yukos head Mikhail Khodorkovsky, Russia's richest person at the time, and several other top Yukos executives were tried and jailed for tax evasion.

Other renationalisation efforts have occurred in Slovakia, which reassumed control of several strategic industries and halted all large-scale privatisation plans, and in Estonia, which renationalised Estonian Railways in early 2007. Additionally, Lithuania and Poland have prevented the privatisation of firms deemed to be of national strategic importance.[10]

What can we learn?

Several lessons can be learnt from these and other privatisation schemes. First, the idea that private ownership could occur in an efficient and equitable manner in the absence of the legal and policy frameworks that underpin the functioning of markets was naive or worse. Furthermore, corruption risks are greater in poor countries.

Privatisation-related corruption rises as the value of the privatised company increases and as the selling country's overall income level declines. The best explanation is that a country's income level correlates closely with its level of institutional development – with low levels weakening or eliminating both the internal and the external monitoring of administrative and investor behaviour. One small, easily hidden act can reward officials with multiples of

8 D. Kaufmann and P. Siegelbaum, 'Privatization and Corruption in Transitional Economies', *Journal of International Affairs*, vol. 50, no. 2 (1997); A. Aslund, 'US–Russia Economic Relationship: Implications of the Yukos Affair', testimony before the House Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Washington, DC, 17 October 2007; A. Shleifer and D. Treisman, *Without a Map: Political Tactics and Economic Reform in Russia* (Cambridge, MA: MIT Press, 2000).

9 A. Aslund, 2007.

10 UNCTAD, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (Geneva: UNCTAD, 2008).

their regular salary. With relatively small payments to government officials or other bidders, investors can eliminate a competitor, obtain a monopoly position or favourable policy stance, win a contract or bend bidding qualifications.

For example, after winning the competition to take over Tanzania Telecommunications Company Limited (TTCL), the investing consortium entered into further negotiations with the government. Two major changes to the original bid document were made, cutting the final price in half and awarding the consortium a 'management assistance fee' of 3.5 per cent of monthly gross turnover. Presumably the other bidders were unaware that these additional arrangements could be negotiated, yet the bidding was not reopened. Though corruption was not proved, the consistent lack of clarity gives great cause for concern and feeds the misgivings of opponents.[11]

This hardly means that transparency can or should be ignored. Worldwide, privatisation has tended to win the economic battles while losing the political wars. The public perception that deals were corrupt has been the primary determinant of the political outcome. Numerous water privatisation efforts have failed recently in Latin America, Africa, Asia and the United States, following opposition from public interest groups claiming not only that deals with multinational contractors were not transparent, but that rates rose unreasonably and the promised service improvements were not carried out. The most high-profile reversal came in 2000 in Cochabamba, Bolivia, where the privatised water utility was returned to public control.

While not sufficient for economic success, transparency is essential for privatisation to be viewed as politically legitimate. The most effective way to combat corruption in privatisation is by increasing the flow of information to the public, not simply on transactions but also on the financial and operational performance of state-owned firms prior to sale. Thus, standard legal procedures promoting transparency, such as those in competitive bidding and procurement manuals of international financial institutions, are helpful and worth promoting.

Another lesson is that both venality and suspicion thrive on opaqueness and ignorance. All the same, transparency is important but not a cure-all. Transparent sales procedures alone do not guarantee technically good privatisation outcomes. For example, Senegal's government followed all recommended transparency procedures in the 1999 sale of part of its electricity firm. The government repurchased the shares eighteen months later, however, following disputes over investments and tariffs, lack of service improvements and arguments between the two private shareholders. A second privatisation attempt, again using good transparency practices, also failed to produce an acceptable bidder.[12]

It is essential to go deeper than this, however, and address the previously used or abused financial management systems applied in state-owned enterprises (SOEs). In many settings, basic operational and financial data on firm performance has been not produced, not sent to

11 Tanzanian Presidential Commission to Review Infrastructure Privatisation, unpublished report of consultants on the privatisation of TTCL, 2005.

12 Boston Institute for Developing Economies (BIDE), 'Impact of Privatization in Africa: Synthesis of Eight Cases' [unpublished report submitted to the World Bank] (Bethesda, MD: BIDE, 2006).

supervisors, not tabulated in supervising bodies or not acted upon. Some governments therefore have not been precisely aware of what they were selling, and buyers were not sure of what they were getting. The resulting uncertainty creates an informational vacuum in which delay, renegotiation and corruption can flourish.

Efforts by governments and their advisers to achieve SOE reform must be renewed and redoubled. A first step is the independent accounting and auditing of SOEs consistent with generally accepted accounting principles. Also needed are financial reporting and management systems that allow treasury officials to measure the fiscal and macroeconomic impact of SOE actions. Having open sales procedures can help sooth public suspicion and mistrust, as was done in Bolivia, which opened all privatisation bids live on television, and in Slovakia, which invited independent observers to vet a transaction.

Information discovered through these procedures can assist all parties. First, reformers become armed with information on the past costs of poor SOE performance and the future costs of continued inaction. Second, potential investors have a clearer picture of what is on the market, allowing them to make more precise offers and rely less on post-sale manoeuvring. Third, the press and public are aided in their quest to find out what is being proposed and who benefits.

The ultimate factor, though, is giving voice to local actors as well as external observers – an authoritative mechanism to confront decision-makers with information and hold them accountable. Weak or absent voice and empowerment in much of the world's poorer areas constitute a prime reason privatisation has been criticised, even when financial and efficiency accomplishments were unquestioned. Again, there is a close correlation between a country's income level and the extent and efficacy of these factors.

Signs of progress are appearing. In 2006 Tanzania's government contracted with a US firm to build and operate a power plant. Much of the negotiation was carried out in secret. The plant did not go online on schedule and the costs to Tanzania were very high. Having had dramatically bad experiences with two previous private generating contracts, citizens and MPs expressed concern and an acute desire to know more. In November 2007 parliament formed a committee to investigate the tendering process. Three months later the committee issued a detailed report that alleges, *inter alia*, that high-ranking officials influenced the decision to retain the US firm, overriding the objections of technicians. The prime minister, the energy and minerals minister and a former energy and minerals minister serving in a different post all resigned – an unprecedented event in Tanzania, and a rare one in Africa as a whole.[13]

A simple yet important lesson is that method matters. Privatisation by selling shares on a stock exchange offers more transparency and broad dispersion of ownership, and thereby fewer

13 'Report of the Select Committee formed by the Parliament of the United Republic of Tanzania on 13 November 2007 to Investigate the Tendering Process for Emergency Power Supply which Awarded the Tender to Richmond Development Company LLC of Houston, Texas, USA, in 2006', Parliament of Tanzania, 2007.

opportunities for corruption than other methods. Kenya used public offerings to sell off significant portions of the national airline, the main electric utility and a mobile phone company. All three sales have been regarded as comparatively clean by internal and external observers alike.[14]

When capital markets are not sufficiently developed for this approach auctioning can be another good method, as was used in Serbia and Poland to divest small and medium enterprises. Open competition among bidders on the public auction floor greatly reduces the likelihood of corrupt dealings. A few countries have also successfully used an open tender process to obtain offers from competing bidders for larger firms.[15]

Finally, open, robust competition is key. Few bidders means a greater chance for corruption, through a greater need for confidential negotiations with selling agents, poor information flow and more complex sales contracts. These complicating conditions apply in many if not most large privatisations in developing and transition countries, particularly in the high-value infrastructure and financial sectors.

14 Y. A. Debrah and O. K. Toroitich, 'The Making of an African Success Story: The Privatization of Kenya Airways', *Thunderbird International Business Review*, vol. 47, no. 2 (2005).

15 I. Goldberg and J. Nellis, 'Methods and Institutions – How Do They Matter?: Lessons from Privatization and Restructuring in the Post-socialist Transition', in I. W. Lieberman and D. J. Kopf (eds.), *Privatization in Transition Economies: The Ongoing Story* (New York: Elsevier, 2008).