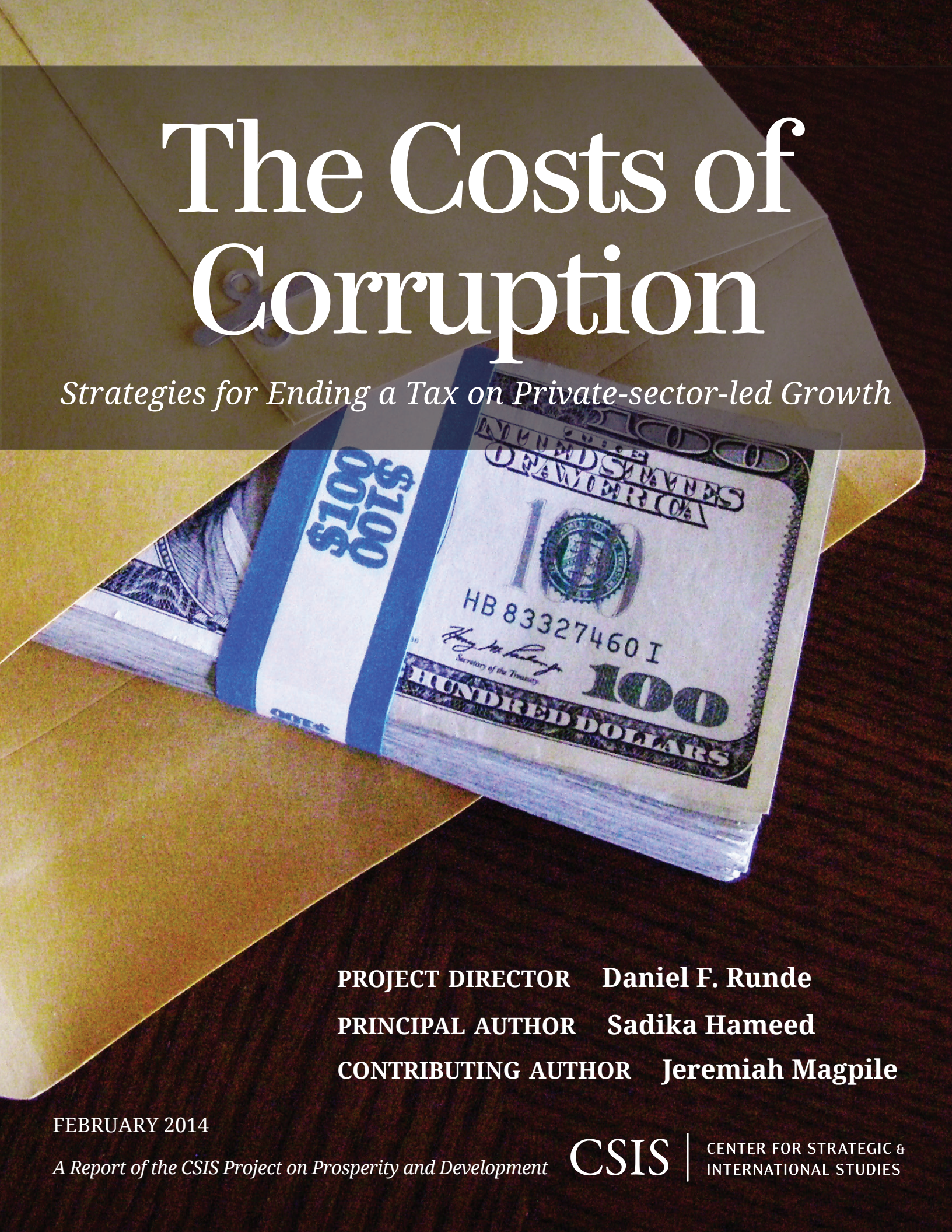


# The Costs of Corruption

*Strategies for Ending a Tax on Private-sector-led Growth*



PROJECT DIRECTOR   Daniel F. Runde  
PRINCIPAL AUTHOR   Sadika Hameed  
CONTRIBUTING AUTHOR   Jeremiah Magpile

FEBRUARY 2014

*A Report of the CSIS Project on Prosperity and Development*

CSIS

CENTER FOR STRATEGIC &  
INTERNATIONAL STUDIES





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Center for Strategic & International Studies  
1616 Rhode Island Avenue, NW  
Washington, DC 20036  
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4501 Forbes Boulevard  
Lanham, MD 20706  
301-459-3366 | [www.rowman.com](http://www.rowman.com)

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*Daniel F. Runde  
Director, Project on Prosperity and  
Development, CSIS*

## | Executive Summary

Corruption is a massive tax on the private sector, ultimately holds back global growth, and impedes poverty reduction. Developing economies bear a disproportionate share of the costs of corruption. Reducing corruption, which attracts foreign investors, should be a major focus not just of development assistance and diplomacy, but also of trade coalitions and business community efforts.

As worldwide trade and financial flows, infrastructure projects, and government procurement increase, private-sector and government stakeholders are going to face increased incentives for combating corruption effectively. Sixty-seven out of 144 economies surveyed by the World Economic Forum identified corruption as one of the top three challenges to conducting business in their country.<sup>1</sup> Solving the problems of corruption requires collective action by companies in partnership with governments, multilateral organizations, civil society, independent media, and an independent judiciary.

Businesses, large and small, increasingly see themselves as victims of corruption. They recognize that corrupt practices have costs in the long run as customers, investors, and suppliers prefer to do business with well-governed, reputable firms. Corruption is both a supply-side and demand-side problem, and both sides must be addressed for the successful elimination of corruption.<sup>2</sup> It is imperative that the private sector, specifically individual businesses and business coalitions, take initiative for the fight against corruption and address the supply-side issue.

The costs to society and to the private sector are staggering. Various estimates put the costs at \$1 trillion for corruption globally. CSIS has reviewed data from the World Bank Group and others and estimates that a segment of private-sector corruption alone in developing countries is at least \$500 billion, more than three times all foreign assistance given in 2012.

With such costs and the risk of lost business and competitiveness, it is in the private sector's interest, as well as in the public sector's interest, to see the highest codes of conduct enforced for all private-sector actors. There are challenges to collective action aimed at offsetting perceived short-term payoffs by individual companies in not complying with strict codes and in providing bribes for short-term gain. Collective action is needed to improve transparency and increase sanctions and costs to companies so that they do not defect from coalitions and continue to adhere to expected standards. Solving these issues requires private-sector leadership along with increased support from governments, aid donors, civil society, and others.

“Corruption is a term of many meanings, and indeed the beginning of wisdom on the issue is to subdivide and unpack the vast concept. At the broadest level, corruption is the

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<sup>1</sup> The World Economic Forum in its annual Executive Opinion Survey asked participants to rank the top five barriers to doing business. World Economic Forum, “Global Competitiveness Report 2013,” 33, <http://reports.weforum.org/the-global-competitiveness-report-2013-2014/>.

<sup>2</sup> Frank Vogl, “Technology Can Help Fight Corruption,” *Financial Times*, September 11, 2012, <http://www.ft.com/intl/cms/s/0/c85dda1c-fb81-11e1-87ae-00144feabdc0.html#axzz2oJb26mOh>.

misuse of office for unofficial ends.”<sup>3</sup> This paper focuses only on corruption in the private sector—which is particularly prevalent when corruption is systemic in the public sector and where there are complex, hindering regulatory frameworks or weak laws and arbitration systems.

This study approaches these issues from various angles: The report looks at why the business community should do more to combat corruption, the opportunity cost of corruption, and the role that the private sector and other stakeholders have played in combating corruption. The report also revisits the literature on the costs of corruption and calculates the dollar value of private-sector corruption in 105 developing countries. Finally, it recommends actionable steps for relevant stakeholders, including the private sector, in addressing corruption worldwide.

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<sup>3</sup> Robert Klitgaard, “International Cooperation against Corruption,” Internet Center for Corruption Research, November 1997, [http://www.icgg.org/downloads/contribution02\\_klitgaard.pdf](http://www.icgg.org/downloads/contribution02_klitgaard.pdf).



# | Introduction

Reducing or removing corruption eliminates a pernicious tax on business, and frees up resources for constructive investments. Reducing or removing corruption attracts foreign investors and increases tolerance of electorates for public officials seeking to make constructive but difficult changes. Reducing or removing corruption should be a major focus of not just development assistance and diplomacy, but also of trade coalitions and business community efforts. Failure to achieve this agenda lowers political support for international development funding, reduces the amount of foreign direct investment, reduces goodwill for difficult political reform by political leaders in developing countries, and ultimately holds back global growth and poverty alleviation.

Developing economies bear a proportionately larger burden from the cost of corruption. The Control Risks Group estimated in 2011 that developing countries lost close to \$1 trillion in “fraud, corruption and shady business transactions,” up by 13.7 percent in 2010. They also found that illicit funds were leaving emerging markets at an accelerated pace.<sup>1</sup> Corruption is becoming more sophisticated via offshore accounts, sham charities, opaque commissions, and other entities.<sup>2</sup>

Businesses, large and small, increasingly see themselves as victims of corruption. They recognize that corrupt practices cause them to lose out on higher premiums, as investors prefer to do business with well-governed firms. While most research on business corruption is perceptions based, and therefore subjective to some extent, a variety of estimates have been attempted to quantify the costs to society and business. Corruption adds 10 percent to the cost of doing business in countries, and up to 25 percent to the cost of public contracts.<sup>3</sup> According to the 2013 Kroll-Compliance Week Anti-Bribery and Corruption Benchmarking Report, 43 percent of those surveyed reported an increase in corruption risks.<sup>4</sup> Sixty-seven out of 144 economies surveyed by the World Economic Forum identified corruption as being one of the top three challenges to conducting business in their country.<sup>5</sup>

The research in this report follows on from a roundtable that was held by the Project on Prosperity and Development at the Center for Strategic and International Studies on the business costs of corruption. In this meeting, participants agreed that while corruption is known to be costly to businesses, it is difficult to pinpoint exactly how costly it is,

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<sup>1</sup> Stella Dawson, “Amount of Dirty Money Leaving Developing World Jumped 14 Pct in 2011,” Reuters, December 11, 2013, <http://www.trust.org/item/20131211234419-58nur/>.

<sup>2</sup> Center for Responsible Enterprise and Trade (CREATe), “Guide to Improving Your Anti-Corruption Program,” 10, <http://www.create.org/views-blog/new-create-launches-anti-corruption-improvement-guide>.

<sup>3</sup> Angel Gurría, Organization for Economic Coordination and Development (OECD) secretary-general, “OECD, an active partner of the G20 and B20 in the global fight against corruption,” remarks at dinner of the B20 Task Force on Improving Transparency and Anti-corruption, Paris, October 10, 2012, <http://www.oecd.org/g20/topics/anti-corruption/oecdanactivepartneroftheg20andb20intheglobalfightagainstcorruption.htm>; also CREATe, “Guide to Improving Your Anti-Corruption Program,” 5, [http://www.create.org/sites/default/files/CREATe\\_AC Improvment Guide\\_preview\\_English.pdf](http://www.create.org/sites/default/files/CREATe_AC%20Improvement%20Guide_preview_English.pdf).

<sup>4</sup> Kroll Advisory Solutions-Compliance Week, “2013 Anti-Bribery and Corruption Benchmarking Report,” <http://www.kroll.com/library/kroll-anti-bribery-report.pdf>.

<sup>5</sup> The World Economic Forum in its annual Executive Opinion Survey asked participants to rank the top five barriers to doing business. See World Economic Forum, “Partnering against Corruption Initiative,” <http://www.weforum.org/issues/partnering-against-corruption-initiative>.

especially in dollar values.<sup>6</sup> Some studies have attempted to place a dollar amount on the cost of corruption, with varying results. One of the most influential figures arose from Daniel Kaufmann's study conducted in 2005 that placed the cost between \$600 billion and \$1.5 trillion; however, Kaufmann's work went beyond private-sector corruption and included household bribery, which included individuals.<sup>7</sup>

This report focuses on corruption in the private sector and the costs of corruption to businesses. As worldwide trade and financial flows, infrastructure projects, and government procurement increase, private-sector and government stakeholders should work toward managing opportunities for corruption within this space. This study approaches these issues from various angles: It looks at why the business community should do more to combat corruption, the opportunity cost of corruption, and the role that the private sector and other stakeholders have played in combating corruption. The report also revisits the literature on the costs of corruption and calculates the dollar value of private-sector corruption in 105 developing countries. Finally, it also recommends actionable steps for the private sector in addressing corruption worldwide.

## Defining Corruption and Unquantifiable Business Costs

“Corruption is a term of many meanings, and indeed the beginning of wisdom on the issue is to subdivide and unpack the vast concept. At the broadest level, corruption is the misuse of office for unofficial ends.”<sup>8</sup> Transparency International defines corruption for both the private and public sector as “the abuse of entrusted power for private gain.”<sup>9</sup> The World Bank defines five different types of corruption.<sup>10 11</sup> However, measurements of corruption calculated or analyzed in this report do not take into account these types of corruption. Private-sector corruption is particularly prevalent when corruption is systemic in the public sector and where there are complex and hindering regulatory frameworks or weak laws and arbitration.<sup>12</sup>

It is important to note that private- and public-sector corruption are interlinked. In fact, as one of the pioneers of corruption literature put it, “Indeed, the private sector is involved in most government corruption.”<sup>13</sup> While this report does focus on the costs of

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<sup>6</sup> See appendix A and table 1 for the reasons why it is difficult to quantify the costs of corruption.

<sup>7</sup> This number went beyond private-sector corruption and also looked at household surveys. This study used information from the World Bank's enterprise surveys, the World Economic Forums global competitiveness surveys, the World Development indicators, and household surveys. The authors ran a number of iterations of regressions with sensitivity analysis and came up with dollar values ranging from \$600 billion to \$1.5 trillion. Their median value of \$1 trillion is cited in many reports. To date no one has replicated their methodology, and it is not our purpose to do so in our research. See Daniel Kaufmann, “Myths and Realities of Governance and Corruption,” *Global Competitiveness Report 2005–2006*, World Economic Forum, 2005, 96. Their estimate also included to some extent household bribery.

<sup>8</sup> Robert Klitgaard, “International Cooperation against Corruption,” Internet Center for Corruption Research, November 1997, [http://www.icgg.org/downloads/contribution02\\_klitgaard.pdf](http://www.icgg.org/downloads/contribution02_klitgaard.pdf).

<sup>9</sup> Transparency International, “What Is the Corruption Perceptions Index?,” [http://www.transparency.org/cpi2011/in\\_detail](http://www.transparency.org/cpi2011/in_detail).

<sup>10</sup> World Bank, “Helping Countries Combat Corruption: The Role of the World Bank,” <http://www1.worldbank.org/publicsector/anticorrupt/corruptn/cor02.htm>.

<sup>11</sup> The other four types of corruption are bribery, theft, political and bureaucratic corruption, and isolated and systemic corruption. For more information on these types of corruption, see World Bank, “Helping Countries Combat Corruption: The Role of the World Bank.”

<sup>12</sup> Ibid.

<sup>13</sup> Klitgaard, “International Cooperation against Corruption.”

business, the relationship between the two types of corruption—the demand side and the supply side—must be recognized for applicable and effective policy recommendations.

The costs of corruption beyond bribery can also include fees in cases of criminal and civil prosecution, continued extortion by government officials and others, exclusion from government and international institutions, remediation costs, shareholder derivative suits, safety risks to consumers and defective products, and tacit encouragement of other illegal activities.<sup>14</sup>

While not covered under either Transparency International's or the World Bank's definition of private-sector corruption, money laundering, tax evasion, and other illicit financial flows are also forms of corruption. These types of corruption likewise take essential resources away from developing countries.<sup>15</sup> Such types of corruption, and private-sector corruption in general, contribute to increasing inequities in developing countries. For example, it was found that tax evasion in Namibia was equal to 9 percent of its GDP and larger than the resources allocated for education. In such countries, vital resources are diverted away instead of being invested in productive resources.<sup>16</sup>

Some argue that corruption facilitates business in certain settings. For example, where the existing bureaucracy is extremely inefficient, the small cost of a facilitation payment could be recovered by the economic value of the larger business transaction it enabled. Ultimately, however, the evidence suggests that facilitation payments do not necessarily reduce the cost of business operations. The long-term cost of fostering such attitudes is much more costly than the short-term gain experienced by firms. Though smaller enterprises can be priced out of the market if they do not pay bribes in the short term, they too suffer in the long run, as corrupt practices contribute to increasing incentives to refrain from policy reform and ultimately a non-transparent investment climate with bad regulatory practices.

## Quantifying the Business Costs of Corruption

A basic calculation by the CSIS Project on Prosperity and Development shows that in 2012 the cost of private-sector corruption was over \$500 billion in 105 developing countries.<sup>17</sup> The private sector included in this number covers the formal, private-sector economy, excluding agriculture and extractive industries, with five or more employees. It does not account for official corruption, theft, pricing manipulations, and favoritism.<sup>18</sup> It is reasonable to see these figures as an additional tax on businesses above and beyond the costs of doing business. Further, private-sector corruption represents 3.7 times the

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<sup>14</sup> PricewaterhouseCoopers International, "Confronting Corruption: The Business Case for an Effective Anti-Corruption Programme," January 2008, <http://www.pwc.com/gx/en/forensic-accounting-dispute-consulting-services/pdf/pwc-confronting-corruption.pdf>.

<sup>15</sup> Individuals are included. However, the private sector is also a major source of tax evasion. See OECD, "Measuring OECD Responses to Illicit Financial Flows from Developing Countries," 2013, <http://www.oecd.org/dac/governance-development/IFFweb.pdf>.

<sup>16</sup> Stuart Yikona, "How Corruption and Tax Evasion Distort Development," World Bank (blog), December 6, 2011, <http://blogs.worldbank.org/governance/how-corruption-and-tax-evasion-distort-development>.

<sup>17</sup> These countries only account for 22 percent of global GDP.

<sup>18</sup> See appendix A for CSIS's calculation of the business costs of corruption and an analysis of the numbers; see appendix B for the methodology.

amount of official development assistance (ODA) disbursed in 2011, which totaled \$141 billion.<sup>19</sup>

While these numbers are interesting, note that the dollar value associated simply with private-sector corruption is only a starting point. It does not take into account the secondary effects on society, incomes, businesses, and the general macro and micro investment climate. Various considerations complicate the dollar valuation of corruption, which are covered in detail in appendix A.

## Initiatives and Laws to Combat Corruption

Most activities to combat corruption have typically been undertaken by governments and donors such as the World Bank and have focused on public-sector corruption.<sup>20</sup> Private-sector corruption, in fact, was largely ignored until the late 1990s. Until 1997, the United States was the only country to prohibit bribes to foreign officials. At that point, OECD member countries and nonmember countries alike agreed to prohibit private-sector bribery through the 1997 OECD Anti-Bribery Convention. And in 2005, the prohibition on bribery was globalized through the United Nations Convention against Corruption, which to date has been signed by 168 countries. Today, countries as diverse as the United Kingdom, Russia, South Africa, China, Vietnam, Mexico, and Brazil prohibit private-sector bribery.<sup>21</sup> An excellent example is the UK Bribery Act, which condemns all types of bribery, including the corporate offense of negligent failure to prevent bribery.<sup>22</sup>

The EU Public Procurement Directive of 2004 requires member states to adopt laws that exclude bidders that have been convicted of fraud from bidding for government procurement contracts. It goes a step further and also excludes businesses considered to have conducted “grave professional misconduct.” For successful bidders, there are additional contractual obligations to adhere to social and environmental issues.

Scotland’s Procurement Information Hub has recently launched a best-practices initiative. Through this it provides essential data for government contractors on spending and supplier data. “The Best Practice Indicators include core evaluation factors, such as procuring goods and services in a lawful and ethical manner, as well as a

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<sup>19</sup> For further research, it would be interesting to restrict ODA to the 105 countries covered by the Enterprise Survey, which would result in a larger and more meaningful ratio. See World Bank, “Net Official Development Assistance and Official Aid Received (Current US\$),” <http://data.worldbank.org/indicator/DT.ODA.ALLD.CD/>.

<sup>20</sup> Transparency International defines public-sector corruption in detail but can be summarized “as the abuse of entrusted power for private gain.” Public-sector corruption can also be defined as individuals within the central government and all its local components and service delivery mechanisms such as the police, military, public roads and transit authorities, primary schools, and health care system that use public funds for their private gain, whose essential role is to provide services based on the motivation to improve citizens’ lives rather than to make a profit. See Rosie Slater, “What Is Public Sector Corruption?,” Transparency International (blog), December 2, 2011, <http://blog.transparency.org/2011/12/02/what-is-public-sector-corruption/>.

<sup>21</sup> CREATE, “Guide to Improving Your Anti-Corruption Program,” 6.

<sup>22</sup> Despite increased standards and rules and regulations, there are still perverse incentives to engage in corruption. This remains a central challenge for all stakeholders who want to reduce corruption. See Eric Gutierrez, “Why Business Should Care about Fighting Corruption,” *Guardian*, July 1, 2011, <http://www.theguardian.com/global-development/poverty-matters/2011/jul/01/bribery-act-business-should-fight-corruption>.

requirement for the delivery of quality products and services.”<sup>23</sup> There is no other such in-depth public-sector spending analysis yet in Europe. Scotland’s example provides a good case study for other countries.

Mexico has made recent advances for compliance in government contracting for contractors, suppliers, and subcontractors.<sup>24</sup> Any activities or omissions in information by these actors that create an “unlawful advantage” are punishable under the new laws.

There are several reasons for the focus on public-sector corruption. Bribery in the public sector, offered or extracted, is the primary concern of many aid and lending agencies, since these organizations tend to work primarily with governments.<sup>25</sup> A strong international consensus exists that involving the private sector and civil society organizations with governments is vital for success.<sup>26</sup> To combat corruption in general requires the participation of the private sector, and private-sector corruption is linked to public-sector corruption because of the relationship between recipient and beneficiary.<sup>27</sup>

## Complexities, Challenges, and Regulatory Environments

In a 2013 speech at CSIS, World Bank president Jim Yong Kim outlined the need to fight poverty in areas “where the legal framework for combating corrupt and illicit behavior is imperfect and institutions of public accountability may not function well or even exist at all.”<sup>28</sup> Countries with the weakest governance structures (and therefore more prone to corruption) tend to be those that most need economic development; but, to be sure, corruption affects all countries. Corruption is a heavy burden, particularly in the developing world. Of the 105 countries covered, which represent only 22 percent of global GDP, CSIS’s estimate of the cost of private-sector corruption represents 4 percent of GDP only. As a result, developing economies bear a proportionately larger burden from the cost of corruption. In these countries, corruption is an area of concern for the private sector. Corruption is a serious concern for donor countries and host governments as well. Aid funding can be diverted through corruption, failing to reach the intended recipients. In today’s world, information travels quickly and the image of the donor country can be significantly affected by a single allegation of corruption, hence making governments important partners in the fight against corruption.<sup>29</sup>

Evidence also shows that while businesses recognize themselves as victims of corruption, and understand the risks associated with noncompliance, many are ill-equipped to deal with anticorruption laws and compliance standards.

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<sup>23</sup> Scottish government, “Scottish Procurement Information Hub,” <http://www.scotland.gov.uk/Topics/Government/Procurement/eCommerce/ScottishProcurementInformationHub>.

<sup>24</sup> Corporations can be fined up to \$10 million for noncompliance.

<sup>25</sup> World Bank, “Helping Countries Combat Corruption.”

<sup>26</sup> See appendix C for select initiatives for combating corruption by some of the major international and U.S.-based organizations.

<sup>27</sup> Simply put, private-sector corruption, where a government official is bribed (the recipient) in exchange for a certain favor to a business (the beneficiary), links private and public-sector corruption.

<sup>28</sup> Jim Yong Kim, “A Commitment to Act,” speech at the Center for Strategic and International Studies, Washington, DC, January 30, 2013, [http://csis.org/files/attachments/130130\\_WorldBank\\_Kim\\_Transcript.pdf](http://csis.org/files/attachments/130130_WorldBank_Kim_Transcript.pdf).

<sup>29</sup> Asian Development Bank/OECD Anti-Corruption Initiative for Asia and the Pacific, “Strategies for Business, Government, & Civil Society to Fight Corruption in Asia and the Pacific,” proceedings of the 6th Regional Anti-Corruption Conference for Asia and the Pacific, Singapore, November 26–28, 2008, 192, <http://www.oecd.org/site/adboecdanti-corruptioninitiative/meetingsandconferences/43804713.pdf>.



Much of the dialogue on corruption is focused on the public sector, and on the administrative vacuum that creates room for corrupt practices. The blame is often on the officials demanding the bribes, and the bribe-payers tend to be portrayed as the “victim” in the situation. Because of the complexity and scope of the issue, an effective strategy against corruption requires cooperation from various groups. Host countries, donor countries, and the private sector all have a significant stake in this issue. Cooperation among these different actors is vital for any anticorruption measure to succeed. Even small and medium-sized enterprises, which traditionally have been excluded from the dialogue, can and must participate through business coalitions and other means of collective action.

# | Why It Is Important for the Business Community to Fight Corruption

Corruption is both a supply-side and demand-side problem, and both must be addressed for the successful elimination of corruption.<sup>30</sup> It is imperative that the private sector, specifically individual businesses and business coalitions, take the initiative to fight corruption and address the supply-side issue. In the past 25 years, the business community has witnessed large costs due to noncompliance or unethical business dealings. Individual corporations have faced fines and settlements ranging from “millions of dollars, to tens of millions, to hundreds of millions, to billions.”<sup>31</sup>

Within the private sector itself, actors can distort the market structure to increase corporate profit through several channels. First, private actors can distort the pricing mechanisms through price collusion and transfer pricing, allowing them to gain monopoly-level profits. The result of distorted markets is missed legitimate and profitable business opportunities.<sup>32</sup> Second, they can abuse inside information through insider trading. Third, they can cause the leakage of financial resources away from the formal economy through capital flight.<sup>33</sup> This then contributes to an unstable and unreliable investment climate, where otherwise it could have had immense potential for businesses’ bottom line, creating a “prisoner’s dilemma.” The dilemma can be overcome only by collective action from the business community by working toward a transparent environment and rule of law for doing business. This can be accomplished through collective corporate action, international standards of transparency, conduct and accountability among industry actors and value chains, international agreements among governments with the involvement of the private sector, improved rule of law, and increased independence in media and various forms of political and legal accountabilities.<sup>34</sup> Evidence shows that the competitive advantage and returns from a level playing field are far greater.<sup>35</sup>

Businesses should do more to combat corruption for a variety of self-serving reasons. In addition to ethical reasons, the most important aspect is that combating corruption reduces costs of doing business, especially in the long run.<sup>36, 37</sup> Greater transparency and ethical practices help attract investments from “ethically oriented investors,”<sup>38</sup> allowing a business to be a preferred partner for consumers and customers that value ethics and

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<sup>30</sup> Frank Vogl, “Technology Can Help Fight Corruption,” *Financial Times*, September 11, 2012, <http://www.ft.com/intl/cms/s/0/c85dda1c-fb81-11e1-87ae-00144feabdc0.html#axzz2oJb26mOh>.

<sup>31</sup> Ben Heineman, “Why Are Some Sectors (Ahem, Finance) So Scandal-Plagued?,” *Harvard Business Review*, January 10, 2013, <http://belfercenter.ksg.harvard.edu/files/HBR%20BIG%20SCANDALS.pdf>.

<sup>32</sup> International Chamber of Commerce, Transparency International, United Nations Global Compact, and World Economic Forum Partnering against Corruption Initiative (PACI), “The Business Case against Corruption,” <http://www.weforum.org/pdf/paci/BusinessCaseAgainstCorruption.pdf>.

<sup>33</sup> Léonce Ndikumana, “The Private Sector as Culprit and Victim of Corruption in Africa,” Working Paper Series No. 330 (Amherst: Political Economy Research Institute at the University of Massachusetts, Amherst, June 2013), 2.

<sup>37</sup> International Chamber of Commerce et al., “The Business Case against Corruption.”

<sup>35</sup> Gutierrez, “Why Business Should Care about Fighting Corruption.”

<sup>36</sup> Ibid.

<sup>37</sup> International Chamber of Commerce et al., “The Business Case against Corruption.”

<sup>38</sup> Ibid.

transparency; it also pays labor dividends by boosting employee morale and retaining quality workers. Reputation is also an important asset in global competitive markets—an asset that can quickly be eroded or become a liability if a business is found unethical in its dealings.<sup>39</sup>

Companies that engage in corruption, or do not have the requisite procedures, codes, and internal practices to shield themselves from corrupt behavior by employees, can face additional costs such as exclusion from bidding on government and International Financial Institutions (IFI) contracts; the risk and the costs of “casino risk,” where the counterpart does not deliver and there is no legal recourse; criminal prosecution; the costs (legal and otherwise) associated with corrective action; and low employee morale and the inability to hire the required talent.<sup>40</sup>

Local companies, particularly medium and large companies, can only benefit from global trade and access to global value chains, particularly those of multinational corporations, by creating anticorruption compliance programs. As one study notes, “Entrepreneurs can only grow into global value chains if they take steps to stop their own firm-level corruption.”<sup>41</sup>

## Opportunity Costs of Corruption

It is difficult to gauge the exact dollar value of the opportunity cost of paying or not paying bribes. This is especially true for cases where counterfactuals that are not perception based are unavailable—that is, where companies have refused to pay bribes and are unable to conduct business, it cannot be known what the revenues would have been.

Corruption distorts incentives and creates inefficiencies in the economy. It gives public officials excessive amounts of discretionary power over regulations, increasing the risk of state capture. This is especially problematic when corruption causes the override of safety or quality regulations, thus creating potential for physical harm to the general population.<sup>42</sup> Such action by officials can further cripple already weak institutions and strip their ability to address structural problems, which perpetuate a negative cycle of corruption and bad governance. In such cases, corruption acts as a barrier to entry for businesses where there may be lucrative opportunities. Another opportunity cost of corruption is price distortion, where a firm is charged a higher price for equipment or materials than is the going market rate. Similarly, firms pay bribes to have inferior equipment and production standards approved by officials. Both are forms of corruption that distort markets and their interaction with the regulatory environment. Resources and people could be allocated inefficiently as well, without adequately reflecting local

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<sup>39</sup> Gutierrez, “Why Business Should Care about Fighting Corruption.”

<sup>40</sup> International Chamber of Commerce et al., “The Business Case against Corruption.”

<sup>41</sup> Frank Brown, “The Advantage of Targeted Anti-Corruption Measures,” Center for International Private Enterprise, December 11, 2013, [http://www.cipe.org/blog/2013/12/11/the-advantage-of-targeted-anti-corruption-measures/#.UriaLXm\\_nwI](http://www.cipe.org/blog/2013/12/11/the-advantage-of-targeted-anti-corruption-measures/#.UriaLXm_nwI).

<sup>42</sup> Daniel Kaufmann, “Corruption: The Facts,” *Foreign Policy* 107 (Summer 1997): 117, [http://www1.worldbank.org/publicsector/anticorrupt/fp\\_summer97.pdf](http://www1.worldbank.org/publicsector/anticorrupt/fp_summer97.pdf).

needs. Individuals would have more incentive to engage in rent seeking than in economically productive activities, reducing the total economic potential of a country.<sup>43</sup>

The opportunity cost of corruption is especially relevant for developing countries, as it represents lost potential growth. The opportunity cost can manifest itself in several ways. Corruption discourages investment and other business transactions. The prospect of dealing with a dysfunctional bureaucracy and incurring added costs of operations in the form of bribes, facilitation payments, and licensing fees discourages both domestic and international investors. Corruption essentially acts as a tax on investment.<sup>44</sup> Conversely, a decrease in the levels of corruption has had measurable positive effects on investment rates and per capita GDP growth rates of some countries.<sup>45</sup>

On the private-sector side, firms that regularly engage in corruption spend large amounts of time building personal relationships with government officials, and consequently spend more time dealing with bureaucracy than firms that do not engage in corruption.<sup>46</sup> In some cases, bribes may also be paid not to speed the process for the payer, but to slow the process for its competitors.<sup>47</sup> In addition, the law cannot enforce corrupt transactions, meaning that firms do not have any guarantee that the bribes they pay will yield returns.<sup>48</sup> Engagement in corruption does not necessarily facilitate business, even in the short term.

Since it is hard to estimate the opportunity cost for businesses engaging in corruption, another way to look at it is to see how companies that do adhere to strict corporate codes of conduct have performed. Deutsche Bank conducted a study of 500 companies rated by S&P, which showed that firms with strong or improving corporate governance systems outperformed those with lower corporate governance standards by 19 percent over a two-year period.<sup>49, 50</sup> Harvard and Wharton Business Schools surveyed 1,500 U.S.-based companies and found that those with better internal governance showed faster sales growth and less agency risk to shareholders, which meant a lower cost of equity.<sup>51, 52</sup> Even in a country like Brazil, where the regulatory environment is not optimal, firms

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<sup>43</sup> Vito Tanzi, "Corruption around the World: Causes, Consequences, Scope, and Cures," Working Paper 98/63 (Washington, DC: International Monetary Fund, May 1998), <http://www.imf.org/external/pubs/ft/wp/wp9863.pdf>.

<sup>44</sup> Shang-Jin Wei, "How Taxing Is Corruption on International Investors?," Working Paper 6030 (National Bureau of Economic Research, 1997), 1.

<sup>45</sup> Paolo Mauro, "Corruption: Causes, Consequences, and Agenda for Further Research," *Finance and Development* (International Monetary Fund and World Bank, March 1998), 12, <http://www.imf.org/external/pubs/ft/fandd/1998/03/pdf/mauro.pdf>.

<sup>46</sup> Cheryl W. Gray and Daniel Kaufmann, "Corruption and Development," *Finance and Development* (March 1998): 8, <http://www.imf.org/external/pubs/ft/fandd/1998/03/pdf/gray.pdf>.

<sup>47</sup> Kaufmann, "Corruption: The Facts."

<sup>48</sup> Chris Blattman, "Corruption and Development: Not What You Think?," November 5, 2012, <http://chrisblattman.com/2012/11/05/corruption-and-development-not-what-you-think/>.

<sup>49</sup> Renato Grandmont, Gavin Grant, and Flavia Silva, "Beyond the Numbers—Corporate Governance: Implications for Investors," Deutsche Bank, April 1, 2004, [http://www.unepfi.org/fileadmin/documents/materiality1/cg\\_deutsche\\_bank\\_2004.pdf](http://www.unepfi.org/fileadmin/documents/materiality1/cg_deutsche_bank_2004.pdf).

<sup>50</sup> John D. Sullivan, Andrew Wilson, and Anna Nadgrodkiewicz, "The Role of Corporate Governance in Fighting Corruption," Center for International Private Enterprise, October 18, 2013, [http://www.cipe.org/sites/default/files/publication-docs/Russian%20National%20Corporate%20Governance%20Report%202013ENGLISH\\_0.pdf](http://www.cipe.org/sites/default/files/publication-docs/Russian%20National%20Corporate%20Governance%20Report%202013ENGLISH_0.pdf).

<sup>51</sup> Paul Gompers, Joy Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118, no. 1 (February 2003): 107–55.

<sup>52</sup> Sullivan et al., "The Role of Corporate Governance in Fighting Corruption."

with above-average corporate governance systems faced 45 percent higher return on equity (ROE) and saw 20 percent higher price-to-earnings ratios.<sup>53, 54</sup> Finally, a study by Credit Lyonnais Securities Asia surveyed 495 companies in 25 emerging markets, finding that companies with the best corporate governance practices had 8 percent higher measures of economic value added (EVA) than the country average.<sup>55</sup>

Another opportunity cost to companies is that they lose out on higher premiums, as investors pay premium for well-governed companies. Investors are increasingly interested in companies with corporate governance systems, and look to sources like the FTSE4Good (published by FTSE group on companies' performance on corporate social responsibility), Bloomberg's investor information tool, and the International Corporate Governance Network.<sup>56</sup> Another study showed that even in a country like Russia, where transparency is poor, concrete steps to be more transparent and have a greater corporate regulatory system can pay off. In a study, 21 Russian firms showed a predicted 700-fold increase in firm value, showing a correlation between corporate governance and firm value.<sup>57</sup>

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<sup>53</sup> Bruno Erbiste, "Corporate Governance in Brazil: Is There a Link between Corporate Governance and Financial Performance in the Brazilian Market?," ABN AMRO Asset Management, July 2005.

<sup>54</sup> Sullivan et al., "The Role of Corporate Governance in Fighting Corruption."

<sup>55</sup> A. Gill, "Saints & Sinners: Who's Got Religion?," Credit Lyonnais Securities Asia Corporate Governance Watch, April 2001, <http://www.webb-site.com/codocs/Saints&Sinners.pdf>. Also cited in Sullivan et al., "The Role of Corporate Governance in Fighting Corruption."

<sup>56</sup> CREATE, "Guide to Improving Your Anti-Corruption Program," 14.

<sup>57</sup> Bernard Black, "The Corporate Governance Behavior and Market Value of Russian Firms," *Emerging Markets Review* 2 (March 2001); Sullivan et al., "The Role of Corporate Governance in Fighting Corruption"; Center for International Private Enterprise, "REFORM Toolkit: Combating Corruption: A Private Sector Approach," January 2011, <http://www.cipe.org/sites/default/files/publication-docs/Anti-CorruptionToolkit0308.pdf>; John Sullivan, "Corruption, Economic Development, and Governance: Private Sector Perspectives from Developing Countries," Global Corporate Governance Forum, *Private Sector Opinion*, 2 (2006), <http://www.ifc.org/wps/wcm/connect/1b03e88048a7e4759d5fdf6060ad5911/Final%2BPrivate%2BSector%2BOPinion%2528Issue%2B2%2529.pdf?MOD=AJPERES>.



## | Private-sector and Other Stakeholder Activities

There is consensus that private-sector involvement is necessary for any efforts to combat corruption. Several multi stakeholder initiatives established in recent years recognize the impact of private-sector cooperation with government and civil society. However, implementation remains a challenge for many of these initiatives largely due to issues related to legitimacy, accountability, and effectiveness.

For example, the Partnering Against Corruption Initiative (PACI) was started by CEOs in 2004. The purpose was to bring together businesses for fighting corruption and improving compliance practices and then to engage in high-level dialogue with governments and other organizations.<sup>58</sup> Members commit to a common set of anticorruption standards and then report on their anticorruption programs. PACI also develops a set of anticorruption tools.<sup>59</sup> Dialogue focused on combating corruption has also highlighted the essential role of top management, particularly CEOs. PACI's "Vanguard" initiative that will be launched in Davos in January 2014 is led by CEOs. These CEOs belong to signatory companies of PACI and are seen as the "champions" of anticorruption initiatives. Their purpose is to foster greater collective action by bringing together businesses, government, and civil society to combat corruption more effectively.<sup>60</sup>

The UN Global Compact (UNGC) is another example of a strategic global framework endorsed by the private sector and governments to work toward principles including anticorruption.<sup>61</sup> These have incentivized over 5,300 businesses from 135 countries, including both multinational corporations and smaller company boards, to set standards for those in their supply chains and to train employees to reduce liability risk. However, the UNGC does not have an effective monitoring mechanism and has only recently moved toward raising implementation standards. As of 2012, only 40 percent of the world's largest 500 global companies and only 10 percent of multinationals have signed. Moreover, roughly 4,000 businesses were removed in 2012 due to, for example, noncompliance.<sup>62</sup>

In addition to government-sponsored global frameworks such as the UNGC, private-sector-led initiatives are geared toward addressing corruption in specific sectors. Some examples include the Construction Sector Transparency Initiative (CoST), the Maritime Anti-Corruption Network (MACN), and the Kimberley Process—a joint private-sector, government, and civil society initiative designed to eliminate the flow of "conflict diamonds" used by rebel movements to finance civil wars. These initiatives demonstrate examples of the growing private-sector response across industries to public demand of better delivery and implementation mechanisms in sectors particularly exposed to

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<sup>58</sup> World Economic Forum, "Partnering against Corruption Initiative," <http://www.weforum.org/issues/partnering-against-corruption-initiative>.

<sup>59</sup> International Chamber of Commerce et al., "The Business Case against Corruption."

<sup>60</sup> Organization of American States, "Partnering against Corruption Initiative (PACI)," <http://www.oas.org/juridico/ppt/paci.ppt>.

<sup>61</sup> United Nations Global Compact, "Transparency and Anti-corruption," <http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/anti-corruption.html>.

<sup>62</sup> Jo Confino, "Cleaning up the Global Compact: Dealing with Corporate Free Riders," *Guardian*, March 26, 2012, <http://www.theguardian.com/sustainable-business/cleaning-up-un-global-compact-green-wash>.

corruption. These initiatives require members to commit to common governance standards and to develop a work plan to achieve these standards.<sup>63</sup>

The Thai Institute of Directors (IOD) built a coalition of Thailand's largest businesses against corruption. The IOD educates executives on the sources of corruption risk, and educates compliance/internal audit staff on antibribery controls. To date, companies representing over 15 percent of the Thai economy and more than one million employees have joined and participated in systemic external evaluation programs. In order to participate, companies must sign the IOD's Collective Action against Corruption Declaration, and adhere to tangible steps that would reduce corruption risks on the business side. The lesson here is that companies are willing to commit resources to participate in anticorruption initiatives because they see the economic value in doing so. This initiative was led and developed by CIPE, which designed the training materials to be consistent with international standards, including the U.S. Foreign Corrupt Practices Act (FCPA), OECD Anti-bribery Convention, and other international conventions.<sup>64</sup>

In Egypt, CIPE focused on establishing a market economy by drawing on a diverse network of organizations and individuals, built over nearly 20 years, representing the full spectrum of Egypt's opinion leaders. They partnered with the United Group (an Egyptian human rights law firm) to support and develop a proposed law and constitutional article on freedom of information to guarantee disclosure on procurement contracts, which is frequently a source of corruption. It is generally recognized that freedom of disclosure or the need for disclosure is tied to integrity programs.<sup>65</sup> Although recent developments in Egypt have affected CIPE's work, preparing for a return to stability is crucial in establishing sustainable advances against corruption.

On the public-sector side, there are a number of laws and best practices at both the national and international levels that complement these private-sector-led initiatives. These include the U.S. FCPA,<sup>66</sup> the UK Bribery Law, and the Dodd-Frank Wall Street Reform and Consumer Protection Act. In particular, the Dodd-Frank Act includes a "whistleblower" provision that allows for monetary compensation to individuals who inform the U.S. government of bribery to foreign officials. If an individual voluntarily provides the government with original information that leads to sanctions of above \$1 million, he or she is eligible for up to 30 percent of the sanctions.<sup>67</sup> This is designed to empower individuals in both the United States and developing countries to report corrupt practices while addressing informational gaps often associated with corruption. However, a number of issues such as conflicting foreign and U.S legal standards, and

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<sup>63</sup> Extractive Industries Transparency Initiative, "EITI factsheet," <http://eiti.org/files/EITI-fact-sheet-English.pdf>; Construction Sector Transparency Initiative, "The CoST programme."

<sup>64</sup> John Morrell, "Private Sector Fight against Corruption in Thailand Gains Momentum," Center for International Private Enterprise (blog), December 11, 2012, <http://www.cipe.org/blog/2012/12/11/private-sector-fight-against-corruption-in-thailand-gains-momentum/#.UrHiJKWgdZg>.

<sup>65</sup> Center for International Private Enterprise, "Programs in the Middle East & North Africa," <http://www.cipe.org/publications/detail/programs-middle-east-north-africa>.

<sup>66</sup> Facilitation payments, unlike bribes, are an exception under the FCPA, but only if they are used to "expedite" or "facilitate" the performance of a routine governmental action by a foreign official, political party, or party official.

<sup>67</sup> Mark V. Vlasic and Peter Atlee, "Democratizing the Global Fight against Corruption: The Impact of the Dodd-Frank Whistleblower Bounty on the FCPA," *Fletcher Forum of World Affairs* 36, no. 2 (Summer 2012), <http://www.fletcherforum.org/wp-content/uploads/2012/09/Vlasic-Atlee.pdf>.

financial costs associated with implementation, suggest that much legal clarification is needed before these provisions can be effectively implemented.<sup>68</sup>

As mentioned earlier, most literature and multilateral efforts to combat corruption have focused on public-sector corruption, as organizations like the OECD and World Bank interface mostly with governments. However, increasingly multilateral organizations, led by the World Bank, seek to curb private-sector corruption as a way to tackle public-sector corruption. The World Bank has launched the innovative Open and Collaborative Private Sector Initiative.<sup>69</sup> The purpose of this initiative is to leverage existing open data practices to increase the impact of the private sector and integrate the private sector into this collaborative open data platform. The foundation of this initiative is the Open Company Data Index, which incentivizes “governments to increase transparency of their corporate registries, and promote efforts related to corporate accountability.”<sup>70</sup> In 2010, the World Bank’s integrity vice presidency, led by Leonard McCarthy, also launched the annual International Corruption Hunters Alliance (ICHA) to leverage new technologies such as crowd sourcing and mobile applications with citizen engagement and multilateral partnerships to combat global corruption.<sup>71</sup>

Similarly, to address demand-side corruption, the OECD and the Basel Institute on Governance have launched a joint initiative called the High-Level Reporting Mechanism (HLRM). The premise is to institute a national ombudsman, as a last resort, with authority to respond to allegations of wrongdoing by government officials particularly to do with bribes. The foundations of this initiative are based on collective action by both the private sector and the government. A pilot program has been launched in Colombia. The results of this new innovative approach of the World Bank remain to be seen.<sup>72</sup> Public-sector corruption is a serious problem in developing countries, and controlling it is a prerequisite for controlling private-sector corruption.

There are guides, best-practice tools, and anticorruption efforts to encourage private-sector companies to avoid bribery and adhere to uniform codes of conduct. One such initiative is Transparency International’s Business Principles for Countering Bribery. The private sector was part of the consortium—including multilaterals, civil society organizations, NGOs, and governments—that developed such guides. However, as the initiatives above have demonstrated, developing these guidelines does not guarantee that the private sector will not engage in corruption.<sup>73</sup> Several factors, including business

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<sup>68</sup> National Chamber Litigation Center, “NCLC Amicus Brief,” August 28, 2012, [http://www.chamberlitigation.com/sites/default/files/cases/files/2012/NCLC%20Amicus%20Brief%20-%20Villanueva%20v.%20Dept.%20of%20Labor%20\(Fifth%20Circuit\).pdf](http://www.chamberlitigation.com/sites/default/files/cases/files/2012/NCLC%20Amicus%20Brief%20-%20Villanueva%20v.%20Dept.%20of%20Labor%20(Fifth%20Circuit).pdf).

<sup>69</sup> Caroline Anstey, “Remarks by World Bank Managing Director Caroline Anstey at Closing Plenary of G8 Conference on Tax, Trade, and Transparency,” June 15, 2012, <http://www.worldbank.org/en/news/speech/2013/06/15/remarks-world-bank-managing-director-closing-plenary-g8-conference>.

<sup>70</sup> This data index is a repository of information about registered corporations in countries along with “open-source, transnational datasets that can help curb corruption, check beneficial ownership, and deepen competitiveness analysis, so that the private sector can also benefit from transparency.” See Anstey, “Remarks by World Bank Managing Director.”

<sup>71</sup> World Bank, “International Corruption Hunters Alliance 2012,” <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/ORGANIZATION/ORGUNITS/EXTDOI/0,,contentMDK:23195265~pagePK:64168427~piPK:64168435~theSitePK:588921,00.html>.

<sup>72</sup> “World Bank Hosts Panel to Discuss Demand-Side Corruption,” *Trace* (blog), June 19, 2013, <http://traceblog.org/2013/06/19/world-bank-hosts-panel-to-discuss-demand-side-corruption/>.

<sup>73</sup> Other such initiatives include Partnering against Corruption Initiative (PACI) of World Economic Forum, Group of Twenty Finance Ministers and Central Bank Governors (G20 and the business group, B20), the Task

operating environment, government capacity, and the political will of donor and host governments, impact the extent to which private-sector initiatives are implemented.

The following section outlines key takeaways from the literature on ways businesses and governments have cooperated to address these limitations.

## | Literature Review

This literature review focuses on drawing out the common themes and some of the main takeaways that arise from the sources consulted. Most efforts to combat corruption depend on exogenous factors that the private sector cannot change directly, such as a complex and unclear regulatory environment. There are ways, however, that the private sector can contribute to a less corrupt-enabling environment; 11 are described in detail below.

1. Businesses must implement strong corporate governance and compliance structures. Corporate leadership must clearly articulate its goal and create a code of ethics that is strictly followed by employees and others with whom the company works, along with an implementation plan that includes training, risk assessment, audits, and other assessment mechanisms.<sup>74</sup> Good corporate governance allows firms to reduce uncertainty and charge a higher premium. To reduce a company's corruption risk, companies must first develop internal anticorruption programs, and use a management systems approach to reduce legal, financial, reputational risks; also, they must ensure the integrity of their supply chain.<sup>75</sup> Companies and NGOs such as CREATE can work together to engage their supply chains through communication, education, and formal training.<sup>76</sup>

Companies with corporate governance training programs financially outperformed those that did not go beyond a declaration of commitment. Effective implementation of strong and sound corporate governance and compliance structures requires certain components that should be built into business plans. There should be a top-to-bottom approach: anticorruption policies and procedures should be part of the expectations for how a company's agents, distributors, contractors, suppliers, business partners, and other third parties—in fact, all members of a business's end-to-end supply chain—behave.<sup>77</sup>

This applies to companies that operate at all levels of the supply chain, upstream to suppliers and downstream to agents, distributors, and other business partners.

While companies in some countries and certain industries are at greater risk for corruption, having an effective compliance program is essential for every company around the globe, no matter its size. Internal anticorruption programs should reflect the size and kind of risks a company faces. These programs should be led by a senior representative. Management approaches should include committed leadership, process improvement, cross-functional teams, training and performance tracking, employee involvement, and customer or third-party involvement.<sup>78</sup>

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<sup>74</sup> Center for International Private Enterprise, "REFORM Toolkit"; Ramon V. del Rosario Sr., "Anti-Corruption Manual for SMEs," Asian Institute of Management Hills Program on Governance, July 2011, [http://csis.org/images/stories/hills/110715\\_Anti-Corruption\\_Manual.pdf](http://csis.org/images/stories/hills/110715_Anti-Corruption_Manual.pdf).

<sup>75</sup> CREATE, "Guide to Improving Your Anti-Corruption Program," 7.

<sup>76</sup> Ibid., 19.

<sup>77</sup> Ibid.

<sup>78</sup> Ibid.



In recent years, leading companies have recognized the important role of CEOs in operationalizing a culture of “high performance, high integrity”<sup>79</sup> to foster the company’s long-term economic health. Benjamin Heineman, former general counsel at General Electric, argues that aside from the provision of resources, companies should also institutionalize a more conscious selection of top personnel. For an example of best practices for compliance, particularly from the perspective of top management and CEOs, see the textbox 1. However, as noted earlier, competent CEOs and board members are a necessary but not sufficient condition for appropriately compliant businesses.

Textbox 1. Tone at the Top: Incorporating High Performance, High Integrity in Company  
Benjamin Heineman, former general counsel and senior vice president of General Electric, has advocated the importance of the CEO’s leadership in implementing principles and processes to foster a corporate culture of “high integrity, high performance.” Heineman’s definition of integrity refers largely refers to a company’s adoption of, and adherence to, ethical standards beyond the formal internal and external rules and compliance with public policy in a way that balances the interests of the company with the interests of the public.<sup>1</sup> Below are some ways he recommends that CEOs operationalize this model:

- Embedding integrity practices through risk assessment of business processes, appropriate risk-mitigation techniques, constant monitoring and review, and appropriate discipline and remediation when wrongdoing occurs.
- Basing employee compensation systems—including the CEO’s—on both performance and integrity.
- Implementing, particularly in overseas markets, consistent systems that assess and adopt ethical practices beyond formal government rules and norms.
- Establishing early-warning systems on legal, ethical, and other integrity risk areas, especially geopolitical considerations.
- Merging capacity building with a company’s standard business and cultural education.
- Empowering employees through mechanisms such as compliance reviews, private polling, and investing in ombudsmen systems that are treated with management respect.
- Encouraging key staff, particularly the financial, legal, compliance, and human resources officers, to function first as partners in the corporate enterprise but also as guardians of the corporation.

<sup>1</sup> Heineman, “Only the Right CEO Can Create a Culture of Integrity.”

<sup>79</sup> According to Heineman, integrity refers largely to the adoption of and adherence to ethical standards beyond the formal internal and external rules (legal and financial); the adoption of proposed changes in public policy based on a fair account of key facts and an appropriate balance between private and public interests; and an employee population that exemplifies the fundamental values of honesty, fairness, candor, trustworthiness, and reliability in both internal and external relationships. See Ben Heineman, “Only the Right CEO Can Create a Culture of Integrity,” Belfer Center for Science and International Affairs, June 6, 2013, [http://belfercenter.ksg.harvard.edu/publication/23145/only\\_the\\_right\\_ceo\\_can\\_create\\_a\\_culture\\_of\\_integrity.html?breadcrumb=%2Fexperts%2F872%2Fben\\_heineman](http://belfercenter.ksg.harvard.edu/publication/23145/only_the_right_ceo_can_create_a_culture_of_integrity.html?breadcrumb=%2Fexperts%2F872%2Fben_heineman); Heineman, “Why Are Some Sectors (Ahem, Finance) So Scandal-Plagued?”

2. Corporate governance practices cannot be implemented by fiat; further, these practices are especially hard to enforce in poor regulatory environments. Internal and external factors guide how corporate governance practices are developed and implemented, meaning that corporate governance must be bolstered by ethical actions within organizations. Effective corporate governance requires shareholder and board cooperation. Examples of good practices are where the shareholders appoint directors and auditors accordingly and where the board acts as a regulator and sets and implements company strategy—and most importantly for corruption, a strategy that drives company ethics. Evidence shows that resisting demands for small bribes requires a combination of concerted top-level leadership and day-to-day, ground-level determination and ingenuity. This will likely be a major challenge for years to come, and an area of focus in future agendas for compliance.<sup>80</sup>
3. Businesses must be educated on the long-term costs of corruption, which can affect reputation, employee morale, cost of business, prospects of conducting business with multinationals, and other factors. They should also be educated on the legal system they deal with and their rights, to successfully deter demands to pay bribes. Evidence reveals overwhelming gaps or complacency in implementing compliance procedures or oversight. A survey of 300 companies to examine attitudes to bribery and corruption globally found:<sup>81</sup>
  - Thirteen (4 percent) of the 300 organizations believed that there was a 90 to 100 percent chance their company would be required to investigate a suspected violation of antibribery laws involving an employee in the next two years; 19 percent thought that it was “somewhat likely” (a 60 to 90 percent chance); 30 percent thought it was “very unlikely.”
  - Only 50 percent of companies surveyed have due diligence procedures in place for selecting local business associates, despite the known risks.
  - Thirty-five percent of the companies lacked formal policy statements forbidding bribes.
  - Forty-seven percent lacked policies or procedures to ban facilitation payments.
  - Ninety-one percent did not have specialized anticorruption training for employees in high-risk areas. Seventy-four percent had no anticorruption training programs generally.
  - Forty percent of those surveyed have “whistleblowing lines” for employees to use in reporting corrupt activities.

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<sup>80</sup> Having strong governance structures does not mean that a company will absolutely not engage in corruption. The underlying assumption is that this is an indicator of a culture that is less tolerant of corruption.

<sup>81</sup> The data in points (a) through (f) are from Control Risks, “International Business Attitudes to Corruption: Survey 2013,” [http://www.controlrisks.com/Oversized%20assets/International\\_business\\_attitudes\\_to\\_corruption.pdf](http://www.controlrisks.com/Oversized%20assets/International_business_attitudes_to_corruption.pdf).

Given these numbers, more needs to be done by all stakeholders. This is a potential role that commercial sections in U.S. consulates can play in facilitating the understanding of doing business in high-risk areas. For example, the lack of knowledge of non-corrupt ways to deal with bureaucracy hinders anticorruption in Russia.<sup>82</sup> In most cases, engaging in corruption may be cheaper in the short run, but in the long run it can be more costly and the price to exit the cycle increases. The bureaucrats or stakeholders that know the complex regulations and accept bribes could continue to extract such payments and in fact increase their demands as businesses grow.<sup>83</sup>

4. The creation of anticorruption coalitions should be encouraged within the private sector, which subscribe to a common, better standard for governance, auditing, and other regulations. Strong and inclusive anticorruption coalitions in the private sector can lobby for uniform and predictable enforcement of law from a position of greater strength. Members must agree to a consensus of what corruption is and refrain from such practices with no exceptions. While this is hard to implement across all companies, it should be the goal that stakeholders work toward. Without collective action, clean firms will not be able to compete with bribe-paying firms. Additionally, systems to fight corruption must have clearly delineated roles and responsibilities for better accountability.

Businesses can also be a “valuable source of working solutions and anticorruption efforts seen as integral to corporate governance.”<sup>84</sup> Decision making and transactions should follow a common code of conduct.<sup>85</sup> This should include at least four components. First, simple transaction-specific pacts should provide transparency in individual projects. There are no external monitors, but it requires a public commitment against corruption. Second, there should be an integrity pact in more complex transaction-specific business activities, with a third-party monitoring structure. It is legally binding, subject to external monitors, and noncompliance incurs punishment. Third, there should be a principle-based initiative that applies generally for simple, long-term initiatives for collective actions, including verification mechanisms. Fourth, all countries should have multi-stakeholder coalitions to act as regulators on one another.<sup>86</sup> Since their inception, transparency pacts have been used in more than 15 countries, which include some of the hardest countries with respect to bad governance and regulatory standards. These countries include Argentina, Colombia, Ecuador, Germany, Indonesia, Mexico, Pakistan, and Paraguay. There have been varying results in savings, ranging widely from 15 to 75 percent.<sup>87</sup>

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<sup>82</sup> Georgiy Satarov, Sergey Parkhomenko, Dina Krylova, and Yuliya Rostovikova, “Business without Corruption: An Action Guide” (Washington, DC: Center for International Private Enterprise, 2007), <http://www.cipe.org/sites/default/files/publication-docs/INDEM%20OPORA%20brochure%20ENG%200407.pdf>.

<sup>83</sup> Ibid.

<sup>84</sup> Sullivan et al., “The Role of Corporate Governance in Fighting Corruption.”

<sup>85</sup> Del Rosario Sr., “Anti-Corruption Manual for SMEs.”

<sup>86</sup> John Morrell and Kim Eric Bettcher, “Approaches to Collective Action: How Businesses Together Can Lead the Fight against Corruption,” Center for International Private Enterprise, September 10, 2013, [http://www.cipe.org/sites/default/files/publication-docs/FS\\_09-10-2013\\_JMKB\\_Collective%20Action.pdf](http://www.cipe.org/sites/default/files/publication-docs/FS_09-10-2013_JMKB_Collective%20Action.pdf).

<sup>87</sup> CREATE, “Government Procurement: Driving Responsible Business Practices,” 2013, <http://www.create.org/sites/default/files/CREATE%20Govt%20Procurement%20Whitepaper%201%209.24.13.pdf>.

However, it must be noted that transparency pacts, though well intended, are hard to implement, requiring more research on development and effective implementation in different environments.<sup>88</sup>

5. Civil society and media should be engaged in their whistleblowing capacity, to encourage public discourse about corruption and force transparency. This is especially helpful if there are no explicit anticorruption laws. In this case, public discourse may be the only effective tool for the private sector to combat corruption. If the “corrupt” action is not illegal, formal authorities cannot help.<sup>89</sup> Citizen engagement and greater transparency can facilitate better policy outcomes, compliance with established norms, and equity in access to policymaking.<sup>90</sup> However, media should be trained to highlight the issues of corruption. At the moment, the media focus on individuals and engages in “name and shame” rather than covering the root causes of corruption.<sup>91</sup> Business associations and coalitions, as well as governments that focus more on tackling corruption, should create formal mechanisms and training/educational programs so that business investigative reporters can also highlight the root causes of corruption for public consumption.
6. Leveraging World Trade Organization (WTO) and OECD accession, developing free-trade agreements, and joining trade bodies/hubs can provide the tools to fight both public and private-sector corruption. Governments have the incentive to be more transparent and improve regulatory structures (and also put pressure on businesses to be more transparent) when they wish to enter trade bodies and accede to international organizations. Russia is a good example. (See textbox 2 for a case study.)

Free-trade agreements (FTAs) may not be as robust as organizational membership in demanding higher standards for governance, but they can still work under the right circumstances. FTAs generally do not have a separate enforcement mechanism to ensure that the terms of agreement are being met. Still, articulating the demand for better governance, anticorruption legislation, and transparency as conditions for the FTA would create more incentive for countries to reform. For example, the U.S.-Colombia and U.S.-Panama FTAs both reinforced the countries’ commitment to combating corruption. The agreements included specific provisions for the countries to publish key information on the procurement process, such as procurement rules, tender criteria, and the bases for their decisions.<sup>92</sup>

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<sup>88</sup> Interview with John Sullivan, December 10, 2013.

<sup>89</sup> Center for International Private Enterprise, “REFORM Toolkit.”

<sup>90</sup> Organization for Economic Cooperation and Development (OECD), *OECD Integrity Review of Brazil: Managing Risks for a Cleaner Public Service*, OECD Public Governance Reviews (Paris: OECD, November 2012), <http://www.oecd.org/ethics/48947397.pdf>.

<sup>91</sup> Interview with John Sullivan.

<sup>92</sup> Matteson Ellis, “Colombia and Panama FTAs Could Be Good for Compliance,” FCPAméricas (blog), October 17, 2011, <http://fcpamericas.com/english/colombia/colombia-and-panama-ftas-could-be-good-for-compliance/>.

### **Textbox 2. Russia Case Study: WTO Accession**

Russia is an example of a country that had to reform and move toward greater transparency and an improved investment climate to gain WTO membership. After 19 years of negotiations, Russia joined the WTO in 2011 by adopting a package of reforms for its trade regime and making other commitments to implement as part of its WTO accession, particularly to protect the commercial interests of foreign and domestic businesses more effectively than before. However, accession to the WTO would not solve all of Russia's economic needs. Russia's WTO entry "is the beginning of a process of reform" to modernize its economy, traditionally dependent on exports of raw materials, especially oil and gas. Russia remains in the process of acceding to the OECD, which has emphasized Russia's continued need for structural reforms and implementation of the OECD Anti-Bribery Convention and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.<sup>1</sup>

Certainly, Russia has taken additional steps to improve its investment climate. For example, a program in conjunction with the Center for Private Enterprise (CIPE) entailed working with the Russian Institute of Directors and involved 150 leading Russian companies to find ways to improve corporate governance. As a result of this initiative, the Russian Institute of Directors and its member companies, despite Russia still facing governance problems, have been at the forefront of corporate governance efforts.

Russian anticorruption laws effective January 2013 suggest that companies do the following: first, identify agents responsible for the companies' compliance; second, cooperate with law enforcement; third, develop anticorruption standards; fourth, adopt a code of ethics; fifth, address conflicts of interest; and sixth, prevent creation of false documents.

<sup>1</sup> Angel Gurría, OECD secretary-general, "Integration of Russia into Global Economic Institutions: Accession to the OECD," remarks at Saint Petersburg International Economic Forum 2013, <http://www.oecd.org/about/secretary-general/integration-russia-global-economic-institutions-oecd-accession.htm>.

7. Illicit financial flows and tax evasion are other forms of private-sector corruption. Though the OECD has put into place laws, regulations, and practices to counter such activities, many loopholes remain. For example, of the 34 OECD countries, 27 of them do not have sufficient beneficial ownership information for legal purposes and none of the countries are fully compliant with "the beneficial ownership recommendations for legal arrangements."<sup>93</sup> As of 2012, 221 individuals and 90 companies have been found guilty of compliance or unethical behavior, but half of all OECD countries have not witnessed a single prosecution. Thirty countries cannot address money-laundering risks because they do not have the measures in place to "regulate and supervise designated non-financial professions and businesses" that may mitigate such risks.<sup>94</sup>

Tax evasion "siphons" away essential financial resources for productive purposes, which are vital for economic diversification and growth. In a study conducted by

<sup>93</sup> OECD, "Measuring OECD Responses to Illicit Final Flows from Development Countries."

<sup>94</sup> Ibid.



the World Bank in Namibia and Malawi, it was found that tax evasion<sup>95</sup> was approximately 9 percent of GDP and for Namibia, 8 to 12 percent of GDP.<sup>96</sup>

8. Improving public procurement practices can reduce public and private corruption. The World Bank has found that on average governments in developing countries will spend up to 20 percent of GDP on procurement annually. Procurement has not been fully leveraged, to the extent possible, as an anticorruption tool because the industry is perceived as “providers of a process-oriented office function” that could be implemented by nonprofessionals.” This overlooks that good procurement systems have positive spillovers on development priorities such as governance, transparency, and accountability—something that a rising middle class in developing countries is increasingly demanding. Though this approach is changing, much more needs to be done. The global Enterprise Survey numbers show that 22 percent of firms that attempt to secure a government contract are subject to requests for bribes. On average, these informal gifts and payments constitute about 2 percent of overall contract value.

Increasing private-sector engagement on procurement issues has proved difficult since no enterprise wants to be the first to disclose its operational details for fear of losing its competitive edge. Bad procurement systems and rampant corruption are interconnected. Procurement is also a closed process that favors political connections over best cost or value—in the end, compromising the end product.<sup>97</sup>

However, governments are increasingly recognizing that procurement reform is a cross-cutting issue that can have an immense effect on broader development issues, for example, infrastructure, governance, investment, and transparency. It is within the private-sector and donor interests to incorporate it into the broader trade and development agenda. The United States, for example, recently amended the Federal Acquisition Regulation (FAR) such that it now sets higher compliance standards for government contractors and their subcontractors. These include requiring contractors to have a written code of business ethics and conduct, implement internal controls and periodic review, and establish internal reporting mechanisms. At the same time, the law permits debarment officials to terminate or defer debarment proceedings in consideration of a contractor’s agreement to adopt these requirements in an administrative agreement monitored by an independent ombudsman who reports to the debarring official.<sup>98</sup>

The biggest challenges for governments to implement transparent and easy-to-use procurement guidelines are lack of technical knowledge and capacity, complexity

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<sup>95</sup> This does not include individuals; however, the private sector is a major source of tax evasion.

<sup>96</sup> Yikona, “How Corruption and Tax Evasion Distort Development.”

<sup>97</sup> A 2010 benchmarking study by A.T. Kearney on global companies attempting to maximize compliance to procurement processes found that the level of procurement maturity within the company heavily influences the scope of compliance programs. Newer programs will focus on compliance in administrative processes, whereas more established systems will focus on strategic processes. Moreover, strengthening procurement compliance is a firm-wide endeavor that can generate bottom-line savings of between 5 to 20 percent. However, many companies have understaffed compliance departments geared toward realizing savings and capturing risk mitigation.

<sup>98</sup> The United States has incorporated similar procurement guidelines in its free-trade agreements, so that its suppliers receive a “fair shake.” See CREATE, “Government Procurement: Driving Responsible Business Practices.”

of issues, type of legal instrument needed, type of procurement organization, and enforcement of the actual rules and regulations. To overcome these challenges, multilateral and bilateral organizations can be extremely helpful and it is also in their interests. Procurement aligns with the broad goal of development finance institutions (DFIs) (International Finance Corporation, Overseas Private Investment Corporation, etc.) to foster investment climates in the developing world. Corruption, especially corruption via procurement, affects how recipient countries use DFI funds, which is of utmost concern to these institutions.

Similarly, companies with access to knowledge, resources, and capacity are well poised to promote the use of technology to improve procurement in a way that combats corruption. Advances in information technology can be leveraged to promote transparency in procurement systems. E-commerce allows governments and other stakeholders to better understand and streamline tender announcements, requests for proposals, acquisition and procurement regulations, and announcements of decisions.

9. Private-sector corruption can have the added effect of providing disincentives for reforms. As corrupt governments that engage in rent-seeking activities domestically are also bolstered by foreign businesses paying bribes or facilitation payments, this becomes the norm and is viewed as a part of doing business. In such an environment, there are not enough incentives or pressure for reform. Bureaucracies change slowly and staffing seldom changes, so new people who would be willing to be more innovative and transparent seldom have the opportunity to enter the bureaucracy. Similarly, for businesses, the “Prisoner’s dilemma” exacerbates corruption—businesses need assurance that other businesses will not continue engaging in corruption, a cycle that needs to be broken for reforms to take place in the business community.
10. Technology can play a key role in reducing all types of corruption. Probably the most obvious example of this is the usage of e-procurement. E-procurement refers to a digitized procurement system used mostly in the public sector, but can also be employed in the private sector. Cutting out the human component in procurement allows for greater objectivity and transparency. It also eliminates the opportunity for individuals to foster corrupt relationships and transactions with each other. Records on transactions can also be easily standardized and made available to the public. Surveys in Kosovo show that companies perceive unfair competition and anticompetitive practices as the biggest obstacles to business.<sup>99</sup> Efforts to reach such standards can be made through the increased use of technology to minimize human-to-human contact, and thus opportunities for corruption. E-procurement was raised as a possibility in Kosovo to increase transparency and efficiency.<sup>100</sup>

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<sup>99</sup> Riinvest Institute for Development Research and CIPE, *Improving Transparency and Governance of Public Funds: Public Procurement Process in Kosovo* (Pristina, Kosovo: August 2012), <http://www.cipe.org/sites/default/files/publication-docs/Public%20Procurement%20Policy%20Paper%20FINAL.pdf>.

<sup>100</sup> Ibid.

See textboxes 3 and 4 for examples where technology has led to greater transparency, compliance, and efficiency.

### **Textbox 3. Pakistan Case Study: The Jhang Model**

The “Jhang model” in Pakistan is an example that was awarded the World Bank’s 2011 Innovation Fund Prize. The model began with a bureaucrat asking for cell phone numbers when they engaged in transactions with local governments. This individual then contacted them to ask about their experience and whether they were required to pay a bribe or facilitation payment. This then expanded to call centers being set up in the province of Punjab run by citizens who would randomly call or text people for their feedback, thus identifying where corrupt activities had taken place and holding people accountable.<sup>1</sup> A similar model can also be applied for private-sector corruption. It provides an opportunity for local businesses to provide this service, but the caveat here is that citizens would need to volunteer the information instead of being contacted after a transaction has taken place.

<sup>1</sup>. Mohammed Rizwan, “Punjab Model for Proactive Governance: New Anti-corruption Drive Makes Waves,” *Express Tribune*, February 19, 2012, <http://tribune.com.pk/story/338621/punjab-model-for-proactive-governance-new-anti-corruption-drive-makes-waves/>.

### **Textbox 4. India Case Study: The Bhoomi Project**

India has seen successes by using technology to combat corruption. One example is the “Bhoomi” project in Karnataka, India, where 20 million land records for farmers were digitalized. Without reliable records, farmers are unable to utilize tools and assets in the formal economy, which includes securing credit and access to arbitration for legal disputes. In this manual system, the average bribe was more than \$2.75; for those using the digitized system, it was approximately 6 cents. As a result of digitization, farmers were able to avoid traditional village accounts and bureaucrats and instead print out a copy at a kiosk, making it more convenient and user friendly for the farmers while also being more accurate. Bribery fell significantly as a result. Of those using the manual system, 66 percent reported the need to pay bribes, whereas only 3 percent of those using the digitized system were required to do so.

11. Regulations on business, investments, and taxes should be streamlined in order to reduce opportunities for corruption and lower the barrier of entry into the formal economy. Loopholes, ambiguity, and frequent change all create opportunities for corruption. Smaller businesses are especially not equipped to deal with such complexities, because they do not have the capacity or resources to hire specialists or the required personnel.<sup>101</sup> These, however, are exogenous factors that a business cannot control and are part of the micro and macro aspects of the investment climate. In this regard, multilateral organizations such as the World Bank, OECD, and United Nations will prove vital in the future in providing an enabling environment by promoting “the control of bribery and fraud in the private sector by helping countries strengthen the legal framework to support a market economy and by encouraging the growth of professional bodies that set

<sup>101</sup> ADB/OECD Anti-Corruption Initiative for Asia and the Pacific, “Strategies for Business, Government, & Civil Society to Fight Corruption in Asia and the Pacific.”

standards in areas like accounting and auditing. In the long run, controlling corruption in the private sector may require improvements in business culture and ethics.”<sup>102</sup>

For example, the Armenian tax code was riddled with ambiguous legislations, frequent changes, and unnecessary bureaucracy. Streamlining the tax code in Armenia and publishing information on the changes reduced tax-related business costs by 12 to 15 percent.<sup>103</sup> Kenya is an example of where extremely complex tax codes continue to make it highly difficult to conduct business.<sup>104</sup>

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<sup>102</sup> World Bank, “Helping Countries Combat Corruption.”

<sup>103</sup> Ngozika Amalu, “Case One: Fighting Corruption through Tax Reform,” in “REFORM Toolkit: Combating Corruption: A Private Sector Approach” Center for International Private Enterprise, October 1, 2010, 8.

<sup>104</sup> David Owiro, “Kenya Property Markets Scorecard: Conditions for Small Businesses,” Center for International Private Enterprise and the Institute of Economic Affairs, December 2011, <http://www.cipe.org/sites/default/files/publication-docs/propertyMarketsKenya.pdf>.

## | Policy Recommendations

Given the landscape of increasing global trade, private-sector infrastructure development, globalized supply chains, and a push into new markets for new customers, there should be more efforts toward increasing the costs of private-sector corruption. Some recommendations below are not original, but they are worth repeating because they have been either underutilized or not implemented in the spirit intended. These recommendations are not all actionable; some present avenues of future research that might better inform the overall discussion on combating corruption. Transparency, enforcement of existing rules and laws, and the enactment of new measures must increase to reduce the toll that corruption takes on the world's economy. However, these are not sufficient without companies implementing management systems, internal processes, and culture change to prevent corruption.

The policy recommendations below outline ways to use diplomacy, and multilateral organizations such as the OECD, G20, and the United Nations to create incentives for companies and governments to participate in global transparency initiatives. (Specific stakeholder initiatives are included in appendix C.) Because private- and public-sector corruption are interlinked, many of the recommendations are cross-cutting and require cooperation among several stakeholders.

1. At the company level: Companies should join the emerging ecosystem of anticorruption initiative and incorporate clear-cut and effective procedures and practices that comply with emerging ethical standards.
2. At the multilateral level: For example, the OECD is currently reviewing the OECD Principles of Corporate Governance due in 2014 or 2015. The OECD should ensure strong disclosure principles, particularly in compliance and ethical standards. The United States should create coalitions to ensure this happens.
3. At the country level: Countries should further develop their disclosure national codes and best practices. Governments, civil society, associations, and, indirectly, multilateral and bilateral assistance agencies should support companies to develop disclosure procedures to ensure compliance with the international standards like FCPA. Transparency can be effectively tackled by addressing demand-side issues such as government-driven corruption. An example of this is CIPE's work with Egypt, discussed earlier, where new laws were enacted to guarantee disclosure on procurement contracts.

### Private-sector Recommendations

1. Develop a deeper research agenda on the link between good governance and its positive effect on the value of the company.
2. Apply new technologies to fight corruption, which requires businesses, coalitions, and other stakeholders to seek policy change to allow modernization of systems through technology.

3. Include comply-or-explain features of international, national, and multisectoral anticorruption initiatives as a common starting point for members; that is, if a company cannot enforce rules, it must explain why not.
4. Strengthen and educate independent media around the world. The latest JP Morgan scandal has shown how the media are increasingly using their whistleblowing capacities to enhance transparency. Use bilateral foreign assistance to support independent media to act as additional watchdogs. Businesses and business coalitions need to work with media to educate and train business journalists on the root causes of corruption, as they have the technical know-how. They also have the impetus to provide such training, as they are directly affected via stock market volatility when scandals erupt in their own sector of work.

## Public-sector Recommendations with International Coordination

1. Governments should form a “national-level coordinating body.”<sup>105</sup> Such an organization should be responsible for creating an anticorruption strategy that includes buy-in from various stakeholders. They should also be responsible for ensuring implementation and oversight. People independent of the coordinating body, ideally those who represent a broad spectrum of civil society, should lead the oversight. For example, Indonesia’s Corruption Eradication Commission (KPK) has built credibility by prosecuting bribery and graft cases related to government procurements and budgets. However, the KPK continues to face challenges due to a small staff and tight \$746 million operating budget.<sup>106</sup>
2. It is impossible to tackle all corruption at once; anticorruption initiatives should instead focus on reducing corruption in areas of the country with a comparative advantage and high potential for foreign investment. Realistically, the “going to zero” option is not viable. However, it is important that key agencies or areas are identified as a starting point.<sup>107</sup> These areas should have the most competitive potential for economic growth, including capacity building within key line ministries. As momentum builds and economic progress is made, the government can evaluate other areas to tackle.
3. Information sharing between governments can provide vital tools and assistance to reduce corruption that takes into account local conditions and culture. Regional diagnostic studies carried out by different countries but for similar sectors can be shared and tweaked to develop greater regulatory and compliance systems. With time, the challenges and prospects will also emerge and can be shared.

## Multilaterals, DFIs, and Aid Organizations Recommendations

1. Provide financial support (even seed funding) for multi-stakeholder coalitions in countries to fight corruption similar to the models described in this report.

<sup>105</sup> Klitgaard, “International Cooperation Against Corruption.”

<sup>106</sup> Natalia Soebagjo, CSIS Hills Program on Governance, “Governance Challenges Ahead for Indonesia,” [http://csis.org/files/publication/130214\\_HillsGovernanceUpdateFebruary2013.pdf](http://csis.org/files/publication/130214_HillsGovernanceUpdateFebruary2013.pdf).

<sup>107</sup> Klitgaard, “International Cooperation Against Corruption.”

2. Require anticorruption components of free-trade agreements, including strengthening state procurement systems. Further research is required on how to implement these components.
3. Make increased investments in “governance” activities, including improved rule of law, increased support for investment climate reforms, and strengthened procurement systems.
4. Require increased research on effective implementation of “transparency pacts.” There should be thorough research of transparency pacts from the time of their inception, to see what has worked or failed in certain environments, and what more can be done on an operational level, especially by the U.S. government, regarding commerce.
5. Address illicit financial flows and tax evasion. While gaps remain in stemming illicit financial flows, there have also been some successes, the latter providing lessons for the future. For example, between 2010 and 2012, OECD countries have repatriated \$147 million and frozen approximately \$1.4 billion. They have also signed 1,300 bilateral agreements with countries for greater information sharing.<sup>108</sup> These are positive steps, though the OECD recognizes that more needs to be done.

Combating tax evasion is a multi-stakeholder task. The most important component of tackling tax evasion is information exchange between countries. In this regard, governments and multilaterals that assist governments in developing compliance and anticorruption frameworks will be key players.

6. Allocate/award special funding for countries that have shown a commitment to combat corruption. This funding can be used to analyze particular sectors that are more prone to legal loopholes and corruption. Following this, a formal strategy can be designed that is context specific to reduce corruption.
7. Get political buy-in, particularly from those who benefit from corruption, for taking on the major challenge of combating corruption. There are ways to get this buy-in. For those leaders who have shown a commitment to broader economic growth, it is essential that any anticorruption improvements are not “political suicide.”<sup>109</sup> For this to be successful, confidential assistance needs to be provided to help political leaders understand anticorruption efforts and the political costs and benefits. Examples from other countries would be helpful.<sup>110</sup> But even for these efforts to succeed, “leaders need political insulation.”<sup>111</sup>
8. Acquire more data, based on the challenges identified in quantifying private-sector corruption, in order to get accurate estimates that can then be applied over time or be used as realistic benchmarks. In the age of big data, it is necessary to explore more options for gathering such data, especially with the outreach that donor agencies and international finance institutions have. This should be a focus

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<sup>108</sup> OECD, “Measuring OECD Responses to Illicit Financial Flows from Developing Countries.”

<sup>109</sup> Klitgaard, “International Cooperation against Corruption.”

<sup>110</sup> Ibid.

<sup>111</sup> Ibid.

when designing national surveys that look at business conduct and investment climate. The role that the private sector can play in assisting with this should also be explored.



# | Appendix A: The Dollar Value of Corruption

## Why the Dollar Value of Corruption Matters

Dollar values are a useful starting point in considering the costs of corruption. They provide objective numbers that are easy to understand and conceptualize. These values, however, do not reflect the comprehensive effects corruption can have on a society. Some people interviewed in the course of this research felt that the dollar value itself had no meaning even if computed over time. Corruption figures would vary more so because of other macroeconomic indicators. The levels of corruption year to year are not likely to change unless the exercise looked over a larger time frame. First, they are simply estimates and cannot be verified. As mentioned before, corrupt transactions are generally not documented; there are no official records of corruption that we can refer back to and compare figures with. Second, these estimates often focus on only the easily quantifiable aspects of corruption. Obvious examples of this would be money lost through bribes and grafts, appropriation of assets, and tax evasion. They usually already have a dollar value assigned to them, and are concrete practices that are relatively easy to identify. Most efforts to gauge corruption are perception based, from which it is difficult to extrapolate actual values.

Such estimates do not take into account the larger effects corruption has on a society, businesses, and the investment in general. Corruption undermines government authority and weakens the rule of law. It harms the reputation of the government and the firms involved. It discourages domestic and foreign investment. It skews economic incentives toward rent-seeking behavior rather than economically productive activities. It paralyzes competitive structures, encourages inefficient resource allocation, and decreases the quality of goods and services in the market. These negative political and economic impacts cannot be readily monetized. For example, it is impossible to assign a specific dollar value to the rule of law. As such, dollar value estimates cannot capture the complete picture of the effects of corruption. They serve as a good point of reference, but should not be the only measure we use to measure the cost of corruption.

All this being said, there are two takeaways: First, more needs to be done to come up with accurate figures for multilaterals, governments, aid agencies, the private sector, and other stakeholders as they try to combat corruption. Second, even though quantitative and qualitative (perceptions-based) estimates may be flawed, they do give a benchmark of what all stakeholders are up against and the necessary steps.

Even at present, initiatives to gauge corruption, whether quantitatively or qualitatively (perceptions based), should not be dismissed lightly. For example, Transparency International found in Indonesia that 50 percent of business executives surveyed lost business in a year because their competitors engaged in corrupt practices.<sup>1</sup> While there is little to prove this other than opinions, it certainly shows how endemic corruption is in Indonesia and a barrier to entry or doing business. Similarly, business executives surveyed in Malaysia and Mexico lost 50 percent and 48 percent, respectively. Indonesia,

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<sup>1</sup> UN Office on Drugs and Crime, “Private Sector Critical to Fight Corruption in East Asia—Pacific,” November 26, 2012, <http://www.unodc.org/southeastasiaandpacific/en/2012/11/private-sector-corruption/story.html>.

Mexico, and Malaysia were the top three countries that lost out because their competitors paid bribes.<sup>2</sup>

## Quantifying the Dollar Value of Business Corruption

A 2005 paper attempted to put a dollar value on the costs of corruption.<sup>3</sup> The paper used information from the World Bank's enterprise surveys, the World Economic Forum's global competitiveness surveys, the World Development Indicators, and household surveys. The authors ran iterations of regressions with sensitivity analysis and came up with dollar values ranging from \$600 billion to \$1.5 trillion. Their median value of \$1 trillion is cited in many reports. To date, no one has replicated the authors' methodology, and it is not our purpose to do so here.

The Kaufman-Mastruzzi figure of \$1 trillion globally (\$1.16 trillion in 2012 USD) would be equal to 2 percent of global GDP (roughly \$58 trillion). In the economies available within the Enterprise Surveys data, an equivalent of just under 4 percent of their GDP goes to corruption. This covers roughly one-fifth of global output—which means that if the Kaufman-Mastruzzi number holds up, then economies with 22 percent of global GDP account for nearly 44 percent of global corruption (see table A1).<sup>4</sup>

Table A1: Costs of Corruption and Covered GDP (2012 USD)

			Share of global GDP (percent)	Share of covered GDP (percent)
Global GDP (2005 to 2012, average):		\$57.96 trillion	100.00	
Covered GDP		\$13.01 trillion	22.45	100.00
Cost of corruption	Naïve	\$515.25 billion	0.89	3.96
	Predicted	\$517.44 billion	0.89	3.98
Kaufmann-Mastruzzi (\$1 trillion)		\$1.16 trillion	2.00	

However, the joint UN Office on Drugs and Crime–World Bank's Stolen Asset Recovery Initiative (StAR) estimates that "criminal activities, corruption, and tax evasion" account for between \$1 trillion and \$1.6 trillion lost every year.<sup>5</sup> In the past 15 years, only \$5 billion in stolen assets has been repatriated.<sup>6</sup> StAR also estimates that developing countries lose between \$20 billion and \$40 billion annually to corruption.<sup>7</sup> It is important

<sup>2</sup> Transparency International, "Putting Corruption Out of Business," <http://www.transparency.org/research/bps2011>.

<sup>3</sup> Kaufmann, "Myths and Realities of Governance and Corruption."

<sup>4</sup> The \$1 trillion figure in 2012 USD would be \$1.16 trillion. The \$517 billion cost that we find is 44 percent of that (\$517 billion / \$1.16 trillion). In other words, these 105 economies make up 44 percent of global corruption (again assuming Kaufman-Mastruzzi's number is valid—that is, it stayed the same). Yet, these 105 countries make up only 22 percent of global GDP.

<sup>5</sup> The loss refers only to theft by public officials and to monies that have been hidden through intermediaries such as lawyers and other actors in other countries.

<sup>6</sup> Stolen Asset Recovery Initiative, "Fact Sheet: Barriers to Asset Recovery Study," World Bank, <http://star.worldbank.org/star/sites/star/files/EnglishBARFacts.pdf>.

<sup>7</sup> UN Office on Drugs and Crime and World Bank, "Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan," June 2007, <http://siteresources.worldbank.org/NEWS/Resources/Star-rep-full.pdf>.

to note the difficulties, though, in quantifying the dollar value of corruption (see textbox A1).

As noted above, this report focuses only on private-sector corruption<sup>8</sup> and tries to gauge the extent of such corruption in 105 countries as of 2012. Appendix B describes the methodology (two different approaches) used to calculate the numbers that appear here. From these two approaches, we found that the cost of private-sector corruption is approximately \$515 billion or more. The corruption figures only account for a certain number of mostly developing countries because the enterprise surveys (from which most of the data was used to approximate the dollar figure) are only conducted in these countries. Thus, the countries covered only account for approximately 22 percent of total GDP in 2012 dollars. (See table A1.)

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<sup>8</sup> Here, the private sector covers the formal, private-sector economy, excluding agriculture and extractive industries, with five or more employees in 105 countries.

### **Textbox A1. Complications in Quantifying Costs of Corruption**

Most research on gauging the extent of corruption is perceptions based. Few studies have attempted to put a dollar value on the size of corruption. The reasons for this include the following.

*First*, there is no universal criterion for corruption. What constitutes corruption can change, depending on the individual or on the cultural context. For example, many Asian and Middle Eastern cultures have practices of reciprocal favors and familial ties that are widely accepted business practices but would be considered corruption in other countries.<sup>1</sup> A common understanding across different countries, as well as the public and private sectors, is necessary to generate figures that can be compared across the board; however, this is an almost impossible feat.

*Second*, it is difficult to obtain accurate information about corruption. Being an illegal activity, corrupt transactions are generally not documented. Without any official records, studies must rely almost entirely on individuals' perceptions and testimony.<sup>2</sup> Most barometers/indices of corruption are based on perceptions of corruption from which it is almost impossible to extrapolate dollar figures, especially for bribery for a country as a whole. It is likely that individuals underreport, if they report at all, both the incidence and dollar amounts for fear of incriminating themselves. There is no effective method to verify these numbers. Moreover, corrupt exchanges in the form of reciprocal favors or gifts may not be readily evaluated in monetary terms. Facilitation payments and other in-kind favors are hard to trace.

*Finally*, the cost of corruption not only includes the dollar amount lost to bribes and grafts, but the

method must account for the opportunity cost of corruption. Corruption and weak governance discourage both domestic and international investment, distort incentives to prefer rent-seeking activity over economically productive ones, and create inefficient legislation that hinders individuals from joining the formal economy. They divert resources away from human capital development and the construction of physical infrastructure that can increase a country's growth potential. The prevalence of corruption has observable negative effects on investment rates and the per capita GDP growth rates of a country, which makes it an especially pressing issue for developing countries.<sup>3</sup>

1. The OECD considers culturally and historically based practices that unfairly favor members of a certain family or clan to be a form of corruption and incompatible with their norms for corporate governance. For example, part of the OECD's initiatives in the Middle East and North Africa (MENA) region involve the elimination of "wasta." Wasta is a cultural practice of reciprocal favors that pervades all aspects of business in the region. Although this practice has been historically accepted as a part of life there, the OECD places them as undue favoritism that causes inefficiencies in the economy. For example, the OECD supports the Jordanian Ministry of Public Sector Development in passing the "Code of Conduct and Ethics for Career Public Office," which explicitly prohibits favoritism and gift acceptance, and hopes similar initiatives would spread across the region. The same goes for the U.S. Foreign Corrupt Practices Act (FCPA), which prohibits the payment of bribes to foreign officials regardless of the practices on the ground. See Bertrand Venard and Mohamed Hanafi, "Organizational Isomorphism and Corruption in Financial Institutions: Empirical Research in Emerging Countries," *Journal of Business Ethics* 81, no. 2 (2008): 482, <http://actoolkit.unprme.org/wp-content/resourcepdf/SSRN-id1417906.pdf>.

2. Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, "Measuring Corruption: Myths and Realities," *Development Outreach* (September 2006): 2, <http://www1.worldbank.org/publicsector/anticorrupt/corecourse2007/Myths.pdf>.

3. Mauro, "Corruption: Causes, Consequences, and Agenda for Further Research."

## | Appendix B: Methodology for Calculating the Costs of Private-sector Corruption

All figures are taken from estimates using the World Bank's Enterprise Surveys<sup>9</sup> and the World Development Indicators. The Enterprise Surveys are a globally comparable, nationally representative firm-level dataset, which include questions on the cost of bribery both in day-to-day transactions and in government procurement. The surveys cover the formal, private-sector economy, excluding agriculture and extractive industries, for companies with five or more employees. The Enterprise Surveys data have been harmonized since 2006, with the surveys conducted on a three-to-four-year cycle. Due to the periodic coverage, only the most recent survey data, following the global methodology, are considered. Costs of corruption are calculated as national indicators and, as such, they are considered to be constant across a country's private sector.

The total cost of corruption contains two main components: transactional corruption (in day-to-day operations) and corruption in government procurement.

### Cost of Transactional Corruption

The World Bank's Enterprise Surveys ask respondents to report what establishments must pay in informal payments or gifts to "get things done," estimated as a proportion of their annual sales.<sup>10</sup> The question is intentionally framed to refer to the general "establishments like this one," and does not refer to bribes directly, in order to discourage nonresponse and to elicit truthful answers to a topic that is frequently difficult to address. As such, mean averages are best considered as general costs of corruption for day-to-day transactions undertaken by the private sector. The figures are calculated separately for manufacturing and services firms and are survey-weighted means to be nationally representative of the nonagricultural private sector.

Estimates for the amount of national, private-sector activity in both manufacturing and services are calculated using World Development Indicators for value added in constant 2011 USD.<sup>11</sup> As these figures are net values, subtracting the cost of intermediate inputs, they are adjusted to a gross estimate using value-added estimates from the Enterprise Surveys, which record annual sales and intermediate costs for private-sector firms. As these values may be subject to outliers, the survey-weighted median value for each sector within each country is used. Value added for manufacturing sectors is calculated as revenues less labor force costs and the cost of intermediate goods and materials. For retail firms, intermediate costs are composed of labor costs and the cost of purchasing

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<sup>9</sup> International Finance Corporation and World Bank, "Enterprise Surveys: What Businesses Experience," <http://www.enterprisesurveys.org/>.

<sup>10</sup> The most recent version of the question reads as follows: It is said that establishments are sometimes required to make gifts or informal payments to public officials to "get things done" with regard to customs, taxes, licenses, regulations, services, etc. On average, what percentage of total annual sales, or estimated total annual value, do establishments like this one pay in informal payments or gifts to public officials for this purpose?

<sup>11</sup> Numbers are given in 2005 constant USD, then deflated to 2012 USD.

goods for resell; value added for other service firms is given by revenues minus total labor costs.

The total transaction cost of corruption (T) is then given by:

$$T = \sum_{p=1}^P VA_p * \left(\frac{1}{v_p}\right) * trans_p$$

where:

P consists of separate figures for manufacturing and services.

trans<sub>p</sub> is the sector-specific mean of the cost paid in bribes to “get things done” as a percentage of annual revenues (source: Enterprise Surveys, see question j7).

VA<sub>p</sub> is national value-added, constant 2005 USD (deflated to 2012 USD). Indicators are taken for manufacturing, which corresponds to the covered manufacturing sectors (ISIC Rev. 3.1, 15–37) covered in the Enterprise Surveys. For services, value-added figures cover ISIC (International Standard Industrial Classification) codes 50 through 99, a broader coverage than the Enterprise Surveys, which cover service sectors in retail, wholesale, construction, transportation, and information technology. Figures for value added are taken from the year corresponding to the fiscal year period covered by each Enterprise Survey (source: World Development Indicators).

v<sub>p</sub> is the survey-weighted median value of value added for both manufacturing and services (source: Enterprise Surveys, see questions d2 and n2a, n2e, n2i).

## Cost of Corruption in Government Procurement

The Enterprise Surveys data additionally gather information on cases where businesses must pay an informal payment or gift to secure a government contract.<sup>12</sup> As these values are expressed in terms of the overall value of the contract, a national-level figure of the overall value of government procurement is estimated using World Development Indicators data. Specifically, the overall value of corruption in procurement of private-sector services (Pr) is given by:

$$Pr = G * gs * proc$$

where:

G is annual government expenditure in constant 2005 USD (deflated to 2012 USD) (source: World Development Indicators). If data for the fiscal year corresponding to the Enterprise Surveys were not available, the previous year’s data were used.

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<sup>12</sup> The full text of the question follows: When establishments like this one do business with the government, what percent of the contract value would be typically paid in informal payments or gifts to secure the contract?

gs is the proportion of government expenditure spent on the procurement of goods and services (source: World Development Indicators). If data for the fiscal year corresponding to the Enterprise Surveys were not available, the previous year's data were used.

proc is the survey-weighted mean of the value of a government contract expected in bribes as reported by private-sector firms in the Enterprise Surveys (see question j6). If data for the fiscal year corresponding to the Enterprise Surveys were not available, the previous year's data were used.

## Imputation of gs Variable

Due to coverage gaps in the gs country-level data, where Enterprise Surveys data were available, a two-step approach was taken. First, in cases where gs was missing, a proportion of 14.48 percent was inserted for non-OECD countries.<sup>13</sup> This is presented as the naïve approach.

A second, predicted approach was then used using linear predictions of gs regressed against G (in constant USD) and GDP (also in constant USD), including year fixed effects and robust standard errors. All data for gs, G, and GDP, from 2005 through 2012, were used to arrive at linear predictions. In cases where predictions were not obtained, the 14.48 percent OECD figure was inserted.

The World Development Indicators data covered 73 countries (out of a total 121) for the gs figures. Both the naïve and predicted approaches included estimates for all 121 economies. The predicted approach provided estimates for 26 of the 48 economies not covered by the initial World Development Indicators data.

## Data Coverage

Estimates of the cost of corruption in the private sector were provided for 105 total economies (out of a possible 121 global Enterprise Survey economies).<sup>14</sup> The data cover the years 2005 to 2012. Only the most recent round of the survey, under the globalized methodology, was considered for estimates.

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<sup>13</sup> Denis Audet, "Government Procurement: A Synthesis Report," *OECD Journal on Budgeting* 2, no. 3 (2002), <http://www.oecd.org/gov/budgeting/43506020.pdf>.

<sup>14</sup> The 16 missing cases represent where we could not get values for either the value added, GDP, or government expenditure numbers.

## | Appendix C: Select Initiatives for Combating Corruption

Organization	Approaches and Methods
United Nations	<p>The United Nations has passed multiple resolutions that address the need for anticorruption measures.</p> <p>The United Nations Convention against Corruption (UNCAC), signed in 2003, is the only legally binding, universal convention against corruption. Its 140 signatories are required to address the following five areas: prevention, criminalization and law enforcement, international cooperation, asset recovery, and technical assistance and information exchange.</p>
World Bank	<p>The World Bank believes that governance and corruption are key issues that affect economic development. The World Bank Group has both published studies on corruption and supported countries in building anticorruption mechanisms.</p> <p>The World Bank has an established Department of Institutional Integrity (INT) focused on advancing governance and anticorruption.</p> <p>The World Bank and the International Finance Corporation (IFC) also publish the World Governance Indicators, the Enterprise Surveys, and the Doing Business Report, which compile quantitative as well as perceptions-based data to create a comprehensive picture of the realities of corruption around the world.</p> <p>The World Bank also hosts the annual International Corruption Hunters Alliance (ICHA) to leverage new technologies such as crowd sourcing and mobile applications with citizen engagement and multilateral partnerships to combat global corruption.</p>
Center for International Private Enterprise (CIPE)	<p>CIPE focuses on three main approaches to fighting corruption: a cross-sector approach across government, civil society, and public sectors, mobilization of the private sector, and support for strong institutions.</p> <p>CIPE generally works in partnerships with local organizations to develop approaches specific to each situation.</p> <p>Successful projects include the creation of business ethics declaration in Thailand and an SME (small and medium-sized enterprise) Policy advocacy project in Russia.</p>
Center for Responsible Enterprise and Trade (CREATE)	<p>CREATE is a nonprofit organization that offers scalable and cost-effective online assessments, independent evaluations, and training for companies and their suppliers designed to benchmark processes for safeguarding IP and preventing corruption.</p> <p>CREATE has also developed a series of best-practice guides targeting company anticorruption compliance programs and IP protection related to patent infringement, copyright theft, and trademark and design rights.</p>



Organization for Economic Cooperation and Development (OECD)	<p>Bribery and corruption is one of OECD's focus areas. They focus most heavily on corruption in the business environment, but also address issues such as public procurement, conflict of interest, and lobbying.</p> <p>The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (or the OECD Anti-Bribery Convention) is a legally binding standard that criminalizes the payment of bribes. Thirty-four OECD members and 6 nonmembers have signed.</p> <p>The OECD also seeks to raise awareness of the issues through the CleanGovBiz Initiative, Initiative to Raise Global Awareness of Foreign Bribery, and other projects.</p>
World Economic Forum (WEF)	<p>Governance and anticorruption partnerships are two fields under the WEF's campaign for economic growth. Their Partnership Against Corruption Initiative seeks to create a dialogue between business leaders and government. Member firms are expected to adhere to a zero-tolerance policy toward corruption and create an internal anticorruption program.</p> <p>The WEF also published the Global Competitiveness Report, which examines the business environments of individual countries around the world.</p>
Transparency International (TI)	<p>TI partners with over 100 local chapters worldwide and works with government, private sector, and civil society partners to tackle corruption worldwide.</p> <p>TI publishes annual surveys, including the Corruption Perceptions Index, Global Corruption Barometer, and Bribe Payer's Index. These reports respectively examine perceptions of public-sector corruption, measure perceptions of corruption within institutions such as the government, media, and NGOs, and ranks countries by their firms' propensity to bribe abroad.</p>
Organization of American States (OAS)	<p>The OAS in 1996 adopted the Inter-American Convention Against Corruption to promote cooperation within member states geared toward preventing, detecting, and punishing corruption. The convention criminalized specific acts such as transnational bribery and illicit enrichment, and strengthened mutual legal assistance and technical cooperation through tools such as extradition, and seizure and forfeiture of property or proceeds obtained in the commission of acts of corruption.</p>
African Union (AU)	<p>The AU adopted the Convention on Preventing and Combating Corruption in 2003 that required member states to adopt regional anticorruption standards including codes of conduct for public servants, procurement and accounting standards, mutual law enforcement assistance, and the strengthening of national anticorruption authorities.</p> <p>The Convention on Preventing and Combating Corruption also contains provisions not found in the UNCAC such as national control measures that bind foreign companies to national legislation; mechanisms that encourage the private sector to strengthen tender procedures and property rights; and minimum guarantees for a fair trial.</p>

Council of Europe	<p>The Council of Europe has established several standards geared toward combating corruption and money laundering. These include the Criminal Law Convention on Corruption, Civil Law Convention on Corruption, Codes of Conduct for Public Officials, and Convention on Laundering, Search, Seizure, and Confiscation of the Proceeds from Crime and on the Financing of Terrorism.</p> <p>The Council of Europe monitors compliance through mechanisms such as the Group of States Against Corruption (GRECO) and the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL).</p> <p>The Council of Europe leverages European monitoring and compliance standards, and technical assistance offered to individual countries and regions, through its cooperation activities.</p>
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## | Appendix D: Conference Report

### The Costs of Corruption: Ending a Tax on Private Sector-led Growth

*Sadika Hameed and Jeremiah Magpile<sup>15</sup>*

The CSIS Project on Prosperity and Development (PPD) held a number of workshops and conducted research culminating in the report, “The Costs of Corruption: Strategies for Ending a Tax on Private Sector-led Growth.” The research focused on the opportunity costs of corruption to businesses and broad-based economic growth and the role of the private sector in addressing these costs. Using even a very narrow definition of private-sector corruption, PPD found that in a given year, the costs exceeded \$500 billion—representing 3.7 times the amount of official development assistance given in 2012. On January 16, 2014, we gathered a group of experts to discuss the findings, the challenges, and the way forward.<sup>16</sup> The following report provides the key thematic issues that were highlighted and discussed.

#### Key Findings and Takeaways

##### ***1. What is the current state of play regarding corruption and anticorruption initiatives?***

In terms of global gross domestic product (GDP) there is less corruption compared to that of the 1990s, but there is more corruption in absolute terms. There are still legal loopholes which large companies often utilize.<sup>17</sup> The incidence of corruption can be divided into three categories:

- *Catastrophic or “grand” corruption.* This includes big bribes paid to government officials, typically by big companies, and is the most damaging form of corruption.
- *Systemic corruption.* This type of corruption insinuates itself into private- and public-sector institutions and regulatory systems and is characterized by uneconomic behavior that creates rent-seeking opportunities for private and public actors. Such actions extract value for personal enrichment in lieu of public

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<sup>15</sup> Sadika Hameed is a fellow with the CSIS Program on Crisis, Conflict, and Cooperation. Jeremiah Magpile is a program coordinator and research assistant with the CSIS Project on Prosperity and Development.

<sup>16</sup> The panel included: Roderick Hills, chairman and cofounder, Hills Program on Governance, CSIS; Michael , former vice president and senior counsel, General Electric; Pamela Passman, president and CEO, Center for Responsible Enterprise and Trade (CREATE); Michael Hershaman, president and CEO, Fairfax Group; Rolf Alter, director, Public Governance and Territorial Development Directorate, OECD; and, Daniel F. Runde, director, Project on Prosperity and Development and William A. Schreyer Chair in Global Analysis, CSIS.

<sup>17</sup> Recently, the *Wall Street Journal* covered a bribery case where a multinational corporation (MNC) made illegal payments through foreign bank accounts using a foreign consultant, resulting in the enrichment of a few elite officials in the Middle East. The MNC was fined only \$384 million, because they were able to disprove “any wrongdoing” and stressed that neither the U.S. Justice Department nor the Securities and Exchange Commission alleged or found that anyone “knowingly engaged in the conduct at issue.”

interest. Systemic corruption is a broad concept that captures the failures of legitimacy, accountability, and effectiveness in regulatory systems.

- *Petty corruption.* This type of corruption includes facilitation payments and is of least consequence individually but still imposes a collective cost on society and can reflect a general culture of tolerance that is often fed by the prevalence of more damaging forms of corruption.

The major focus of governments and international organizations in the 1990s was on catastrophic corruption. There are now tools under domestic and international law that aim to eliminate the problem of catastrophic corruption, provided there is focus on the issue and the tools are used and implemented effectively.

Systemic corruption is harder to counter, and there is now debate about systemic failure in the aftermath of the 2008 financial crisis. The gold standard of regulatory excellence that would assure the integrity of those systems has yet to be identified. The challenge of regulatory excellence has implications for how regulations and accountability can be effectively enforced at both the domestic and international level.

Systemic corruption is the compelling issue today. Martin Wolff in the *Financial Times* highlighted the problems facing our regulatory regimes in the aftermath of the financial crisis. He cited the failure of the intellectual elites in these terms: “an explicit deal exists between elites and the people: the former obtain the privileges of power and property; the latter, in return, obtain security and, in modern times, a measure of prosperity.” Wolff points to the collapse of the financial system and the economic stagnation that followed, what Larry Summers calls secular stagnation that is eluding the remedies of traditional economic policies. Accompanying this lack of growth is the growing problem of inequality that is being attributed to globalization and technological change.

Petty corruption is a reflection of the culture that is created around integrity, and it is largely a function of the public sense that anything goes when the elites and leadership of a society are on the take.

From a company perspective, there has been a shift away from systemic to transactional forms of corruption. Criminalization of bribery through treaties and standards has a transactional focus. The solution to the problem, however, is systemic; a certain set of codes and policies can ensure that a compliance system is, in fact, in place. Instead of looking at incidences of corruption, there is a greater need for a systemic approach.

## ***2. The momentum for the fight against corruption has waned for a number of reasons.***

First, the energy in the activist community has been dissipated by all-encompassing definitions of corruption that are difficult to operationalize. These range from bribes and foreign payments to campaign finance reform and allegations of a corrupt financial system. Second, there has been erosion in the ability of the United States to assert the same leadership role in the international fight against corruption that was critical to getting the Organization for Economic Cooperation and Development (OECD) Anti-bribery Convention active. Third, general confidence in public institutions is at an all-time low. For example, the World Bank, International Monetary Fund (IMF), and United Nations have faced corruption scandals that have in part compromised their credibility.

This has also raised questions about their priorities and commitment. Fourth, the financial crisis and subsequent events since 2008 have raised profound questions about the nature of regulatory systems in preventing systemic failure and economic decline. Efforts to pursue accountability have faced their own legal and political obstacles. Finally, the anticorruption movement has itself become overly bureaucratized making it difficult to maneuver efficiently to respond to challenges.

Nevertheless, the fight hasn't diminished entirely. What is encouraging is that the examples of recent corruption cases—for example, the bribery settlement by Siemens and the fines that JP Morgan has paid—has brought to the forefront for all CEOs in the United States the potential for catastrophic consequences of noncompliance practices.

### ***3. Most company compliance systems and procedures are far from sufficient in preventing corrupt practices down the value chain or in supply chains.***

Over the past 45 years there have been an incredible number of cases of business corruption, but a large majority, particularly in the 1970s and 1980s, were accidental. In the 1970s up to 400 American companies admitted to bribing foreign officials<sup>18</sup> due to the inherent culture of doing business (then known as “questionable payments,” now known as “facilitation payments”). The U.S. government has since had incredible success in combating private-sector corruption and identifying practices of noncompliance for two reasons. First, the Securities and Exchange Commission (SEC) was able to require access to internal control mechanisms that would help in identifying facilitation type payments. It also required external auditors to report suspicious payments to independent bodies or “forensic accounting.” Congress in 1977 also created the Foreign Corrupt Practices Act (FCPA).

However, major challenges in mobilizing effective internal compliance practices remain. Panelists also raised the point that effective implementation at all levels remains a major challenge.

According to a 2013 compliance survey by PricewaterhouseCoopers, the top risks identified by companies were bribery, supply chain issues, and intellectual property issues. Companies were forced to pay fines over the acts of their own employees or their business partners. While some multinational companies are extending their codes of conduct and supplier or vendor codes and training throughout their supply chains and business partners, this is still an uncommon practice.

Through its research, CREATE found that, of the companies they surveyed, effectiveness is a serious challenge: in 52 percent of the cases, executives did not understand the need to implement effective systems until something went wrong; 52 percent found intellectual property protection to be very challenging; and 42 percent generally found anticorruption to be a challenge. Respondents noted that there are significant corruption and supply chain problems among their supply chains. In emerging markets this number is the highest—more than 60 percent. Only 30 percent of companies rated their compliance programs as effective.

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<sup>18</sup> These also formed the bulk of the corruption cases in the 1970s.

***4. In addition to addressing corruption because of their bottom line needs, companies must prevent corruption because it is “the right thing to do.”***

Very few companies go beyond simply following anticorruption regulations. In particular, very few recognize that corruption affects not just individual companies but also sectors in countries that are more prone to corrupt practices, the investment climate in general, and economic growth. Corruption undermines democracy and trust in government. Most importantly, it provides disincentives to government officials to engage in policy reforms that would lead to poverty alleviation and sustainable economic growth.

***5. There is a very strong economic incentive to combat corruption.***

Corruption is a distortion of market prices. Private and public corruption indicates that market forces do not play their full role. This results in an uneven playing field. Corruption is also the first and most important correlating factor to the loss of trust in businesses.

Projects involving corruption are generally unprofitable and companies hoping to make up the amount paid in bribes through increased contract amounts or by cutting costs have not been successful. Contracts obtained through corrupt practices have negative impact on companies' net profit and revenues.

Compliance can be a competitive differentiator for companies leading this movement. In ensuring that compliance systems are in place, multinational companies can sustain economic growth and competitive advantage. Companies with effective anticorruption initiatives can avoid costly litigation and legal, reputational, and financial harm. Supply chain companies and business partners can use a strong anticorruption ethos to differentiate themselves from competitors and to position themselves strongly in front of business partners, potential employees, and customers.<sup>19</sup>

For example, General Electric (GE) has garnered a reputation of excellence in enforcing stringent compliance measures. The steps taken by GE in the last 23 years to date remain relevant. In 1990, most GE executives felt that competitors' use of bribery was a more significant barrier than any trade barrier they faced. GE began to pursue more innovative and technical measures to comply with the Foreign Corrupt Practices Act (FCPA). A strategy was formed to make integrity a competitive advantage and advocate an international agreement to ensure that GE's competitors were subject to the same standard. Though there was initial push back, GE emerged on the winning side.

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<sup>19</sup> GE has a compliance program that is recognized as the best in class. It makes all its compliance materials available to all employees electronically and offers an eBook version of the code that includes real-life examples and other tools. GE and other corporate leaders are working with the supply chain to embed responsible business practices across their networks and foster a culture of compliance. A new Microsoft program requires that partners provide anticorruption training for all employees who resell, distribute, or market the product and provide its services if these networks do not have their own systems. Hewlett-Packard, IBM, and Fluor provide similar programs to supply chain partners. Cisco too works closely with its supply chain costumers to follow the same code of conduct. CREATE.org is working with several private equity firms in Asia who use its system to assess their portfolio companies' capacity to prevent corruption and help where they are experiencing weaknesses.

***6. The fight against corruption must leverage existing technologies and societal participation and must not be limited to the private sector.***

Combating corruption requires healthy institutions, strong enforcement, and verification. Corruption is a two-party crime—there is a clear giver and a receiver. But while the justice departments are willing to prosecute corporations, they typically do not disclose corrupt government officials. For instance, when the World Bank demanded the names of the officials involved in the bribery of the “Padma Bridge” project in Bangladesh, the government chose to look for other sources of funding rather than disclose the names of the officials.<sup>20</sup> The growing participation of civil society and governments in the fight against corruption suggests that anticorruption initiatives are moving away from this norm. In this context, the use of new media by civil society to “name and shame” corrupt practices remains of great significance and has potential to catalyze anticorruption initiatives in areas where there is poor rule of law. Technology empowers civil society as watch dogs and regulators both on the private and public sector. This has been especially apparent in India in 2012 and 2013, where mass movements, fueled through new media tools, began against corrupt government officials.

Companies and other stakeholders have in many cases plateaued in creativeness in compliance systems and creating more effective mechanisms. Harnessing the power of civil society and new media tools will play an important role in ensuring this trend does not continue.

***7. Anticorruption in procurement processes should remain a top priority for governments and private-sector actors despite the amount of effort and work that has already been done.***

Procurement accounts for about 15 percent of GDP in OECD countries. The way that procurement is undertaken has a big impact not only for governments, but also on the private sector and more largely on economies. For example, the OECD has developed some principles on good practices, particularly on transparency. This means procurement is viewed as a cycle from needs assessment to monitoring results. Most governments do not have such mechanisms in place. For those that do, for example United States, it is also important to look at procurement at more local levels.<sup>21</sup>

Discussions on more proactive forms of engaging procurement systems to combat corruption were however dropped in the last Doha Round of the World Trade Organization (WTO). There should instead be a system that discloses the procedures of public procurements and holds people, organizations, and institutions accountable similar to the WTO tariff disclosure mechanism.

***8. Collective action holds potential for leveling the playing field but continues to face challenges in implementation.***

There has been a great deal of dialogue on collective action over the course of 15 years, and a growing number of collective action initiatives continue to emerge. Private-sector

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<sup>20</sup> For more information, see World Bank, “World Bank Statement on Padma Bridge,” press release, June 29, 2012k, <http://www.worldbank.org/en/news/press-release/2012/06/29/world-bank-statement-padma-bridge>.

<sup>21</sup> For example, in the United States, 60–65 percent of procurement happens at the local level.

initiatives follow a similar process—getting companies to ascribe to a code of conduct, which in fact is voluntary. However, until there is oversight and enforcement over collective actions, ensuring that the companies are, in fact, complying with the policies will be difficult. Identifying third party organizations that would certify these companies is challenging given legal reasons. Compacts are typically sectoral agreements in which a group of companies agree to work together to stop bribery. There is skepticism with multilateral initiatives engaging the private sector for two reasons. For one, they are not enforceable, as the UN Global Compact has demonstrated when member companies blatantly violating commitments were removed. It is hard to find a compact of companies willing to adopt a truly effective enforcement mechanism, even when such a mechanism has been proposed. Second, discussion of antibribery issues competes for CEO attention with the tougher problems of ensuring that they maintain the high internal standards of their own compliance system. The trade-off is public appearance in support of an important principle or the down and dirty of maintaining integrity in commercial practices.

### ***9. The United States has unique but underutilized tools in combating corruption.***

The United States has corporate criminal liability. While it is rarely, if ever, used, it is nevertheless a powerful inducement for holding a CEO accountable for what happens on his watch. Second, the FCPA has a “knowledge” standard that imputes knowledge up the chain of command by holding executives accountable for what they should have known and for creating a culture of impunity. U.S. law requires that companies that seek benefits from the U.S. government, whether in the form of advocacy or export financing, commit themselves to maintaining and enforcing a company-wide antibribery compliance system. Failure to maintain such a system is a contractual violation for which they can be held accountable. It is much easier to see if a company has a system to prevent bribery than to figure out if a bribe was paid in a particular transaction.

### ***10. Leading by example could be a solution.***

Like the fight to protect intellectual property rights, there needs to be a momentum for anticorruption. More courageous companies are needed to lead by example. Just as companies have invested in quality management and health and safety, they need to make anticorruption measures an integral part of their operations. Being proactive and preventative is key in addressing these challenges.

It is not tone from the top, but actions from the top that should matter. Robust management systems could prevent corruption and effectively use intellectual property, while ensuring that companies have appropriate policies and procedures in place and that employees and business partners are aware of these policies and procedures; compliance teams in place to conduct due diligence, training, and monitoring; and finally, systems in place enforce corrective action in cases of corruption.



## | About the Project Director and Authors

**Daniel F. Runde** holds the Schreyer Chair of Global Analysis at the Center for Strategic and International Studies (CSIS), where he leads the Center's study of international development focusing on private-sector led development. He is also the codirector of the Project on U.S. Leadership in Development and director of the Project on Prosperity and Development. Previously, he led the Foundations Unit for the Department of Partnerships and Advisory Service Operations at the International Finance Corporation (IFC), the private-sector arm of the World Bank Group. Earlier, Mr. Runde was director of the Office of Global Development Alliances (GDA) at the U.S. Agency for International Development (USAID). He began his career in financial services at Alex. Brown & Sons, Inc., in Baltimore and worked for both CitiBank and BankBoston in Buenos Aires, Argentina.

Mr. Runde has written and spoken frequently on international development and foreign policy issues. He has been quoted in Bloomberg, the Financial Times, Politico, and NPR. He has also authored influential reports and articles on topics including rethinking U.S. engagement with BRIC and other middle-income countries, the use of development finance instruments, and the role of the private sector in international development. He was selected to serve as a member of the Global Agenda Council on the United States for the World Economic Forum in Davos, Switzerland. He is a member of the Board of Directors of the Peter C. Alderman Foundation and a member of the Atlantic Council, the Bretton Woods Committee, and a Life Member of the Council on Foreign Relations. He received an M.P.P. from the Kennedy School of Government at Harvard University and holds a B.A., cum laude, from Dartmouth College.

**Sadika Hameed** is a fellow with the CSIS Program on Crisis, Conflict, and Cooperation, where she focuses on private-sector development, quantitative analysis of political transitions, cooperation in South Asia, and monitoring and evaluation of multilateral programs in fragile, conflict-affected, and violent situations. Prior to joining CSIS, Ms. Hameed worked as an economist and governance specialist with the World Bank and USAID in Afghanistan and Pakistan. She earned an M.A. in international policy studies from Stanford University, an M.S. in economics from the University of Manchester, and a B.A. in economics and finance from the University of Manchester.

**Jeremiah Magpile** is the project coordinator and research assistant for the CSIS Project on Prosperity and Development. He holds a B.A. in international relations from American University.







1616 Rhode Island Avenue NW | Washington, DC 20036  
t. 202.887.0200 | f. 202.775.3199 | [www.csis.org](http://www.csis.org)

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4501 Forbes Boulevard, Lanham, MD 20706

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