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COMBATING MULTILATERAL DEVELOPMENT BANK CORRUPTION: U.S. TREASURY ROLE AND INTERNAL EFFORTS [PART II]

HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

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COMBATING MULTILATERAL DEVELOPMENT BANK CORRUPTION: U.S. TREASURY ROLE AND INTERNAL EFFORTS [PART II]

Wednesday, July 21, 2004

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
WASHINGTON, D.C.

The committee met, pursuant to notice, at 9:33 a.m. in SD–219, Dirksen Senate Office Building, Hon. Richard Lugar, chairman of the committee, presiding.

Present: Senator Lugar.

STATEMENT OF HON. RICHARD LUGAR, U.S. SENATOR FROM INDIANA

The CHAIRMAN. This hearing of the Senate Foreign Relations Committee is called to order. Today the committee meets to review United States policy toward the multilateral development banks, which include the World Bank, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, and the European Bank for Reconstruction and Development.

This is the second in our series of hearings examining ways in which the United States Congress and our government can contribute to anti-corruption and anti-fraud efforts at the multilateral development banks. Our committee is committed to continued oversight of the multilateral development banks through hearings, site visits, interviews, and document reviews.

The United States has strong national security and humanitarian interests in alleviating poverty and promoting progress around the world. That is why the Congress funds foreign assistance programs and also why we fund multilateral development banks. The MDBs leverage our resources to promote poverty reduction and development around the world.

For 2004, the United States provided the MDBs with $1.2 billion, and the MDBs provided developing countries with more than $35 million in financing. In our May 13 hearing, we learned that MDBs have been taking steps to curb corruption, but that more needs to be done to ensure that bank funds are used properly.

Today our hearing will focus on what the United States Treasury Department is doing to stem corruption at the MDBs. The Treasury Department is responsible for dealing with the MDBs on behalf of the United States. We also will discuss the World Bank's efforts to impede fraud and its response to prosecutions of corruption related to one of its projects.

As one of its anti-corruption initiatives, the World Bank commissioned former Attorney General Richard Thornburgh to produce three reports analyzing World Bank operations. We will discuss these three reports, which make recommendations for improving the World Bank's mechanisms to address fraud and corruption, streamlining the process used to debar companies that fail to abide by World Bank policy and strengthening the Department of Institutional Integrity, the World Bank office responsible for investigating allegations of fraud and corruption.

We also will discuss the Lesotho Government's ongoing campaign against corruption. Lesotho has made a significant effort to prosecute a number of companies for bribery related to a World Bank-financed project. The World Bank's response to Lesotho prosecutions is important, not only in that country, but to the perceptions of countries and companies around the world. How the World Bank deals with international corporations convicted in a court of law for corruption associated with World Bank projects will be a powerful indication of the seriousness of the World Bank's anti-corruption efforts.

Finally, our hearing will examine the responsibilities and activities of the Treasury Department concerning investigative oversight of the multilateral development banks. Our initial inquiry into this topic suggests that there is confusion or some indecision within the Treasury Department about its oversight role. In February 2004, my staff forwarded a specific allegation of World Bank corruption to the Treasury Inspector General's office. We received a response stating, and I quote, "we are in the official phases of determining Treasury OIG's criminal investigative jurisdiction in matters like the one you have referred to this office. At this time, we anticipate no further action with this matter." A copy of the Inspector General's letter will be entered into the record.

[The information referred to follows:]

OFFICE OF THE INSPECTOR GENERAL,
U.S. Department of the Treasury,
February 27, 2004.

Mr. Keith Luse,
Senior Professional Staff Member,
U.S. Senate Committee on Foreign Relations,
Washington, DC 20510-6225

Dear Mr. Luse,

Thank you for your correspondence forwarding the conspiracy allegation concerning **[redacted]** embezzling six million from a wire transfer to **[redacted]**. We note from the attached documents that **[redacted]** is represented to be **[redacted]** and, apparently, has a relationship with the World Bank.

As you are aware, the Secretary of the Treasury serves as a World Bank Governor from the United States and, in 2003, the United States committed $25.8 billion in subscriptions and contributions. For fiscal year 2003, the President's budget for the Treasury International Accounts amounted to $1.47 billion, including funds for the multilateral development banks, debt forgiveness, and technical assistance. Further, the Department of the Treasury's Office of International Affairs oversees U.S. participation in the International Monetary Fund and the multilateral development banks, including the World Bank, the Inter-American Development Bank, the African Development Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development.

The Office of Investigations is in a rebuilding cycle brought on by Treasury resources being divested to the Department of Homeland Security. As such, we are refocusing our planning, business processes, investigative, and prevention efforts to better protect the Department's programs like those for which the Office of Inter-

national Affairs has responsibility. We are in the initial phases of determining Treasury OIG's criminal investigative jurisdiction in matters like the one you have referred to this office. We note your correspondence with the World Bank and the Offices of Inspector General for the Department of State and the United States Agency for International Development with whom we are coordinating this matter. At this time, we anticipate no further action with this matter.

We thank you for forwarding the aforementioned information to the attention of this office. If you have any questions concerning this matter, please feel free to call upon me at **[redacted]**. Staff questions and requests for support related to this matter should be directed to **[redacted]**.

NICK D. SWANSTRON,
Assistant Inspector General for Investigations.

The CHAIRMAN. I am perplexed that the Office of Inspector General of the Treasury Department remains unsure of its jurisdiction in multilateral development banks matters, because the Treasury Department has had the responsibility for MDB oversight since the creation of the World Bank in 1946. We invited the acting Inspector General of the Treasury Department, Dennis Schindel, to testify today, but he declined.

His staff informed us in an e-mail that the Treasury Inspector General's office was not currently working on multilateral development bank corruption. It said, "we are exploring bases for invoking jurisdiction to do work in this area, but have not reached any conclusions." They added that the Treasury Inspector General is, "low on resources since our divestiture to Homeland Security."

Now, given the United States has provided more than $39 billion in direct contributions to the MDBs since 1960, I am concerned that the Treasury Department is unable to dedicate sufficient resources to investigate the use of those funds. Congress needs to determine whether the Treasury Department Inspector General is suffering from a lack of resources. If we need to direct additional funds to ensure that the Office of the Inspector General can provide effective oversight, we should do so. If the Treasury Department Inspector General's office is not the best location for MDB oversight, then the administration and the Congress should work together to provide clear authority for this mission to another agency.

[Additional information received by the committee from Dennis S. Schindel, Acting Inspector General, Department of the Treasury, follows:]

STATEMENT SUBMITTED FOR THE RECORD BY ACTING INSPECTOR GENERAL
DENNIS S. SCHINDEL

REGARDING TREASURY OFFICE OF INSPECTOR GENERAL JURISDICTION
WITH RESPECT TO MULTI-LATERAL DEVELOPMENT BANKS

August 13, 2004.

Thank you for the opportunity to discuss with the Committee the role and jurisdiction of the Treasury Office of Inspector General (OIG) to investigate and audit the activities of multi-lateral development banks (MDBs) that receive appropriated funds through the Department of the treasury.

The Inspector General Act of 1978, as amended, 5 U.S.C. Appendix 3 (IG Act), gives inspectors general the authority and responsibility to conduct and supervise audits and investigations relating to the programs and operations of their establishments, and to keep the establishment's head and Congress fully and currently informed about problems and deficiencies relating to the administration of those programs and operations.

To carry out these responsibilities, the IG Act requires all offices and employees of the establishment to cooperate with OIG audits and investigations, and mandates that OIGs have access to "all records, reports, audits, reviews, documents, papers, recommendations, or other material available to the applicable establishment which relate to the programs and operations with respect to which that Inspector General has responsibilities under this Act." 5 U.S.C. Appendix 3, Sec. 6(a)(1). OIGs additionally have authority to subpoena documentary evidence necessary to the performance of their duties under the IG Act. Id., Sec. 6(a) (4).

While Inspectors General (IGs) can generally audit and investigate recipients of appropriated funds, such as contractors and grantees, and can demand and even subpoena necessary information to that end, these powers cannot be made to apply to the entities at issue here. The international agreements that establish MDBs, and the U.S. law that implements the agreements, makes clear that the MDBs possess an effective immunity to the OIG's authority.

For example, the agreement establishing the World Bank specifically provides that the archives of the Bank "shall be inviolable," and further states that all officers and employees of the Bank are immune from legal process for acts performed in their official capacities, except where the Bank waives such immunity. Article VII, Secs. 5,8. Federal law enforces this immunity: 22 U.S.C. Sec. 286h states that Secs. 5 and 8, among other provisions in the Bank agreement, "shall have full force and effect in the United States and its Territories and possessions."

We therefore believe that current law effectively bars our ability to demand access to the MDBs in order to carry out audit and investigative operations with respect to their stewardship of the appropriated funds which are provided to them via the Department of the Treasury.

Lastly, I must note that the resource limitations under which we operate since last year's divestiture of two thirds of our personnel would impose a serious obstacle to our ability to take on new audit and investigative work in any case. We hope that our FY 2005 appropriation will allow us to expand our audit and investigative staffing, and increase our oversight of the Treasury.

I would be happy to provide further information to, and engage in discussion with, the Committee on this issue.

The CHAIRMAN. Today, we have two panels to discuss corruption and the multilateral development banks. On our first panel, we are pleased to welcome Mr. John Taylor, Under Secretary for International Affairs at the United States Treasury Department. On our second panel we will hear from Mr. Richard Thornburgh, former U.S. Attorney General, and former Governor of Pennsylvania; Mr. Guido Penzhorn, advocate and senior counsel of the Durban Bar in South Africa and prosecuting attorney in corruption cases in Lesotho; and Ms. Kimberly Ann Elliott, a research fellow at the Institute for International Economics. At this time, I hear the fire alarm and so the hearing is temporarily recessed until we can reassemble.

[Recess.]

The CHAIRMAN. The hearing is resumed. It's now our privilege to hear from the Honorable John B. Taylor, Under Secretary for International Affairs, Department of the Treasury in Washington, D.C. Secretary Taylor, we thank you once again for coming to the committee and we look forward to your testimony.

STATEMENT OF HON. JOHN B. TAYLOR, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. TAYLOR. Thank you very much, Mr. Chairman, and thanks for inviting me to discuss the U.S. efforts to fight corruption in the use of funds at the multilateral development banks. It's an issue we take very seriously. We're committed to every possibly effort to help prevent, detect, and punish corruption at the MDBs. Such corrupt acts are intolerable and we feel it's our obligation to help en-

sure that the multilateral development banks, all of them take the steps necessary to ensure an effective anti-corruption apparatus.

My testimony today focuses on the five MDBs that you mentioned in your opening remarks, Mr. Chairman, the World Bank, the Inter-American Development Bank, the African Development Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development. My written testimony describes the recent anti-corruption efforts that have been taken, the U.S. role in reforming the institutions and how it relates to those efforts. I'd like to summarize the statement briefly here and if possible enter the full testimony into the record.

The CHAIRMAN. The full testimony will be published in the record.

Mr. TAYLOR. Thank you very much. Let me emphasize at the outset, Mr. Chairman, that at all the institutions we're now pursuing a reform agenda that is an essential tool in the fight against corruption, and that agenda can be called a measurable results agenda. Through our efforts, the needs for rigorous results measurement has now been broadly accepted by the international community. All of the institutions have begun to mainstream mechanisms to measure and report the results of their projects. The new reforms emphasize measurable results with specific timelines to get things done. They provide incentives to the institutions, financial incentives, by tying increased financial support to the establishment of results measurement systems and the achievement of the measurable results.

If the flow of money is tied to concrete measurable results, we feel the chance of diverting MDB resources for corrupt purposes will be lowered considerably. While more needs to be done certainly, we have built broad support among shareholders and management on the importance of measuring results and accountability, and we will continue to pursue this priority aggressively.

We at the United States Treasury conduct our oversight of the corruption-related and other issues at the MDBs in many ways, Mr. Chairman. On a regular basis we work with our executive directors, we review all loans, grants, and policy proposals to make sure they include fiduciary safeguards and measurable results. We chair the Inter-Agency Working Group on Multilateral Assistance, which meets weekly to review all MDB loans and grants. We meet regularly with the NGO community and other interested parties.

When we find problems with projects, our first effort is to work with management to point out the problems and see what can be done to deal with them. The ultimate voting decision on projects is the responsibility of the U.S. Government. The working group and input from the NGOs helps us gather expertise and perspective of different agencies in the private sector, informing our decisions.

But let me describe a few of the actions that have been taken by the MDBs and there's more details in the written testimony. Recently, in November 2000, and importantly, the World Bank created this new Department for Institutional Integrity. So far, investigations by this new department have led to the Bank's imposing administrative sanctions on at least 180 firms and individuals. The names of the firms and individuals that are sanctioned are made public, they're posted on the Web site. The Bank has a hotline for

both bank employees and others to call if they believe there is any corruption going on. The complaints can be confidential and anonymous. This is good progress.

Similar actions are being taken at the other MDBs, different names for the departments, different procedures, but they're all taking similar approaches at this point, as documented in my written testimony.

Another broad area where the anti-corruption effort is underway is regarding specific projects. In this area, beginning with the World Bank again, the World Bank has in place procurement and consultant guidelines that govern the purchase of goods, civil works, consulting services that are financed in whole or in part from bank loans for investment projects. These guidelines certainly include anti-fraud and corruption provisions, and they provide for the Department an example of a sanction or other remedies if the Bank determines that firms have engaged in corrupt or fraudulent practices. We're advocating now similar actions at the other MDBs, as described in my testimony.

Overall, Mr. Chairman, we're going to continue to push vigorously this strong measurable result framework for all projects. That is, for the specific projects, as they're being completed, as they're being put in place, that there will be these measurable timelines. On both the outputs and on the outcomes, what gets measured, gets done, so establishing a strong results-based program will sharply reduce the likelihood that monies will be diverted for corrupt purposes.

At the country level, where there are still significant problems, is where the windows of the MDBs that are devoted to the poorest countries have or are currently establishing what is called performance-based allocation systems. I think these are very important. These systems provide more resources to those countries that improve governance and take steps to combat corruption, while those who do not take such efforts receive fewer resources.

For example, under the most recent replenishment of the funds in IDA, 17 countries will have their resources allocations reduced because of poor performance on the country institutional assessment guidelines, the so-called CPA. In the recently concluded Asian Development Fund negotiations, our negotiators achieved an increase in the weight given in good governance to anti-corruption, increased the weight that good governments would be given, and good governance includes anti-corruption in this performance-based allocation system. These systems provide incentives for countries to tackle the governance issues in order to receive greater resources. It's a financial incentive to improve.

Mr. Chairman, I also want to mention the work that's underway that's related to Section 581. This is a central part of our efforts now. It's really implementing Section 581 of the fiscal year '04 Appropriations Act, as signed into law last January 23rd, passed by this committee, of course. And these issues in Section 581, the provisions, were the product of considerable consultation between the U.S. Treasury and the Congress. Section 581 aims to increase transparency and accountability, and this is an objective we all strongly support.

On March 2nd of this year, I sent a memo to each of our executive directors at the institutions conveying the Section 581 language along with the request that they use every effort to advance the goals in Section 581. We are continuing to work vigorously on these goals. I believe we're making good progress on getting them done.

In conclusion, Mr. Chairman, let me reiterate that the Bush administration takes very seriously the threat that corruption poses to economic development and the effective use of MDB resources. I've tried to describe briefly here and more fully in my written testimony that the MDBs have taken important steps to combat corruption, that management of the MDBs are to be commended for these positive steps that they have taken in recent years to fight corruption.

Clearly, more needs to be done. We are fully dedicated to the efforts and I look forward to continuing to consult with the Congress on our projects. Thank you.

[The prepared statement of Mr. Taylor follows:]

PREPARED STATEMENT OF JOHN B. TAYLOR

Chairman Lugar, Ranking Member Biden, Members of the Committee, I welcome the opportunity to discuss with you U.S. efforts to fight corruption in the use of funds by the Multilateral Development Banks (MDBs). It's an issue we take very seriously. We are committed to every possible effort to help prevent, detect, and punish corruption associated with development assistance provided by the MDBs. Such corrupt acts are intolerable and, as custodians of taxpayer dollars intended to stimulate economic growth aid alleviate global poverty, it is our obligation to help ensure that the MDBs take all the steps necessary to ensure an effective anti-corruption apparatus.

My testimony today will focus on five MDBs: the World Bank, the Inter-American Development Bank (IDB), the African Development Bank (AfDB), the Asian Development Bank (AsDB), and the European Bank for Reconstruction and Development (EBRD). I will describe the recent anti-corruption efforts and the U.S. role in reforming the institutions.

Our efforts to strengthen anti-corruption efforts are focused on three levels. First, at the institutional level, we are focused on improving the functioning of MDB internal control processes for internal auditing, investigative mechanisms, whistleblower protections, and corporate procurement—and increasing the disclosure and accountability of MDB operations.

Second, at the project level, we are focused on encouraging the MDBs to conduct analysis and design projects that help reduce opportunities for corruption, strengthen fiduciary standards, and help ensure that Bank funds will be well spent.

Third, at the country level, we focus on enhancing the transparency and accountability of recipient countries' governance systems and disclosure in MDB operations and analysis, aid to channel MDBs resources toward countries that have good governance in place. Treasury reports annually to the Congress on the country specific anti-corruption programs supported by each MDB, and actions taken by recipient countries.

At all these banks we are pursuing a reform agenda that is an essential tool in the fight against corruption—measuring results. The need for rigorous results measurement has been broadly accepted internationally. All of the institutions have begun to mainstream mechanisms to measure and report the results of their projects. The new reforms emphasize measurable results with specific timelines. They provide incentives to the institution by tying increased financial support to the establishment of results measurement systems and results achieved in all operations; especially in the design of country assistance strategies and individual projects and during project implementation. If the flow of money is tied to concrete and measurable results, the chance of diverting IDB resources for corrupt purposes will be lowered considerably. While more needs to be done, we have built broad support among shareholders and management on the importance of measurable results and accountability and will continue to pursue this priority aggressively.

We at the U.S. Treasury conduct our oversight of corruption-related and other issues at the MDBs through a variety of practices and processes. On a regular basis we work with the Executive Directors (USEDs) on their participation in Board policy discussions and with management of these institutions. In the case of corruption, this means urging the institutions to establish effective and accountable policies and mechanisms to reduce the opportunities for corruption and to detect and punish corruption when it occurs. Treasury reviews all loans, grants, and policy proposals to make sure they include fiduciary safeguards and measurable results. Treasury chairs the inter-agency Working Group on multilateral Assistance which meets weekly to review all MDB loans and grants coming up for approval. This group includes State, Commerce, and USAID. My staff meets regularly with the NGO community and other interested parties to solicit input on MDB policies and projects. When we find problem projects, our first effort is always to work with management to improve loans or grants which we believe do not meet our standards. The ultimate voting decision on projects is the responsibility of the U.S. government. This working group and input from NGOs helps us gather expertise and the perspective of different agencies and the private sector in forming our decisions.

Let me now to describe the actions taken by the MDBs in the three levels described above.

Structural Changes Within the Institutions

In the late 1990's the World Bank created what is now called the new Department of Institutional Integrity (INT). So far INT investigations have led to the Bank's imposing administrative sanctions on about 180 firms and individuals. The names of firms and individuals sanctioned are made public. The Bank has a hotline to which the public or staff can report incidents of corruption or other inappropriate practices. Complaints may be made confidentially or anonymously. We are working closely with management and other shareholders to provide the unit with the resources, both human and financial, and the authority it needs to do its job effectively on an ongoing basis. This includes implementation of the key recommendations of the report of former Attorney General Thornburgh on ways to strengthen the unit's capabilities, staffing and performance. The Bank's Executive Board reviewed and endorsed these recommendations yesterday, in fact, and we will be monitoring progress very attentively.

Last year, the Inter-American Development Bank established its Office of Institutional integrity to enhance the scope of investigations previously undertaken by the Oversight Committee on Fraud and Corruption (OCFC). This office is now responsible for pursuing allegations of fraud and corruption by IDB staff or consultants, or in IDB-sponsored projects. The Oversight Committee of Fraud and Corruption (OCFC) now serves as the secretariat for the Office of Institutional Integrity, and trains officials in member countries on implementing anti-corruption programs. The OCFC also makes public a semi-annual report of its activities. Like the World Bank, the IDB has established a toll-free hotline and other mechanisms for reporting, on a confidential and anonymous basis, allegations of fraud and corruption with whistleblower protections. Last week, the IDB created a stand-alone Audit Committee of the Board.

The African Development Bank's Board of Directors has recently approved the establishment of an Oversight Committee on Corruption and Fraud (OCCF) that will be responsible for receiving and handling allegations of fraud and corruption. The Bank will opt a formal whistleblower protection program once the OCCF becomes operational. The Bank has also modified its procurement regulations to be more explicit regarding corruption. Over the past few years, about 30 tenders have been canceled, companies sanctioned, and, together with their affiliates, barred from participating in Bank projects.

The Asian Development Bank's Office of the Auditor General (OAG) is the point of contact for reports of allegations of fraud or corruption concerning AsDB-financed projects or its staff. In 2003, the OAG established an Anti-corruption Unit (OAGA) to handle all such reports. The Bank has established a variety of mechanisms through which allegations of fraud and corruption can be conveyed in a confidential and discrete manner.

The European Bank for Reconstruction and Development just launched an inspection function, which will enable individuals to submit grievances about a project. The Chief compliance Officer (CCO) works with independent experts to determine whether banking operations were in full compliance with Bank policies, and, if necessary, the CCO undertakes problem-solving measures, which may include mediation and independent fact-finding. The EBRD has just hired a new CCO, an American with considerable experience working on anti-corruption issues. The new COO will coordinate the new inspection function and will also handle all matters related

to fraud and corruption. The EBRD has a hotline through which individuals can anonymously report allegations of misconduct of Bank officials, employees, or consultants.

At each of the institutions, our U.S. Executive Directors have spearheaded efforts to increase transparency through information disclosure policies that require the MDBs to release more documents, especially those relating to Board discussions, country performance, measurable results, and anti-corruption measures. The Boards of Directors of the EBRD, the AfDB, and the IDB have all approved improvements in disclosure policies in the past 18 months and our Executive Directors will work to ensure their effective implementation. We expect similar actions will be taken at the World Bank and the AsDB in the near future. We continue to work with the MDBs management and other member countries to institute additional improvements.

Projects

The World Bank has in place procurement and consultant guidelines that govern the purchase of goods, civil works, and consulting services financed in whole or in part from bank loans for investment projects. The guidelines emphasize the need for economy and efficiency in the implementation of the project and the importance of transparency in the procurement process. They state that open competition is the basis for efficient public procurement. The guidelines include anti-fraud and corruption provisions and provide for debarment or other remedies if the Bank determines that firms have engaged in corrupt or fraudulent practices. If World Bank procurement guidelines have not been followed, then the Bank could declare a misprocurement and the borrowing government will lose the funding.

The IDB has recently authorized a comprehensive review by external consultants of its overall procurement practices. We are strongly advocating reforms that will adopt transparent and accountable procurement policies, and standard documents, fully harmonized with those of other MDBs.

The AsDB has taken steps to improve the financial management and governance of projects by revising the guidelines that govern the financial management practices of executing agencies and by implementing an automated project rating system to improve consistency, standardize ratings, and reduce subjectivity. These procedures will enable better identification of financial irregularities in project implementation. In addition, corruption and fraud awareness workshops are held regularly for project staff.

The AfDB conducts Financial Management Reviews (FMRs) of projects. The FMR is designed to assess financial management and audit functions of specific projects. The Bank has successfully carried out FMRs in five countries (Cameroon, Madagascar, Malawi, Uganda, and Zambia), covering four key sectors (agriculture, transport, public utilities, and the social sector). The AfDB's internal audit department evaluates the quality of independent audits of Bank projects. This department is investigating at least two projects for fraud and corruption.

At the urging of the United States, the EBRD now includes a certification of compliance with integrity check procedures for each project with the documents presented to the Board of Directors. The Bank is instituting mandatory training for staff on this process of "integrity" due diligence. In addition to due diligence, EBRD routinely incorporates improvements in accounting and corporate governance in the design of its projects.

Overall, the United States continues to push vigorously in all the MDBs for strong result measurement frameworks for all projects, so that we can monitor and assess the outputs and outcomes. What gets measured gets done, so establishing a strong result-based program will sharply reduce the likelihood that monies will be diverted for corrupt or fraudulent purposes.

At the Country Level

The windows of the MDBs that are devoted to the poorest countries have or are currently establishing performance-based allocation systems. These systems provide more resources to those countries that improve governance and take steps to combat corruption, while those who do not take such steps receive fewer resources. For example, under the most recent replenishment of funds in IDA, seventeen countries will have their resource allocations reduced. In the recently concluded AsDF negotiations, donors agreed to increase the weight given to good governance, which includes anti-corruption, in the performance allocation system for the AsDF. These systems provide incentive for countries to tackle these governance issues in order to receive greater resources.

Also at U.S. urging, the MDBs are doing more diagnostic work on governance issues. Governance and corruption are routinely discussed in MDB country assist-

ance strategies. The World Bank, in some cases working with the IMF and regional development banks, has taken the lead in preparing key diagnostic studies such as Country Financial Accountability Assessments, which looks at public financial management; Public Expenditure Reviews, which looks at the effectiveness of expenditures in terms of outputs and outcomes; and Country Procurement Assessment Reports, which looks at the contract management process and public procurement. The U.S. insisted on the expansion of these diagnostics as part of our Incentive Contribution to IDA, the targets for which IDA has met and exceeded.

The MDBs have also provided substantial amounts of assistance to help build accountable public-sector institutions and develop national anti-corruption efforts. The World Bank is also a leader in fighting money laundering and the financing of terrorism. Also, the AsDB has issued an extensive manual on countering money laundering and the financing of terrorism.

In 2003, the IDB approved $772 million, or 11 percent of total lending volume, for projects with the principal aim of improving governance at the country level. These include projects to modernize the Attorney General's Office in Colombia, strengthen tax administration in Peru and improve decentralization of administration in Uruguay.

The AfDB has developed a new diagnostic tool, the Country Governance Profile. The profile's analysis helps a member country and the AIDB develop governance programs and capacity building programs to address identified weaknesses in governance. Profiles for Nigeria, Ghana, Mauritania, Malawi, and Zambia are completed, and those for another ten countries are underway.

The AsDB approved a new policy enabling AsDB to increase its assistance to countries to counter terrorist financing and put in place anti-money laundering initiatives. The new policy has also enabled the AsDB to further strengthen its capability to protect internal funds from misuse. Further, the AsDB recently launched a Regional Trade and Financial Security Initiative. The $7 million initiative, which is supported by cash and in-kind contributions from the U.S., Australia and Japan, will finance anti-money laundering activities and port security in Asian developing countries. Finally, in 2003, the AsDB approved $458 million for projects to strengthen good governance in borrowing countries.

The EBRD has less direct influence on recipient countries' governance than the other MDBs because it focuses primarily on investments in the private sector. However, it has undertaken efforts to improve governance and combat corruption, such as its input into Transparency International's work on business principles for countering bribery. Where feasible and appropriate, the EBRD also engages in policy dialogue with the host country, in the context of projects, to highlight where regulatory frameworks could be improved, thus reducing the opportunities for corruption. In addition, the EBRD periodically reviews the business environment of its countries of operations.

Transparency and Section 581

A central part of our effort going now is the implementation of Section 581 in the FY 04 Appropriations Act signed into law on January 23, 2004. This provision, which was the product of discussions between Treasury and Congress, aims to increase transparency and accountability. This is an objective we all strongly share.

On March 2, 2004, I sent a memo to each of our U.S. Executive Directors in which I conveyed the Section 581 language along with a request that they use every appropriate opportunity to press for the goals set forth in that section. Working with the Executive Directors, we have already made considerable headway. For example,

- At the Inter-American Development Bank, the new information disclosure policy includes a provision for release of the Board minutes within 60 days of their approval, a first within the MDB system.
- The new African Development Bank policy includes a commitment to make country strategies and operation policies public at least 50 days prior to formal Board discussion.
- The EBRD is implementing a Committee of Sponsoring Organizations (COSO) system of internal controls over the financial statements, the implementation of which will be reflected in a letter from management and from the external auditor in the EBRD's 2004 annual report.
- A new draft Asian Development Bank policy includes a large number of the transparency provisions of Section 581, including making public an annual report containing statistical summaries of fraud and corruption cases pursued by their investigative unit.

For our part, the U.S. Treasury has begun posting a record of our votes on MDB projects on our website on a monthly basis as well as the U.S. position on inspection panel cases that we send to the Executive Directors.

In my view, more needs to be done to build on this progress. We need to increase the use of public fiduciary and governance diagnostics. We need to create additional incentives for establishing and achieving measurable results, and improve governance in borrowing countries. The U.S. continues to urge further measures to maintain progress. Among the priorities we are currently pursuing are the following:

- As a key element of implementing our results agenda, we will continue to advocate for the establishment of independent evaluation functions where they do not currently exist, such as at the AfDB and the EBRD, which functions would report directly to the Boards of Directors with the heads of evaluation hired by and accountable to the Board. Evaluation of results is both critical to achieving results and to ensuring that funds are used as intended by the governments that are the beneficiaries.
- The MDBs must also work towards achieving uniform best practice procurement policies, procedures, and documents that will be used by all the MDBs.
- At the IDB, the office of the U.S. Executive Director is engaged in several initiatives in procurement: (1) the overhaul of the IDB's project procurement systems with the objective of a new system using MDB-system wide best practices for policies, procedures and standard bidding documents; (2) reform of corporate procurement; and (3) the creation of a Sanctions Committee to give the Bank authority to disbar firms.
- We are also pushing the World Bank and the African Development Bank to release the country ratings (Country Policy and Institutions Assessment, CPIA)—including governance—that determine country resource allocations under its performance-based allocation system.
- The MDBs need to further improve and mainstream staff education, incentives, and processes for anti-corruption work. Each MDB must enforce clear guidelines defining corrupt behavior and stringent penalties for staff that violate the rules.
- The MDBs should continue to strengthen their whistleblower protections.
- We will continue to work with the World Bank to ensure that the Department of Institutional Integrity (INT) has the necessary resources and authority from the Board to carry out its responsibilities of investigating allegations of corruption and ensuring accountability of staff in all the Bank's operations.

Conclusion

In conclusion, Mr. Chairman, let me reiterate that this Administration takes very seriously the threat that corruption poses to economic development and to the effective use of MDB resources. As I have described in my testimony, the MDBs have taken important steps to combat corruption and the United States is at the forefront of continuing efforts to broaden and deepen those initiatives, including ensuring the full effectiveness of new anti-corruption units. The managements of the MDBs are to be commended for the positive steps they have taken in recent years to fight corruption, following the example set by the World Bank. Clearly more needs to be done, and we are fully dedicated to these efforts, and look forward to continuing to consult with Congress on our progress.

The CHAIRMAN. Well, thank you very much, Secretary Taylor. Let me just say at the outset that one of the major functions of any Senate committee is oversight. When that function is not well-performed, usually there will be problems down the trail. Quite rightly, critics of the committee will say, why was there no oversight and why didn't you care?

Now, we're in the process of getting ready for reauthorization of these multilateral development banks. It's a very important procedure that requires the confidence of our members in the House and the Senate. There are frequently critics of the Banks. There are critics of American foreign assistance generally. It is imperative that there be absolute confidence in the contributions that are made. Granted that these are multinational, the contributions come from many countries, but the United States' contribution of

taxpayer funds is very considerable. So it's in that spirit that we have tried to begin that preparation.

As I pointed out in my testimony—and it was not meant to be just anecdotal—we came across a case, and essentially attempted to find what was occurring in Treasury at the level of the Inspector General. And as I've recited, without hopefully being melodramatic about it, Mr. Schindel, who is responsible, I gather, felt he simply didn't want to testify, which is unusual. It's not that people always want to testify before our committee, but we've not had many conspicuous examples of people simply finding that this was not a worthwhile activity, so I'm especially grateful that you are here. You are knowledgeable about international banks and finance and obviously a very, very able spokesperson for the Department of the Treasury. So I just want to underline how much I appreciate your presence.

Now, let me just ask this rudimentary set of questions. When allegations of corruption related to MDBs are forwarded to the Treasury, how does the Department process the allegation? Is something more done beyond simply forwarding the allegation to the World Bank or other relevant multilateral development banks? What follow-up is done to ensure the Banks' diligence in pursuing that?

And since the Treasury Inspector General is not investigating fraud and corruption, what part of the administration is? In other words, try to trace, aside from these very important guidelines that you just mentioned, measurable results, following through to make sure the job gets done. Specifically, when the hotline produces somebody who says, you ought to take a look at this, what happens over at the Treasury?

Mr. TAYLOR. The first line of attack if our staff hear about issues like this is to work through our executive directors at the institutions. They're basically the conduit for communicating to the management and the staff of the institutions.

The CHAIRMAN. Now, by institutions you mean the Banks, the World Bank, or what have you?

Mr. TAYLOR. Yes, sir. Not to say there are not many other ways to communicate, but this is the first things to do. They in turn communicate, raise the issues that occur on specific issues. On the issues that have to do with process and procedure, that appears in many different ways. There's communications directly to the management, there's working through the executive directors, working through the other shareholders, because almost of all the things that are reform-oriented require the other shareholders to participate. And so we work with them on suggesting things like these measurable results, and they're not easy to get through, there's lot of different viewpoints.

The U.S., in my experience here, Mr. Chairman, the United States is most often in the lead in pushing the items that you're interested in in this hearing, and we're very proud to do that. But it sometimes requires working, getting a consensus internationally—these are international organizations—to make it work.

If we see there's something wrong with the procedures or we hear reports, for example, one of the people coming later today, former Attorney General Thornburgh, writes reports. We hear about those. That helps us, it helps guide us, and we will use those

to work with the institutions to help them make the changes and say what we think is important and our executive directors can speak at the board meetings quite actively about that, so those are some examples.

The CHAIRMAN. Well, even then, what happens if somebody brings an allegation to Treasury that in a specific country, on a specific project, money is being misappropriated, it's being stolen, it's being transferred to other accounts of people clearly in violation? What do you do about that?

Mr. TAYLOR. Well, we communicate it through our executive directors to the institutions, and if there's a problem with how they're being handled, then we address that directly to the management. But the process is, especially now with the World Bank, the Department of Institutional Integrity is set up, there's been some recent changes in how the sanctions process works, the nature of the committee has changed due to outside recommendations. The communication is not the problem. The actions and making sure that there's actions taken is the problem in my experience.

The CHAIRMAN. Well, does our government, if it believes that a particular institution, whatever the institution may be, is not taking appropriate action, do something about it? In other words, what recourse do we have at that point? Is our money all gone, and we just say, well, we just made a bad mistake on this one?

Mr. TAYLOR. No, I don't think we want to take that kind of an approach. We want to be very demanding of the institutions. We want the institutions to work well. I always—I don't hesitate to criticize personally. To me, you criticize the institutions to make them work better. You criticize them because you know they have an important role in the world, you like the institutions, I like the institutions, but we want them to work better.

So we don't mince words. We're candid with the criticisms that we have. If we hear reports from the staff that the process is not working well, we inquire at all levels on this. We take it very seriously and it's something that I certainly place a lot of emphasis on and Secretary Snow does as well.

The CHAIRMAN. You touched upon the fact that you believe that in many ways the United States may be among the most vigorous in terms of demanding transparency. In our study in preparation for the hearing, we found that of 147 countries eligible for World Bank lending, 77 of them require parliamentary approval of multilateral development bank loans, or a ceiling in which the executive branch can accept the loans. In other words, the Parliaments of these countries are trying to ride herd on executives that are taking in the money, not with the supposition of malfeasance, but with recognition of the ways of this world and of the fact that a good number of the governments that they are overseeing may have some problems.

We found in our first hearing that this oversight is well-founded. There are some specific projects. You mentioned measurable results, such as the building of bridges and dams and roads and so forth. You can get some idea of whether there is a road or a bridge. But increasingly we heard from the banks that the loans are for so-called budgetary support—funds that may have been intended for the uplifting of whatever the objectives were of that govern-

ment. This becomes very murky, in terms of finding measurable results in an education system. We are finding difficulty with that ourselves, for example, with No Child Left Behind. We are trying to get some grip on how this all works.

With an increasing amount of money headed in that direction, there could be increasing skepticism about so-called budget support. A taxpayer in this country could very well raise the question. We are having difficulty meeting our own deficit problems. Some budgetary support here may be required. In Country X, for example, we are able at least to establish that a school got built, that schoolchildren are being taught, as opposed to a contractor siphoning money out of the process, thus undermining the entire international banking system. Furthermore, if we're not sufficiently observant, or if we have not allied with enough nations to track these people down and prosecute them, then there's going to be a lot of skepticism about this.

Now, I'm not raising bogey men. For example, patriot Paul Volcker is investigating Oil-for-Food or Food-for-Oil or whatever went on there. There are lots of people now on top of that situation, and the whole foundation of the United Nations is under question. Even senior officials, people who don't like the United Nations, are now really into this with a vengeance, indicating that's what happens if you have multinational work and so forth. This is serious business.

I'm hopeful that at Treasury, as you say, you've got some pretty good guidelines going here at this point, and that we're vigorous, as you point out, relative to other people. But at the same time, with your own background in international affairs, quite apart from the financial affairs of this country, please take another hard look at this and inform the Secretary that we think this is serious, and we think he ought to think it is serious. I'm sure he's focused on a lot of reforms now. This is a reform Secretary. I'm supportive of that, and so are most Senators. But we want to make sure that occurs also in these international situations that are not specifically his responsibility. This situation needs to come quickly into focus. We must build confidence as we get into the reauthorization process particularly, because we're going to have testimony from many sources next year about each of these banks.

I would just say that as a result of our first hearing, they all realize that. They are taking the situation much more seriously. So that's obviously a salutary effect of having oversight.

Mr. TAYLOR. Mr. Chairman, I very much appreciate what you're doing with these hearings. It's just the best in terms of oversight and trying to improve things. I'd like to respond to a couple of the points you made in your statement. Regarding budget support, I agree this is an area where we need to be very careful. I don't think there's any reason why we cannot insist on just as good measurable results and timelines for budget support as for project support.

I made a particular point of traveling to a number of countries around the world, mainly in Africa, to observe how these measurable results are working. In some cases, they're working really well. You can see schools, individual schools where the PTAs are working with the parents and the teachers are working together to

document how many textbooks are purchased and how much they spend and how much of a discount they got, rather than the reverse is what we're worried about in this hearing.

But I quite frankly say it's all too rare. We need to get more of that done, and there's no reason why you can't have adjustment loans, policy loans, budget support, have just as good a system of measuring results as other kinds of support, and we're going to continue to work on that as much as possible.

I agree the measurable results, there's different ways to do it. The No Child Left Behind focuses on performance and test scores. That is great. Ultimately we want to do that. We're starting with completion rates for primary education, that if the IDA programs lead to somewhat higher completion rates in primary schools, then there's a reward for that. And that's not test scores yet, but it's certainly on the way. You've got to have the kids staying in school at least through 6th grade to accomplish something in the schools.

Mr. Chairman, on the Inspector General issue, I want to say a couple things if I may, because we have consulted, our staffs have consulted with the acting IG. First of all, of course, the IG reports both to Congress and to the Secretary of the Treasury. In consulting with the IG, I want to make the following statements. I'm going to read these if I may, Mr. Chairman. The Treasury Inspector General is responsible for conducting and supervising audits and investigations relating to the programs and operations of the Department except for the Internal Revenue Service. This authority would reach to Treasury's conduct of the process by which appropriated funds are made available to the development banks. It is unlikely that the IG's jurisdiction would extend to how the development banks actually distribute the funds and how the borrowers actually use the funds.

I understand that the IG's office would be willing to discuss this directly with the committee and we can provide all the contact information that you need if that's the way you'd like to go, sir. So it is something we've been trying to address. I understand what you're saying here. I think we need to work with the acting IG to figure out exactly what the terms of reference, but what I just read to you here is the effort that we've already put into this, represents the product of the effort we've put into this.

The CHAIRMAN. Well, I appreciate that, and I thank you for taking the situation seriously and entering this into the record. I would like to expand on the measurable results. Specifically when this pertains to situations like education or health or humanitarian situations. It occurs to me that the United States again and again has a great story to tell about work we are doing with people in many countries of the world. We have hearings on public diplomacy and the difficulties our country has had in that area, about the Pew Foundation polls asking people, do you like the United States or do you like Americans or don't you, with extraordinarily and tragically perverse negative results.

The fact is that the good story of what we are attempting to do doesn't get told very often. Maybe we are not very adept at telling it. All I can say is that to the extent the Treasury Department, through your reports, through following through on these measurements of success, on specifics, while working with other countries,

with other institutions, could have a lot to do. The alternative would be things simply being handled in a more routine fashion, without seeing too much of the light of day, perhaps outside the Department, without the certainty that you feel keep them from fulfilling the requirements. That's an extension of mission, but one that I hope you'll consider carefully.

Mr. TAYLOR. Very much so. I think the international institutions have a very important role to play in providing assistance. Bilateral assistance is also important with the Millennium Challenge Account, it's a very important part of what we're doing. But this is good because it's international and we get the leverage, of course, five times as much as we put comes out, got to be done right.

But I think it is an important thing, and I find, if I could just add personally from my dealings with other countries on this, sometimes when you're out in front on issues like measurable results or anti-corruption, it maybe doesn't look like the most popular thing to do, but the headlines frequently are about how much money is going less than how it's being used. But it's so important, and if you go around, as I think you have to, and see on the ground what's happening, you just know that there's so much more to do in using a given dollar more effectively.

So that's got to be part of it, and our approach in asking for authorization and asking for appropriations from the Congress is to emphasize the way the funds are used and doing the best we can to show they're being used well. But I very much appreciate your point on the foreign policy, sir.

The CHAIRMAN. Well, thank you very much. I appreciate your long-time public service. I think that the thing that we have to offer, in addition to the money and the supervision, is a sense around the world of our integrity, that even if others don't blow the whistle on corruption, that we do, we will. That makes a big difference down deep in terms of fledgling democracies, as well as those that are more mature.

Well, thank you so much for coming to testify.

Mr. TAYLOR. Thank you, Mr. Chairman.

The CHAIRMAN. The chair would like to call now upon a second very distinguished panel, including the Honorable Richard Thornburgh, of counsel to Kirkpatrick & Lockhart in Washington, D.C.; Mr. Guido Penzhorn, advocate and senior counsel of the Durban Bar, Durban, South Africa; and Ms. Kimberly Ann Elliott, research fellow of the Institute for International Economics in Washington, D.C.

We welcome another distinguished panel and we appreciate very much your patience in waiting through our emergency of the morning. The next break in the action will not be grave. We will simply be observing a roll call vote in the Senate at about 11:30. I will recess the hearing for about 10 minutes to go to the floor, vote, and return. But we will attempt to maintain the flow of the hearing as best we can. I would like for you to testify in the order that I introduced you. That would be first of all Mr. Thornburgh, the Honorable Richard Thornburgh. And let me just say that the testimony of all three of you will be placed in the record in full. Please pro-

ceed as you wish, either with summary or with the delivery of that full testimony.

Secretary Thornburgh.

STATEMENT OF HON. RICHARD THORNBURGH, OF COUNSEL, KIRKPATRICK & LOCKHART

Mr. THORNBURGH. Good morning, Mr. Chairman. Thank you for inviting me to be here today to discuss the efforts of the World Bank to deal with the problems of fraud and corruption in projects financed with bank funds. As the largest contributor to the Bank, the United States clearly has a critical stake in understanding how bank funds are used and what type of commitment the Bank has made to preventing these funds from being wasted as a result of fraudulent or corrupt practices.

As you are aware, the Banks' articles of association, to which the United States is a signatory, require that the Bank make arrangements to ensure that the proceeds of any loan are used only for the purpose for which the loan was granted. For an organization that has disbursed as much as approximately $25 billion a year in countries having some of the least developed economic, political, and legal systems in the world, this is not a simple undertaking.

Funds loaned by and activities undertaken by the Bank are vulnerable to fraud and corruption by bank employees, by contractors, consultants, and others utilized in the execution of its projects and by officials and governments to whom the loans are made. An effective program to combat fraud and corruption is important, not only to ensure that disbursed funds are utilized in the manner intended, but also to maintain the Bank's reputation and to assure the continued willingness of member states to support its operations.

Unfortunately, during most of the Bank's first 50 years, the culture within the Bank discouraged not only the taking of any action to address problems of fraud and corruption, but even the discussion of such action. When Jim Wolfensohn became president of the Bank in 1995, he instilled a notable shift in attitude. In a speech to the Bank's board of governors the following year, Mr. Wolfensohn became the first senior official within the Bank to acknowledge openly that fraud and corruption constitute a major problem for the Bank and for the nations that the Bank was attempting to assist.

Along with a new attitude, Mr. Wolfensohn brought an institutional change as well. Beginning in 1966, the Bank undertook a number of steps designed to assess evidence of fraud and corruption in bank finance projects and to temporarily or permanently preclude suppliers, contractors, and consultants found to have engaged in such practices from participation on future bank projects.

Thereafter, the Bank engaged me, along with my colleagues, Ronald Gainer and Cuyler Walker, both of whom have joined me here this morning, to consult with the Bank on furthering the adequacy and proper functioning of the program. During our engagement by the Bank, we have issued three reports, all of which have been furnished to your staff by the Bank. They dealt principally with the Bank's procedures for investigating allegations of fraud and corruption. The first report issued in January 2000.

The second reported issued in August 2002 dealt principally with the Bank's procedures for sanctioning acts involving fraud and corruption, and the third report issued in July 2003 dealt with a strategic plan that had been produced within the Bank for its investigative unit and our analysis of the steps the Bank had taken to develop its internal investigative facilities.

I should point out that in all cases the nature of our assignment was to assist the Bank in developing policies, procedures, and structures to enable it to protect its funds from fraudulent and corrupt practices. In preparing these reports, we were not asked to evaluate, quantify, or assess the specific nature, scope, or extent of the problem, nor were we asked to review or make recommendations relating to any particular case or a set of circumstances in which bank projects were alleged to be affected by fraud or corruption.

Before summarizing certain of our findings and recommendations, it's worth taking a moment to note the uniqueness of the environment in which the Bank operates and how that necessarily has influenced the structures and procedures it has put in place to address fraud and corruption. As an international organization, the Bank does not possess many of the tools that a national government may bring to bear on a situation in which it has been the victim of fraud or corruption. The Bank does not have traditional law enforcement powers such as subpoena power or the ability to otherwise compel the production of documents or witness testimony or to conduct searches or electronic surveillance.

As a result, the Bank must rely almost exclusively on informants and cooperating witnesses to build a case. Furthermore, since the Bank finances projects all over the world and often in some of the most remote parts of the world, the Bank's investigators are invariably viewed as outsiders with none of the advantages that come with knowing and being known by local citizens or authorities who are closest to the circumstances related to matters under investigation.

In light of these factors, it is not realistic to expect the Bank's investigators to be as effective as police and prosecutors of a sovereign nation in establishing facts that support allegations or suspicions of fraud and corruption. When it comes to seeking redress for wrongdoing involving bank funds, the Bank is, however, no different than any other private party to a contract. If it desires to recover monetary damages, the Bank may initiate a civil action in a country in which the courts have jurisdiction over the matter. If it believes that a particular matter involves a violation of law, the Bank may refer the matter for criminal prosecution in the country whose laws may have been broken. In either case, the Bank must be able to uncover the underlying facts giving rise to the suspicions, which requires a sophisticated investigative capability since perpetrators of acts of fraud and corruption will be careful to cover their tracks as best they can.

Another important factor must be noted. Since the Bank would be within its rights to treat those engaged in fraud and corruption in bank finance projects simply as contracting parties in a commercial transaction, such miscreants are subject to being declared in-

eligible from participation in such contracts in the future on the mere suspicion of improper conduct.

However, the Bank is determined that its status as a leading international organization, that among other things promotes the rule of law and the independence of the judiciary in developing countries, requires that it apply elements of fundamental fairness, what we know in this country as due process, when dealing with allegations of fraud and corruption at a bank project.

The bank has painstakingly tried to strike an appropriate balance between protecting the funds it loans out and respecting basic principles of fairness. From the inception of its anti-fraud and corruption efforts in the mid-1990s, the Bank has separated the two distinct functions that make up this effort, the investigation of activities involving fraud and corruption whereby the Bank focuses on covering and compiling evidence of such actions and the evaluation of the strength of that evidence whereby the Bank determines whether sanctions should be imposed, and if they are, what sanctions are appropriate.

In each of the three reports that my colleagues and I prepared, we were asked to deal with both aspects of the Bank's program, at least to some extent. I will address our principal findings and recommendations relating to how the Bank deals with both investigations of instances of fraud and corruption on the one hand and sanctioning those found to have engaged in such practices on the other.

In January of 2000, we recommended to the Bank that the investigations unit be merged into a new independent department, the Department of Institutional Integrity, to be created and assigned the principal responsibility for conducting all investigations on behalf of the Bank in instances of fraud and corruption. We also recommended that this new department exercise operational independence under the authority of the president of the Bank and report directly to the president.

As part of the implementation of this new structure, we also made the following recommendations: that the new department be headed by a director with experience in investigating and prosecuting fraud and corruption cases; that the director be appointed for a fixed 5-year term to minimize the potential for undue influence; that the department recruit and develop a cadre of experienced in-house staff possessing investigative skills, knowledge of bank procurement and personnel procedures, forensic auditing and contract auditing skills, and other characteristics necessary for mounting an aggressive effort against fraud and corruption; that the use of outside law firms and auditors, previously a major tool for dealing with corruption allegations be minimized; that the department's personnel have access to all records, documents, and properties of the Bank in conducting its investigations; and that the Oversight Committee on Fraud and Corruption be reconstituted and given a policy-making, as opposed to operational, mission with responsibility for general supervision and coordination of all the Bank's programs intended to address problems of fraud and corruption, not just investigations.

I am pleased to say that all these recommendations were accepted by the Bank and have been implemented. Beyond the over-

arching recommendations for restructuring its investigative efforts that we made in January of 2000, we offered as well a series of additional recommendations relating to the Bank's efforts to uncover fraud and corruption in projects it finances.

These recommendations and similar recommendations outlined in our 2002 report are set forth at pages 8 through 11 of my full statement, and included the following: that the Department of Institutional Integrity, now known within the Bank as INT, develop and nurture close working relationships with other offices in the Bank whose responsibilities and activities necessarily overlap with and complement those of INT, including the legal department, the internal audit department, and the professional ethics office; that INT receive a mandate from the board so that its authority is derived from the Bank's governing body and not just from its chief executive officer; that INT develop procedures for reporting to the president of the Bank regularly on ongoing investigations and prepare an annual report to the president summarizing its activities and accomplishments during the preceding year and making recommendations for management and procedural improvements to aid in the deterrence or detection of fraud and corruption.

Last year, my colleagues and I had the opportunity to revisit these and other issues when we were asked by the Bank to review and comment on a strategic plan that the Department of Institutional Integrity had prepared, and to review and evaluate how the structures that had been put into place were actually working and to what degree more needed to be done to implement our earlier recommendations.

The proposed strategic plan focused on all aspects of the management and operation of INT. I will briefly comment on only the two most salient of these. The first is the department's proposed strategy to move from an emphasis on reacting to allegations of fraud and corruption when they are made to a program that includes proactive and preventive actions. The second concerns the proposed budget and staff for the department.

We found the proposal for becoming more proactive to be sound and consistent with our earlier recommendations. If INT depends solely on a reactive approach that responds exclusively to allegations of wrongdoing reported to the Bank, it would in effect reward the most skillful manipulators of bank funds, since it is usually only the most obvious forms of fraud and corruption that tend to raise sufficient suspicions to be reported to INT. It will, of course, always be critical to the effectiveness and credibility of the Bank's anti-corruption program for INT to maintain its capability and commitment to zealously pursue allegations of wrongdoing when they are reported. We believe that these three kinds of efforts—reactive, proactive, and preventive—should not be viewed as step-by-step progressions, but as component elements of an effective, coherent, overall strategy, regardless of the level of INT funding resources.

An aspect of INT's strategic plan that is a prime candidate for some form of econometric cost benefit analysis is its proposal to structure a triage approach for case selection. Recognizing that the Bank's resources are finite and that INT is not likely to receive sufficient funding to enable it to undertake all the investigative activi-

ties that may be warranted, the proposed triage system would build upon a systemization of considerations that have been applied informally in INT's past allocation of resources.

We encountered some concern that the concept of triage may seem to contradict the Bank's sincere expression of zero tolerance for fraud and corruption. Refusal to tolerate should not be confused with striking out at every instance of wrongdoing. As long as cases receive at least preliminary investigation and assessment by INT personnel, as complemented by INT's proposal, as long as matters apparently even involving low levels of seriousness, are occasionally brought to the sanctioning state, and as long as all geographic regions in which the Bank makes loans receive some degree of regular attention by INT's investigations, the triage system can be recognized as in furtherance of the zero tolerance concept, not in derogation of it.

Turning to INT's proposal for significant increases in its overall budget and staffing level, it is interesting to note this was met with considerable skepticism in some quarters in the Bank. INT's staffing level had already given some offices in the Bank the impression of an instant bureaucracy exploding onto the Bank's scene and apparently destined to expand without boundaries.

In assessing the justification for the Bank's expenditures on its anti-fraud and corruption program, the appropriate measure should not be a comparison of INT's accelerated growth in total staff over its first few years with a bank-wide growth in staff over the same period, but the size of the staff needed to do the job in an effective and cost-justified manner, tempered to a reasonable degree, of course, by budget realities, competing bank responsibilities, and similar constraints.

Doing nothing, as was the case before, or doing only as much as can be accomplished by an arbitrarily limited level of personnel growth, is clearly not the proper response for an institution with a staff that probably possesses as great a capacity for collective econometric analysis as any institution in the world.

While INT's strategic plan represents a major step forward, the planned use of resources must be continually subjected to rigorous analysis, and the manner in which it operates must be continually analyzed to identify areas where improvement can be made.

In our report to the Bank last year, we identified a few steps that could be taken to improve INT's operations. They included the following: We continue to believe that INT would be well-served by having its terms of reference endorsed by the board. We believe that INT's stature would also be enhanced if various constituencies, both within and outside the Bank, receive a clear and unambiguous message from the Bank's senior management that it is committed to the fight against fraud and corruption. We believe that while the president should continue to have the ultimate authority and responsibility for INT, a more regularized process would be useful for acquainting the board of directors with the general nature of the problems that INT is able to uncover.

Finally, we believe that the public disclosure of sanctions imposed by the Bank on the basis of findings of fraud or corruption should be automatic. Such disclosure will help achieve a level of deterrence that is one of the most valuable results of the Bank's ef-

forts. In addition, it will add credibility to the Bank's anti-corruption program and will enable member nations and other international organizations to protect themselves from becoming victims of these perpetrators in the future.

If an INT report contained evidence of criminal activity, then it is likely that the government of the country whose laws have been broken will want to obtain that information. Some have argued that the Bank may either have a legal or moral obligation to provide such information to its member countries. Without resolving those issues, it is apparent from a practical perspective that the Bank will have an interest in making criminal referrals in most, if not all, instances where it uncovers evidence of a crime.

We have recommended to the Bank that as the number of matters eligible for criminal referral continues to increase, the Bank should regularize policies and procedures for evaluating such cases and for interacting with national officials in notifying them of the evidence and giving them access to bank files.

When INT investigators discover fraud and corruption in bank finance contracts, the evidence may also place them in a unique position to identify problems in the Bank's operating procedures that have implications far beyond the matter being investigated. The Bank would be doing itself a disservice if it failed to take advantage of the educational value of the reservoir of information accumulated by INT through case studies or other methods of disseminating lessons learned.

As I mentioned at the outset, in 2002 we were asked by the Bank to review and evaluate its process for imposing sanctions on firms and individuals that have been found to engage in corrupt activities. The principal tool available to the Bank under such circumstances is to declare the wrongdoer ineligible for future bank finance contracts, a process known as debarment.

We made recommendations to the Bank in some 18 separate categories pertaining to its structures and procedures for imposing sanctions. These recommendations were thoroughly reviewed by the Bank's management and were presented to the Bank's executive directors. I've been informed that earlier this month all of those recommendations were accepted by the board, and the Bank will proceed to implement those recommendations.

We also made a key recommendation related to the question of whether the sanctions committee should have the authority to impose sanctions on behalf of the Bank or should simply make recommendations to the president. Requiring the president of the Bank to review and evaluate every case in which fraud and corruption has been found and to determine whether the recommended sanctions are appropriate would place an enormous burden on the president's time. Furthermore, since the parties subject to sanction come from countries that are represented on the board of the Bank to whom the president reports, there is at least the perception that the president could be subjected to political pressure and undue influence on behalf of a party that had the support and sympathies of its government. For these reasons, it seems advisable not to include the president in the sanctioning decisions, and that as long as the sanctions committee is composed at least in part of individuals who are not current bank employees, the committee should be

vested with authority to make final decisions without further review or appeal.

The other recommendations contained in our 2002 report on the sanctioning process are set forth at pages 25 through 28 of my prepared statement, and are largely concerned with procedural matters and the Bank's desire to strike an appropriate balance between an efficient and expeditious process on the one hand and ensuring that the accused is afforded fairness on the other.

In closing, Mr. Chairman, let me note that from a near standing start, and in less than a decade, the World Bank has created a greatly enhanced and increasingly credible capability to deal with the problems of suspected fraud and corruption in its activities. Problems remain, to be sure, many of them referenced in my statement. But given a continued level of commitment from executive leadership, buttressed by clear authorization for its activities from the Bank's board of directors and a widespread recognition within the organization itself of the worth of such an undertaking, there is no reason why this effort cannot mature into a showcase operation of how to deal with a challenge of integrity problems within an international organization.

Key to meeting this challenge will be the continued ability to attract and retain INT staff and leadership of the highest caliber and widest experience, and to ensure that INT is recognized to be a genuine resource by all engaged in the worldwide operations of the World Bank group. An admirable beginning has been accomplished. Care must now be taken to ensure that continued improvement remains the aspiration for the future. Thank you.

[The prepared statement of Mr. Thornburgh follows:]

PREPARED STATEMENT OF RICHARD THORNBURGH

Good Morning. I am pleased to be here today to talk to you about the ongoing efforts of The World Bank to develop effective policies and procedures for combating fraud and corruption in projects financed with Bank funds.

As the largest contributor to the Bank, the United States has a critical stake in understanding how Bank funds are used and what type of commitment the Bank has made to preventing those funds from being wasted as the result of fraudulent or corrupt practices. As you are aware, the Bank's Articles of Association, to which the United States is a signatory, require that the Bank "make arrangements to ensure that the proceeds of any loan are used only for the purpose for which the loan was granted . . ." For an organization that has disbursed as much as approximately $25 billion a year in countries having some of the least developed economic, political and legal systems in the world, this is not a simple undertaking.

Funds loaned by and activities undertaken by the Bank are vulnerable to fraud and corruption by Bank employees, contractors, and consultants utilized in the execution of its projects and by officials in governments to whom loans are made. An effective program to combat fraud and corruption is important not only to ensure that disbursed funds are utilized in the manner intended, but to maintain the Bank's reputation and to assure the continued willingness of member states to support its operations. Unfortunately, during most of the Bank's first fifty years, the culture within the Bank discouraged not only the taking of any action to address problems of fraud and corruption, but even the discussion of such action.

When James D. Wolfensohn became President of the Bank in 1995, he instilled a notable shift in attitude. In a speech to the Bank's Board of Governors in 1996, Mr. Wolfensohn became the first senior official within the Bank to acknowledge openly that fraud and corruption constitute a major problem for the Bank and for the nations that the Bank was attempting to assist. Along with a new attitude, Mr. Wolfensohn brought institutional change as well.

In 1996 the Bank's Executive Directors approved, in concept, the establishment of a committee to assess evidence of fraud and corruption in Bank-financed projects

and to temporarily or permanently preclude suppliers, contractors and consultants found to have engaged in such practices from participation on future Bank projects.

In 1996 and 1997, the Bank revised its procurement guidelines in order to make it manifest that fraud and corruption would not be tolerated.

In early 1998, the Bank began the process of regularizing the investigation of allegations of fraud and corruption by suppliers, contractors and consultants with the establishment of an Investigations Unit. At the outset, the Investigations Unit was composed of a very small number of newly-hired Bank employees, most of whom were former U.S. prosecutors. Since the number of in-house investigators was insufficient to respond to various allegations of fraud and corruption the Bank was receiving, the Bank contracted out the conduct of most of its investigations to outside law firms and auditors.

Also in 1998, the Bank established two committees of high-level officials to implement aspects of its anti-fraud and corruption program. One committee, the Oversight Committee on Fraud and Corruption, was given responsibility for the oversight and supervision of all investigations of fraud and corruption, whether involving Bank staff or Bank-financed projects. The other, the Sanctions Committee, was given responsibility for assessing evidence revealed by the investigations and for recommending to the President of the Bank the appropriate disposition of such cases.

It was at this stage in the evolution of the Bank's program to combat fraud and corruption, that the Bank engaged me, along with my colleagues Ronald Gainer and Cuyler Walker, to consult with the Bank on the adequacy and functioning of the program. During our engagement by the Bank, we have issued three reports. The first report, issued in January 2000, dealt principally with the Bank's procedures for investigating allegations of fraud and corruption. The second report, issued in August 2002, dealt principally with the Bank's procedures for sanctioning acts involving fraud and corruption. And the third report, issued in July 2003, dealt with a strategic plan that had been produced within the Bank for its investigative unit and our analysis of the steps the Bank had taken to develop its internal investigative capabilities.

I should point out that, in all cases, the nature of our assignment was to assist the Bank in developing policies, procedures and structures to enable it to protect its funds from fraudulent and corrupt practices. In preparing these reports, we were not asked to evaluate, quantify or assess the specific nature, scope or extent of the problem, nor were we asked to review or make recommendations relating to any particular case or set of circumstances in which Bank projects were affected by fraud or corruption.

Before addressing our findings and recommendations, it is worth taking a moment to note the uniqueness of the environment in which the Bank operates and how this necessarily has influenced the structures and procedures it has put in place to address fraud and corruption.

As an international organization, the Bank does not possess many of the tools that a national government may bring to bear on a situation in which it has been the victim of fraud or corruption. The Bank does not have traditional law enforcement powers such as subpoena power or the ability to otherwise compel the production of documents or witness testimony or to conduct searches or electronic surveillance. As a result, the Bank must rely almost exclusively on informants and cooperating witnesses to build a case. Furthermore, since the Bank finances projects all over the world and often in some of the most remote parts of the world, the Bank's investigators are invariably viewed as outsiders with none of the advantages that come with knowing and being known by local citizens or authorities who are closest to the circumstances related to matters under investigation. In light of these factors, it is not realistic to expect the Bank's investigators to be as effective as police and prosecutors of a sovereign nation in establishing facts that support allegations or suspicions of fraud and corruption.

When it comes to seeking redress for wrong-doing involving Bank funds, the Bank is, however, no different than any other private party to a contract. If it desires to recover monetary damages, the Bank may initiate a civil action in a country in which the courts have jurisdiction over the matter. If it believes that a particular matter involves the violation of the law, the Bank may refer the matter for criminal prosecution in the country whose laws may have been broken. In either case, the Bank must be able to uncover the underlying facts giving rise to its suspicions, which requires a sophisticated investigative capability since perpetrators of acts of fraud and corruption will be careful to cover their tracks as best they can.

While the Bank does not possess traditional law enforcement powers, it does enjoy special legal status including certain privileges and immunities that private actors and even national governments do not have. Except under certain exceptional and

narrow circumstances, the Bank is not subject to the jurisdiction of the courts of any nation. This gives the Bank tremendous discretion in dealing with suppliers, contractors and consultants, as well as national governments themselves and its own employees. At the same time, it also imposes a heightened obligation on the Bank to act responsibly since, while its actions may not be subject to challenge in traditional ways, it will be subject to considerable scrutiny due to its governing charter and its high profile around the world.

Another important factor must be noted. Since the Bank would be within its rights to treat those engaged in fraud and corruption in Bank-financed projects simply as contracting parties in a commercial transaction, such miscreants are subject to being declared ineligible from participation in such contracts in the future on the mere suspicion of improper conduct. However, the Bank has determined that its status as a leading international organization that, among other things, promotes the rule of law and the independence of the judiciary in developing counties, requires it to apply elements of fundamental fairness (or what might be thought of "due process" in a judicial proceeding) when dealing with allegations of fraud and corruption in a Bank project. When I describe our analysis of the Bank's sanctioning process and some of our recommendations for strengthening it, I will share some examples of the types of issues with which the Bank has wrestled in trying to strike the appropriate balance between protecting the funds it loans out and respecting basic principles of fairness.

From the inception of its anti-fraud and corruption efforts in the mid-1990s, the Bank has separated the two distinct functions that make up this effort—the investigation of activities involving fraud and corruption, whereby the Bank focuses on uncovering and compiling evidence of such actions, and the evaluation of the strength of that evidence, whereby the Bank determines whether sanctions should be imposed and, if they are, what sanctions are appropriate. In each of the three reports that my colleagues and I prepared, we were asked to deal with both aspects of the Bank's program at least to some extent. I will address our principal findings and recommendations relating to how the Bank deals with both investigations of instances of fraud and corruption, on the one hand, and sanctioning those found to have engaged in such practices, on the other.

With respect to the investigation of fraud and corruption, as I noted previously, in 1998, the Bank had established its Oversight Committee on Fraud and Corruption to oversee the investigations of allegations of fraud and corruption involving Bank staff and Bank-financed projects. The Bank had set up an internal Investigations Unit with a small number of well-qualified investigators, but, due to its limited capacity, had to contract out most of the investigative work to law firms and auditors. This structure had evolved in a piecemeal fashion over the course of several years as the effort to be more responsive to allegations of fraud and corruption gained momentum, and, while it was clearly well-intended, we found it to be somewhat cumbersome and inefficient.

The Oversight Committee was composed of senior officials of the Bank who brought a wealth of knowledge of and experience with Bank operations to the table. However, understandably, none of these officials had experience with investigative practices and procedures. Moreover, all had considerable demands on their time which made it difficult for the Committee to meet regularly and to provide the day-to-day support and attention that the Investigations Unit required. Some had oversight responsibility, directly or indirectly, for some of the very operational components of the Bank whose projects were the subject of investigation.

The Investigations Unit did not have sufficient staffing or resources to follow up on the various allegations of fraud and corruption that were being received by the Bank. The use of outside investigators has been satisfactory when the Bank had only a few matters under investigation at a time, but as the caseload increased, it became cost-prohibitive to continue to engage an ever-increasing number of outsiders who were unfamiliar with Bank practices to do this work. We were also concerned that since the Investigations Unit reported to a committee of several senior officials, there was at least the appearance that the Unit lacked independence and could be subject to inappropriate pressure under certain circumstances. I should note that we did not observe any such pressure, but the opportunity itself was sufficient to raise reservations about the oversight role of the Committee.

Based on these findings, in January 2000, we recommended to the Bank that the Investigations Unit be merged into a new independent department, called the Department of Institutional Integrity, to be created and assigned the principal responsibility for conducting all investigations on behalf of the Bank into instances of fraud and corruption. We also recommended that the new Department exercise operational independence under the authority of the President of the Bank and re-

port directly to the President. As part of the implementation of this new structure, we also made the following recommendations:

- that the new Department be headed by a Director with experience in the investigation and prosecution of fraud and corruption cases;
- that the Director be appointed for a fixed five-year term to minimize the potential for undue influence;
- that the Department recruit and develop a cadre of experienced in-house staff possessing investigative skills, knowledge of Bank procurement and personnel procedures, forensic auditing and contract auditing skills, and other characteristics necessary for mounting an aggressive effort against fraud and corruption;
- that the use of outside investigators be minimized;
- that the Department's personnel have access to all records, documents and properties of the Bank in conducting its investigations; and
- that the Oversight Committee on Fraud and Corruption be reconstituted and given a policy-making (as opposed to operational) mission with responsibility for general supervision and coordination of all of the Bank's programs intended to address problems of fraud and corruption, not just investigations.

I am pleased to say that these recommendations were accepted by the Bank and have been implemented.

Beyond the overarching recommendations for restructuring its investigative efforts, in January of 2000, we made a series of additional recommendations relating to the Bank's efforts to uncover fraud and corruption in projects it finances. These recommendations included the following:

- that the Department of Institutional Integrity, now known within the Bank as "INT," develop and nurture close working relationships with other offices in the Bank whose responsibilities and activities necessarily overlap with and complement those of INT, including the Legal Department, the Internal Audit Department and the Professional Ethics Office;
- that INT receive a mandate from the Board, so that its authority derive from the Bank's governing body not just from its chief executive officer;
- that INT develop procedures for reporting to the President of the Bank regularly on on-going investigations and prepare an annual report to the President summarizing its activities and accomplishments during the preceding year and making recommendations for management and procedural improvements to aid in the deterrence or detection of fraud and corruption;
- that INT develop a strategic "risk management" plan for prioritizing its investigative resources based on an assessment of those contracts, projects, geographic regions and countries that may be particularly susceptible to fraud and corruption;
- that, in order to regularize and enhance the operations of INT, as well as to ensure fairness in the conduct of investigation, the Bank put in place written procedures with respect to INT's practices in the following areas:
- adopting policies and procedures that ensure investigations conform to acceptable norms, respect the rights of the accused and develop evidence that can be used effectively in subsequent proceeding;
- designing systems to ensure that resources are used efficiently and to enable the Department to track ongoing investigations to ensure adequate internal monitoring and oversight.
- developing policies and procedures, based on objective written criteria, to guide the Department in its decisions about making other offices within the Bank aware of problems at the appropriate time for informational purposes or remedial action, about pursuing a matter either through civil or criminal courts, and about making disclosures to affected or otherwise interested parties outside the Bank; and
- establishing procedures for the recruitment, hiring and training of qualified individuals capable of conducting investigations in a multicultural international organization.

In our 2000 report, we also proposed:

- that in addition to investigating wrong-doing that had already resulted in the loss of funds, the Bank develop ways to reduce opportunities for fraud and corruption from occurring in Bank-financed projects, such as: increasing the scope of and resources available for the pre-review of contracts; and increasing the re-

quirements that disbursements be made only in increments upon demonstrated achievement of specific milestones;

- that the Bank regularly review its loan agreements, procurement guidelines and standard contracts, and insert additional provisions designed to facilitate the prevention and detection of fraud and corruption, such as: strengthening the Bank's audit rights, document retention requirements and contract representations and warranties; ensuring that investigators have access to relevant personnel and documents (whether in the control of the Bank or third parties); and expanding the definitions of "fraud" and "corruption" in the Bank's documents;
- that the Bank conduct routine background checks on new employees and on suppliers, contractors and consultants engaged in Bank-financed projects;
- that the Bank strengthen the financial disclosure requirements applicable to high ranking officials and others in particularly sensitive positions; and
- that the Bank adopt "whistleblower" rules protecting Bank staff that report misconduct, disclose information or otherwise cooperate with investigations involving allegations of fraud and corruption, as well as other types of wrongdoing.

Last year my colleagues and I had the opportunity to revisit some of these issues when we were asked by the Bank to review and comment on a strategic plan that the Department of Institutional Integrity had prepared and to review and evaluate how the structures that had been put in place were working and to what degree more needed to be done to implement our recommendations.

The proposed strategic plan focused on all aspects of the management and operation of INT. I will briefly comment on only the two most salient of these. The first is the Department's proposed strategy to move from an emphasis on reacting to allegations of fraud and corruption when they are made, to a program that includes proactive and preventive actions. The second concerns the proposed budget and staff for the Department.

We found the proposal for becoming more proactive to be sound and consistent with our earlier recommendations. If INT depends solely on a reactive approach that responds exclusively to allegations of wrong-doing reported to the Bank, it would reward the most skillful manipulators of Bank funds, since it is usually only the most obvious forms of fraud and corruption that tend to raise sufficient suspicions to be reported to INT. It will, of course, always be critical to the effectiveness and credibility of the Bank's anti-corruption program for INT to maintain its capacity and commitment to zealously pursue allegations of wrongdoing when they are reported. The proposed proactive and preventive efforts are a logical extension of INT's current work and are likely to strengthen INT's potential impact on the Bank's overall objective of detecting and deterring instances of fraud and corruption in Bank-financed projects.

We believe that these three kinds of efforts, reactive, proactive and preventive, should not be viewed as step-by-step progressions, but as component elements of an effective, coherent overall strategy, regardless of the level of INT funding. In any event, a more authoritative answer may be expected to emerge from a comparison of the costs and benefits of the three approaches that balances them against each other and that balances the overall utilization of Bank resources against the potential savings realized by reducing losses to fraud and corruption. Such an approach offers the prospect of more thoughtful resolution of competing considerations than less disciplined forms of evaluation.

Another aspect of INT's strategic plan that is a prime candidate for some form of econometric cost-benefit analysis is its proposal to structure a triage approach for case selection. Recognizing that the Bank's resources are finite and that INT is not likely to receive sufficient funding to enable it to undertake all the investigative activities that may be warranted, the proposed triage system would build upon a systemization of considerations that have been applied informally in INT's past allocation of resources. This is the only reasonable approach that can be taken.

We have encountered some concern that the concept of triage may seem to contradict the Bank's sincere expression of "zero tolerance" for fraud and corruption. Refusal to tolerate should not be confused with striking out at every instance of wrongdoing. As long as all cases receive at least preliminary investigation and assessment by INT personnel as contemplated by INT's proposal, as long as matters apparently involving even low levels of seriousness are occasionally brought to the sanctioning stage, and as long as all geographic regions in which the Bank makes loans receive some degree of regular attention by INT's investigators, the triage system can be recognized as in furtherance of the zero tolerance concept, not in derogation of it.

Turning to INT's proposal for significant increases in its overall budget and staffing level, it is interesting to note that this was met by considerable skepticism in some quarters of the Bank. INT's staffing level had already given some offices in the Bank the impression of an instant bureaucracy exploding onto the Bank scene and apparently destined to expand without ultimate boundaries. At the same time, the staffing level had given INT personnel the impression of overwork and inadequate willingness by the Bank to confront fraud and corruption affecting large regions in which it operates.

It is important to recognize that any responsible business enterprise would have been attempting, from the time of its inception, to stem fraud and corruption that interfered with its mission. In the Bank, however, senior management began to acknowledge the problem openly only in 1996 " after significant amounts already had been lost to fraud and corruption. The Bank has a great deal of catching up to do.

In assessing the justification for the Bank's expenditures on its anti-fraud and corruption program, the appropriate measure, therefore, is not through comparison of INT's accelerated growth in total staff over its first few years with the Bank-wide growth in staff over the same period, but the size of the staff needed to do the job in an effective and cost-justified manner (tempered, to a reasonable degree, of course, by budget realities, competing Bank responsibilities, and similar constraints). Doing nothing, as was the case before, or doing only as much as can be accomplished by an arbitrarily limited level of personnel growth, is clearly not the proper response for an institution with a staff that probably possesses as great a capacity for collective econometric analysis as any institution in the world. The Bank needs to develop a reasonable means of measuring, and recognizing in a practical fashion, the value of investigations as well as the costs. This is generally appreciated within the Bank, and many of the expressions of concern about INT's rapid growth and future ambitions appear to be bottomed primarily on a desire for assurance that the Department has the analytical capacity for concentrating resources effectively and the managerial capacity to assure that the anticipated effectiveness can be realized—all in the context of the Bank's principal mission.

While INT's strategic plan represents a major step forward, the planned uses of resources must be continually subjected to rigorous analyses and the manner in which its operates must be continually analyzed to identify areas where improvement can be made. In our report to the Bank last year, we identified a few steps that could be taken to improve INT's operations. These included the following matters:

- We continue to believe that INT would be well-served by having its terms of reference endorsed by the Board. While the Board has been asked to approve the strategic plan for INT, it has never taken any affirmative action on INT's role as the principal instrument of the Bank for the investigation of fraud and corruption in Bank operations. We think that bestowing such a mandate upon INT would strengthen its ability to obtain cooperation from other offices in the Bank and its authority to conduct investigations in countries throughout the world.
- We believe that INT's stature would also be enhanced if various constituencies, both within and outside the Bank, receive a clear and unambiguous message from the Bank's senior management that it is committed to the fight against fraud and corruption. Since, as President Wolfensohn has noted, this objective was not always a part of the Bank's culture, it may be premature to assume that all Bank staff have accepted its importance. The President has consistently spoken out about the significance of this effort, as have several other Bank officials. It would be helpful if these senior managers would make it a point to regularly reaffirm the priority the Bank places on its anti-corruption effort and its connection to the Bank's antipoverty agenda, and also acknowledge INT's central role in this effort. Another way to deliver this message within the Bank would be to incorporate information about the Bank's anti-fraud and corruption program and its importance into all of the Bank's core training program.
- We believe that while the President should continue to have the ultimate authority and responsibility for INT, a more regularized process would be useful for acquainting the Board of Directors with the general nature of the problems that INT is able to uncover. If the Board is to be expected to support INT's efforts and actions, it should be given a more complete understanding of what INT is doing and what its investigations uncover. In particular, the Board, through its Audit Committee, should have the opportunity to receive sufficient information about INT and its findings to appreciate whether there are endemic problems in a particular country or geographic region, whether there are systematic problems in how the Bank administers its programs, and whether there

are internal obstacles within the Bank that prevent INT from effectively conducting its investigations. At the same time, if the Audit Committee is going to be given access to such information, its members must recognize that INT would not be free to disclose the details of some ongoing investigations, and that such disclosure could be perceived as subjecting INT to the risk of undue influence from the Executive Directors whose nationals may be implicated in wrongdoing.

Last year, we also reviewed a set of issues that concern how and with whom the Bank shares the results of its investigations, in particular: whether the Bank should publicly disclose that it has concluded that a firm or individual has engaged in fraudulent or corrupt practices and that the firm has been sanctioned by the Bank; whether the details and the results of INT's investigation should be shared with affected or interested parties; under what circumstances the results of an investigation should be referred to law enforcement agencies or prosecutors for possible criminal charges; and in what ways the lessons learned from those investigations can be imparted to Bank managers.

The public disclosure of sanctions imposed by the Bank on the basis of findings of fraud or corruption should be automatic. Such disclosure will help achieve a level of deterrence that is one of the most valuable results of the Bank's effort. In addition, it will add credibility to the Bank's anti-corruption program and will enable member nations and other international organizations to protect themselves from becoming victims of the perpetrator in the future.

Beyond publicizing the fact that sanctions have been imposed, the Bank is understandably cautious about releasing the details of INT's investigative reports that describe the evidence of fraud and corruption giving rise to sanctions. Nevertheless, there will often be stakeholders, both within the Bank and in interested member states, that would benefit from knowing the details of the fraudulent and corrupt activities described in these reports. Just as there is a deterrent effect from the public disclosure of sanctions, the disclosure to responsible officials of the particular events giving rising to those sanctions may provide an opportunity for the introduction of corrective measures that could prevent such events from recurring in future Bank-financed contracts. Over time, this could be of considerable benefit to the Bank.

We recognize that there frequently will be information contained in INT case reports that the Bank would have a legitimate interest in keeping confidential. Such information includes: information about INT's sources and methods of investigation, the disclosure of which could undermine INT's investigative capacity; information about cooperating witnesses, the disclosure of which could subject those individuals to retaliation or physical harm; information of a less than compelling nature, the disclosure of which could cause unjustified damage to the subject of an investigation; and information that, although seemingly credible, has no bearing on the culpability of the subject of an investigation and unfairly portrays an innocent third party in a negative light, the disclosure of which could cause damage to that party's reputation. In such instances, the Bank could decide on a case-by-case basis either to decline to release a case report in its entirety or to withhold those portions of the report that the Bank determines should not be released. The fact that these concerns may arise in some situations does not suggest that the Bank should routinely decline to release such INT reports.

If an INT report contained evidence of criminal activity, then it is likely that the government of the country whose laws have been broken will want to obtain that information. Some have argued that the Bank may have either a legal or a moral obligation to provide such information to its member countries. Without resolving such issues, it is apparent from a practical perspective that the Bank will have an interest in making criminal referrals in most, if not all, instances when it uncovers evidence of a crime. We have recommended to the Bank that, as the number of matters eligible for criminal referral continues to increase, the Bank should regularize policies and procedures for evaluating such cases and for interacting with national officials in notifying them of the evidence and giving them access to the Bank files.

When INT investigators discover fraud and corruption in Bank-financed contracts, the evidence may place them in a unique position to identify problems in the Bank's operating procedures that have implications far beyond the matter being investigated. INT may be able to glean instructive information from a single case report, and, in addition, over the course of the many diverse and disparate matters that INT investigates, it may discover patterns and trends that should be called to the attention of operational managers within the Bank, as well as to the attention of officials in member countries with responsibility for the awarding or supervision of Bank-financed contracts. The kinds of information that might be revealed in INT's

investigations include information that would show if there are endemic problems in a country or geographic region, if there are systematic problems in how the Bank administers its programs, and if there are particular techniques or schemes that are being used to facilitate acts of fraud or corruption in Bank-financed contracts. if these lessons are made known to operational managers in the Bank and national officials, it may be possible to correct the problems, or at least improve the procedures for the awarding and executing of Bank-financed contracts to the extent that the potential for future problems is lessened. The Bank would be doing itself a disservice if it were to fail to take advantage of the educational value of the reservoir of information accumulated by INT.

In our 2003 report, we also identified a number of technical issues relating to the Bank's policies and procedures concerning the investigation of incidents involving fraud and corruption that need to be resolved. These issues include:

- whether the Bank should be willing to grant immunity to a cooperating witness or to immunize certain information provided by a witness, and, if so, whether such authority should be given to the Director of INT or should be exercised only with the approval of a senior official outside of INT;
- whether the Bank should be willing to reimburse witnesses for expenses incurred as a result of their cooperation with INT;
- under what circumstances INT should have access to the contents of a staff member's computer files and e-mail databases; and
- under what circumstances the Bank should make Bank staff available to testify in court given that, as a result of the Bank's privileges and immunities, Bank staff cannot be compelled to provide testimony.

Issues of this nature must be dealt with in all national criminal justice systems, and they are resolved in the normal course. We understand that the Bank is still in the process of reviewing these matters and is attempting to resolve them in the near future.

It is likely that other procedural issues with confront the Bank as INT matures as an investigative body. When such issues do arise, we have encouraged the Bank to resist the understandable tendency to resolve these issues by circumscribing INT's activities in a manner that would simply minimize the potential for complaints by the subjects of investigations. Since INT possesses only a limited set of investigative tools and none of the powers common to law enforcement agencies, we have advised the Bank that it should be reluctant to take away any prerogatives that INT would otherwise possess. To resolve such matters, we have also advised the Bank that, where there is disagreement between INT and senior managers over INT's methods of operation, the newly reconstituted Committee on Fraud and Corruption, now known as the Investigations Policy Committee, is an appropriate vehicle for recommending a resolution of the matter.

As I mentioned at the outset, in 2002, we were asked by the Bank to review and evaluate its process for imposing sanctions on firms and individuals that have been found to have engaged in fraud and corruption in Bank projects. The principal tool available to the Bank under such circumstances is to declare the wrong-doer ineligible for future Bank-financed contracts, a process known as debarment. We made recommendations to the Bank in some eighteen separate categories pertaining to its structures and procedures for imposing sanctions. These recommendations were thoroughly reviewed by the Bank's management and were presented to the Bank's Executives Directors. I have been informed that, earlier this month, all of our recommendations were accepted by the Board and that the Bank will proceed to implement those recommendations.

One of our principal recommendations with respect to the sanctioning process concerned the composition of the body given authority to frame the sanctions to be imposed by the Bank. As I described previously, in 1998 the Bank established a Sanctions Committee composed of five senior officials of the Bank to review evidence of fraud and corruption and determine whether or not to debar those found to have engaged in such actions. At the outset this composition was sensible because senior managers of the Bank are in a better position than any others to make thoughtful evaluations of whether it is in the interest of the Bank and its member nations to continue to do business with a firm that has engaged in practices that raise serious ethical concerns. However, over time, it became apparent that the composition of the Committee could be problematic.

Some of the difficulties were of a managerial and administrative nature. An increasing caseload imposed greater time pressures on Committee members for reading the case files in preparation for hearings and for engaging in what has become in essence an adjudicatory exercise, rather than an exercise in business discretion.

As senior Bank officials, each of the Committee members already has a full plate due too their principal responsibilities within the Bank and most had active travel schedules which made them unavailable for extended periods of time.

Other difficulties were more troublesome in that they could be perceived as affecting the basic fairness of the Committee's determinations. First, the members of the Committee, other than the General Counsel, are not lawyers, yet they are often called upon to deal with essentially legal issues, such as the weight to be given certain kinds of evidence and the adequacy of the overall submissions required to satisfy a particular standard of proof. Second, the managerial and professional positions of the Committee members within the Bank open the entire process to claims of at least an appearance of conflict of interest. The premise of perceived conflicts is that Bank managers cannot fairly judge matters concerning loans that their subordinates evaluated and supervised, and that they themselves may have approved. Third, and closely related to concerns about conflicts of interest, is the fact that senior officials by the nature of the positions in the Bank may be perceived as being subject to externally generated pressures from member governments trying to protect their own nationals. These latter two concerns—conflicts and external pressures—could be costly to the Bank in terms of the credibility of the debarment process.

For these reasons, we recommended to the Bank that the composition of the Committee be reconstituted to employ a system in which (a) the membership of the Committee is drawn both from current Bank employees who are not the most senior managers and from individuals who are not current Bank employees; (b) the membership on the Committee be balanced to ensure that it is composed of individuals with training and extensive experience in procurement matters, in law, and in the operations of the Bank or other international development banks; (c) the total membership consists of seven such individuals, with current Bank employees constituting no more than three; and (d) the Committee sits in panels of three to hear cases, with two members of each panel, including the chairman, being drawn from the Committee members who are not current Bank employees. We believe that a careful iteration of such an approach reasonably could be expected to minimize concerns about the current system—regarding membership availability and allocation of time, conflicts of interest, outside influences, and pressures of increasing caseload—while maintaining necessary membership experience and expertise.

We also made recommendations as to whether the Sanctions Committee should have the authority to impose sanctions on behalf of the Bank or should simply make recommendations to the President. Requiring the President of the Bank to review and evaluate every case in which fraud and corruption has been found and to determine whether the recommended sanctions are appropriate places an enormous burden on the President's time. Furthermore, since the parties subject to sanction come from countries that are represented on the Board of the Bank to whom the President reports, there is at least the perception that the President could be subjected to political pressure and undue influence on behalf of a party that had the support and sympathies of its government. For these reasons, it seems advisable not to include the President in the sanctioning decisions and that, as long as the Sanctions Committee is composed, at least in part, of individuals who are not current Bank employees, the Committee should be vested with authority to make final decisions without further review or appeal.

One of the reasons we are comfortable with making the Sanctions Committee's decision final and non-appealable is that we also recommended that the Bank appoint an officer to review all cases that are directed by INT to the Sanctions Committee to determine whether the evidence is sufficient to warrant sanctions and to suggest what sanction might be appropriate. As a result, there would be two levels of review in the process, the Bank officer and the Sanctions Committee. Considerations of fairness would not dictate that further opportunities for appeal would be required.

The purpose of the reviewing officer within the Bank was intended to improve the Bank's sanctioning process in two other fundamental respects. First, we were concerned that the only mechanism for disposing of a case, no matter how strong or weak the evidence might be, was to conduct a full-blown hearing before the Sanctions Committee. Committee members must spend considerable time preparing for Committee proceedings and, as the quantity of evidence presented to the Committee continues to grow, an ever-increasing amount of time conducting hearings and meeting to decide how to rule on those cases. As the number of cases becomes larger, it will be more and more difficult for the Committee to hear cases and dispose of them in an efficient and timely manner. The role envisioned for the Bank's internal reviewing officer could alleviate much of this pressure. The accused will know that the reviewing officer, who is independent from those investigating the case, has re-

viewed the evidence and concluded there is sufficient evidence to warrant a hearing before the Sanctions Committee. The accused will also know what sanction has been recommended by the reviewing officer. Under these circumstances, the accused may decide it is in its best interests to avoid the time and cost of proceeding to a full hearing before the Committee. In such cases, the sanction suggested by the reviewing officer will take effect and the matter will be closed without requiring any of the Sanctions Committee's time.

The second important feature of our recommendation for a reviewing officer is to provide the Bank with a mechanism for temporarily suspending the accused from participation in new Bank projects pending final action by the Sanctions Committee. Under the Bank's original procedures, an accused party remained eligible to be awarded additional Bank projects until the Sanctions Committee process had been completed and a debarment had been approved by the President. (The consequences of this approach are compounded by the fact that, since it could cause enormous costs and delays to a project that is already underway, a debarment does not affect contracts that have been previously awarded to a party that is subsequently debarred—although, under other long-standing Bank procedures, the contract could be canceled if it was tainted by the same fraudulent or corrupt actions that gave rise to the debarment.) Since the accused could continue to compete for additional Bank contracts during the pendency of its case before the Sanctions Committee, the accused had an incentive to delay the proceedings as long as possible rather than bringing them to a speedy conclusion. Plainly, the Bank has an obligation to protect funds entrusted to it from misuse at the hands of a party who has already been shown by credible evidence to have engaged in fraudulent or corrupt practices, and the Bank would only look foolish were it to award further contracts under such circumstances on the mere technicality that it had not completed its formal processes. For these reasons, we recommended that if the reviewing officer determines, on the basis of the evidence presented by INT, that the accused has engaged in fraudulent or corrupt practices, then the accused would be temporarily suspended until the Sanctions Committee's decision on the matter becomes effective.

The other recommendations contained in our 2002 report on the sanctioning process largely concerned procedural matters and the Bank's desire to strike an appropriate balance between an efficient and expeditious process on the one hand, and ensuring that the accused is afforded fairness on the other. Our recommendations on these procedural matters included the following issues:

- in response to arguments from some parties before the Sanctions Committee that the Bank should be subject to some sort of statute of limitations that would bar it from pursuing matters that occurred in the distant past, we recommended that, where there is reasonably sufficient evidence to establish that a firm has in fact engaged in fraudulent or corrupt practices, no matter how long ago the incident occurred, the Bank should retain the opportunity to protect its assets from misuse in the future by debarring the firm from participating in subsequent Bank-funded contracts;
- in considering the manner in which evidence is presented to the Committee, we recommended that the practice of receiving both written submissions and oral presentations should continue, with the caveat that, in order to keep the proceedings manageable, reasonable limits should be placed on the length of written submissions (other than documentary evidence) and the duration of oral presentations;
- with respect to the burden of proof, we recommended that the Bank should have the burden of establishing that an accused party has engaged in fraudulent or corrupt practices, and that, where such evidence has been presented, the burden should shift to the accused to show cause as to why that party should not be sanctioned as a consequence of such behavior;
- since the standard of proof applied by the Bank that the evidence be "reasonably sufficient" to support a finding that fraud or corruption had occurred was considered ambiguous by several members of the Sanctions Committee, we recommended that the Bank adopt of a more descriptive standard, such as "more likely than not;"
- in response to demands from parties before the Sanctions Committee that they be given unfettered access to all documents in the Bank's possession, we recommended that the Bank maintain the practice under its existing procedures with respect to providing access to its documents whereby the accused is not given unlimited access to Bank documents but is entitled to have access to all relevant evidence in INT's possession, or known to INT, that would reasonably

tend to exculpate the respondent or that would mitigate the respondent's culpability;

- with respect to documents in the possession of parties under investigation by the Bank, we recommended that the Bank's procurement guidelines and the documents required to be submitted by bidders on Bank-financed projects be revised to enhance the Bank's ability to obtain meaningful information from the records of all parties that bid on Bank-financed contracts, whether or not they ultimately are awarded the contract, and that an accused's obstruction of or failure to produce such documents or otherwise to cooperate with an investigation should be considered by the Sanctions Committee, and the Committee should be permitted to draw an inference from such actions by the accused that the evidence it refuses to produce would tend to establish the accused's culpability;
- in response to demands from parties before the Sanctions Committee that the accused be permitted to confront adverse witnesses and compel them to testify in person before the Sanctions Committee, we recommended that the Bank should continue the practice whereby the Sanctions Committee accepts witness testimony that is provided indirectly through either INT or the accused, and that the Sanctions Committee assess the weight to be given to such testimony in view of all the circumstances, including the lack of opportunity to evaluate the witness's credibility by face-to-face observation and the lack of opportunity for the other party to cross-examine the witness;
- with respect to the range of possible sanctions that may be imposed on the basis of a finding of fraud or corruption, we recommended that the range be expanded to include one or some combination of the following: (a) permanent debarment; (b) debarment for a term of years; (c) a compliance program in lieu of debarment involving the positioning of monitors on a board of directors or elsewhere within a finn, the termination of corrupt employees, the initiation of ethical training for all employees, the adoption of systematic audits and investigations, and the encouragement of voluntary reporting by employees; (d) restitution; (e) formal reprimand; (1) other appropriate sanctions; and in all cases (g) publication of the particulars of any sanction imposed;
- where there are circumstances beyond the underlying events surrounding the fraudulent or corrupt activities of the accused, such as prior conduct involving similar behavior, the magnitude of losses caused by the accused, or the damage done to the credibility of the Bank's procurement process, we recommended that the Sanctions Committee take such aggravating or mitigating circumstances into consideration in determining the appropriate sanction to impose;
- In considering the impact of the panoply of possible aggravating or mitigating circumstances, we recommended that the Sanctions Committee give special weight to the degree of cooperation an accused party provides to the Bank in the course of an investigation because of the benefits to the Bank and the efficient use of its resources that would result from such cooperation, and we recommended, in particular, that the Bank develop a voluntary disclosure program that would encourage firms and individuals to volunteer disclosure of wrongdoing before it is suspected by the Bank; and
- with respect to the parties that are potentially subject to being sanctioned by the Bank, we recommended that the authority of the Sanctions Committee to debar should apply not only to the parties that enter into contracts for Bank-financed projects, but also to any individual or entity that, directly or indirectly, controls or is controlled by the contracting party.

In addition to these recommendations, in our report on the sanctioning process we made recommendation similar to those described in our 2003 report that the Bank should make public disclosure of the sanctions it imposes and should share evidence of criminal activity with national law enforcement agencies and with other international organizations.

From a near standing start and in less than a decade, the World Bank Group has created a greatly enhanced and increasingly credible capability to deal with the problems of suspected fraud and corruption in its activities. Problems remain, to be sure, many of them referenced in my testimony today. But given a continued level of commitment from executive leadership, buttressed by clear authorization for its activities from the Bank's Board of Directors and a widespread recognition within the organization itself of the worth of such an undertaking, there is no reason why this effort cannot mature into a showcase operation of how to deal with the challenge of integrity problems within an international organization. Key to meeting this challenge will be the continued ability to attract and retain INT staff and lead-

ership of the highest caliber and widest experience and to insure that INT is recognized to be a genuine resource by all engaged in the worldwide operations of the World Bank Group. An admirable beginning has been accomplished. Care must be taken to ensure that continued improvement remains the aspiration for the future.

The CHAIRMAN. Thank you very much for that remarkable testimony, and likewise for the written statement that buttresses your oral testimony today. At this point, I want to recess the hearing. We're in the last four minutes of the roll call vote. We will quickly do our duty, and then return and proceed with our other two witnesses.

[Recess.]

The CHAIRMAN. The committee is called to order again. We now look forward to hearing from Mr. Guido Penzhorn, advocate and senior counsel, Durban Bar, Durban, South Africa. Welcome to the committee. Please proceed with your testimony.

STATEMENT OF GUIDO PENZHORN, ADVOCATE AND SENIOR COUNSEL, DURBAN BAR, DURBAN, SOUTH AFRICA

Mr. PENZHORN. Mr. Chairman, I must thank you for the opportunity of being here, but I must also extend the thanks of the Lesotho authorities for the recognition that my being here signals for the work that they've done in Lesotho in combating corruption. The Lesotho authorities sometimes feel that they are somewhat alone in a world awash with corruption and that they are isolated in their efforts, and this invitation is a source of great encouragement to them.

Mr. Chairman, in this paper I will briefly set out the work done in combating bribery in Lesotho involving multinational construction companies and consultants, and I will then express a few thoughts from my experience in leading these prosecutions.

By way of background, the Lesotho highlands water project is the result of a treaty between South Africa and Lesotho dating back to 1986. You may recall, Mr. Chairman, that that was at the time of the stranglehold of sanctions against South Africa, and this was a way for South Africa to somehow get out of the stranglehold. And this treaty then allowed for the damming of water in Lesotho for the use in Gauteng in South Africa and for Lesotho to get the benefit of not only the revenue, but also the hydro power that would then be generated.

Phases 1A and B have recently been completed, and negotiations are underway in respect to phase 2. This is a multibillion dollar water project, and in fact, I understand one of the biggest dam projects in the world.

We started by prosecuting the chief executive of bribery in a bribery scandal that was up to then quite unprecedented in South Africa. He was convicted and sentenced to 15 years' imprisonment. The Canadian consultancy, Acres, was then prosecuted. They were convicted and fined about 15 million rand, which is about 6 ½ million U.S. dollars. The engineering company from Germany, Lahmeyer International, was then prosecuted, convicted, and on appeal their fine was increased to 12 million rand, which is about $2 million.

We then prosecuted the French firm, Schneider Electric SA, which had taken over Spie Batignolles, which had been involved in

the project. They in fact pleaded guilty and a fine of 10 million rand was agreed with them, and there are other prosecutions pending.

Initially in 1999, these prosecutions were met with praise from the international community, but also with a degree of skepticism. The thought seemed to be that the chief executive, the recipient of the bribes, would be prosecuted and then once he is sentenced everybody would go on with their business. However, when the prosecutions then moved to the multinational companies involved, people started to take notice, and more particularly when the convictions started coming in, and then they really started taking notice.

And what must be remembered is that these prosecutions must be seen against the background of mounting criticism in Lesotho against the prosecutions. No doubt some of these criticisms were very well-intended, because it was felt that Lesotho can hardly afford to mount these prosecutions involving expensive lawyers from South Africa and expensive accountants and specialist witnesses and so on, and it was felt that the money could be better spent in, for instance, the enormous AIDS pandemic that you have in Lesotho at the moment.

However, some of the motivations for criticizing these prosecutions and seeking to undermine them no doubt also go to the very problem that you have with bribery, and that is, you don't know how far it goes. Some of the people criticizing the prosecutions may well have been doing so because they themselves were involved and they wanted to keep this thing covered up.

We received help, Mr. Chairman, from various instances, particularly from the Swiss, also from OLAF, the anti-corruption European Union unit. And we also received help from the World Bank, and we received considerable help from the World Bank. From early on, the World Bank extended to us access to their records that they had with regard to the companies that we were investigating. On the other hand, we extended our assistance to the World Bank which was the result of our investigations, and that cooperation was very fruitful and that cooperation has extended until now, and we are still cooperating quite extensively with the World Bank and we are very appreciative of the help that we've received from the World Bank.

But I must add though that that assistance fell short of financial assistance, and this is a bugbear with the Lesotho authorities because various promises have been made with regard to financial assistance which was never forthcoming. One must realize that faced with its own economic and social problems, such as a frightening AIDS pandemic, Lesotho cannot really afford the costs incurred in these prosecutions. But it did what it had to do, and this involved the allocation of funds that could well have been used for other purposes.

This clearly illustrates in my submission Lesotho's measure of commitment to fighting corruption. From our vantage point, we do not see any such commitment on the part of other countries, *i.e.,* those whose companies were and still are involved in the water project. There is a lingering impression in Lesotho, Mr. Chairman, as well as in South Africa, that the interests of the first world countries in the present prosecutions lies not so much in the suc-

cessful outcome of these prosecutions, but rather in protecting the interests of its companies that are involved. Hopefully, this impression will in time prove not to be correct.

I'd like to deal with a few lessons that we've learned. Corruption is a worldwide industry. What Lesotho has shown is that something can indeed be done about it. All that is required is real and not merely token resolve. Such resolve presupposes a prosecuting arm that is not hamstrung by political considerations or, more importantly, skeletons in cupboards of persons in a position to influence prosecuting decisions. After all, the one sure way to get away with bribery is to compromise those that make the decisions whether or not to prosecute. This may explain why in so many countries, among others Africa, little seems to be done about what appears from the outside to be obvious corruption. My team and I were fortunate in that we did not have this problem in that the Lesotho prosecuting authorities gave us their unqualified support.

International bribery is notoriously difficult to detect. The reason for this is that you do not have an obvious victim. The victim is the state and the public at large who would not normally get to know of this. Bribery involves two parties, the briber and the bribee, and the perception which we have found in the first world is that in Africa bribery is an Africa problem. And what I mean by this is that it is felt that the initiative for the bribe comes from the bribee as opposed to from the briber.

What these prosecutions that we have been involved in has shown is that that is in fact not the case, that the initiative comes from the briber, from the briber company, and it initiates this through agents, and that's where the bribe comes from.

I'd like to turn to something which I think is particularly important. I've heard testimony and I've read testimony from persons such as Nancy Boswell that testified before you at the last hearing as well as other testimony, and this testimony focuses on the supply side of bribery. In other words, from the vantage point of the donor agencies or the contractors involved. And then it focuses on transparency in the process, proper accountability, the level of corruption in a particular country, making sure the official is not bought off.

Now, our perspective is from the demand side, and what we dealt with in Lesotho in this highlands water project is a project that was overseen by the World Bank, by the European union, by a joint investigating or oversight committee of South Africa and Lesotho, the regular inspections by the World Bank and the EU, regular visits, contracts that were won on merit—both Acres and Lahmeyer, the ones that were convicted, won their contracts on merit—bribe payers that actually did not get their contracts, and so on.

In other words, we're dealing with a perfectly transparent process. Where the real problem came in is that you are dealing with a sophisticated system all revolving around the agent or the middle man. This agent doesn't seek to obtain the contract by getting the chief executive of the authority to override procedures, or to bypass tenders that are better. Rather, it involves compromising him in his discretion.

To use a simple analogy, it's like when my son is prosecuted for drunken driving and I pass the policeman $100 and he accepts it,

he's compromised, whether or not he helps my son or doesn't help my son or how he helps my son is not the point. The point is I have compromised him, and this is the nature of the bribery that we are dealing with here.

The second problem is that the agent's costs are included in the tender amount, it is built in. And this was in fact the defense of companies like Acres and Lahmeyer that said, but the money that we paid to our agent is perfectly transparent, it's on our books, it's accounted for, et cetera, et cetera, what's the problem. In fact, they have a contract with the agent. That contract says the agent must do certain things and they somehow established that he did certain things.

The point is then how do you prove it? You cannot really prove it from the supply side, because from the supply side you seem to work from the assumption that corruption comes from the demand side. That is perhaps why Lahmeyer and Spie Batignolles passed muster in an EU inspection, that is perhaps why Acres escaped World Bank sanction the first time around, because it was viewed from this perspective.

We view it from the other perspective, namely through circumstantial evidence on the ground where the contracts take place, and this circumstantial evidence involves that the agent, for instance, wasn't really needed, the nature of the agreement between the contractor and the agent, other factors, the manner of the payments, *i.e.,* that they were paid into secret accounts, the amounts of the payments, whether the agency relationship is a secret one or not.

The point I'm making is that from our perspective from the demand side, we were then able to establish bribery. And as I said, Mr. Chairman, this all surrounds the question of the use of agents, and without sounding too simplistic, this is where the heart of the problem is. Certainly an agent or a middleman can serve a legitimate purpose. However, if he is given carte blanche to obtain the contract, and especially on the basis of a contingency fee, he's almost invited to obtain the contract through corrupt means. This is what the judge said in the Sole case, where he said that the agent there undertook in effect to secure the award of the contract, that is, to the extent that his fee would only become payable with the award of the contract. How can a consultant give such an undertaking bona fide?

Now, although in Lesotho we are only dealing with the involvement of construction and consulting companies, it would be naive in our submission to think that the use of representatives to hide bribery is confined to the construction industry. The overwhelming probability suggests that this is also the way it is done in other large contracts involving public officials.

Now, in this regard, Mr. Chairman, and these are my closing remarks, the Lesotho Court of Appeal, the highest court in Lesotho, has expressed itself very strongly in both the Lahmeyer case and the Acres case, and it has called on the international community, and specifically the World Bank, to readdress its practices and its procedures and to look more closely at the use of agents, because that is where the heart of the problem is. But also, what it has asked the donor agencies such as the World Bank to do is to help

the courts in a place like Lesotho with regard to a deterrent form of punishment.

The companies that we prosecuted are not natural persons, they are artificial persons, and you can't send them to prison. And what happens is, if you can't take his liberty away, what punishment do you impose upon him? The fines that the courts were able to impose, the companies more often than not paid out of their profits. In other words, it's like paying a criminal who stole things from your house, you punish him by ordering to give half of it back, but he still keeps the other half, so what sort of punishment is that? And that is what the Lesotho courts have asked the international community and the donor agencies to do, namely, to ensure that the companies involved are properly punished. I understand that in the case of Acres that the rehearing that has taken place has been concluded and we look forward to seeing what the result of that hearing is.

In conclusion then, my last point, and that is this, in southern Africa, where I come from, we are dealing with a transparent process in the water process. We are dealing with the ability to prosecute these companies. What we are really looking for, that is, the Lesotho authorities, is support and encouragement from the outside world in this process, and for Lesotho to know that it's not alone in combating bribery.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Penzhorn follows:]

PREPARED STATEMENT OF GUIDO PENZHORN[1]

COMMENTS ON THE CURRENT LESOTHO BRIBERY PROSECUTIONS

In this paper I will briefly set out the work done in combating bribery in Lesotho involving multi-national construction companies and consultants. I will then express a few thoughts and make some suggestions from my experience in leading these prosecutions. In doing so I will deal in particular with the role played by the international community and the role it can play through international donor/lending agencies such as the World Bank.

Introduction

The Lesotho Highlands Water Project is the result of a treaty between South Africa and Lesotho dating back to 1986 in terms of which water is dammed in the mountains in Lesotho for the purposes of supplying water to the Gauteng province of South Africa as well as hydro-power to Lesotho. Phases 1A and 1B have recently been completed and negotiations are underway in respect of phase 2. This is a multi-billion dollar project and in fact one of the biggest dam projects in the world.

In the mid 1990s an audit by Ernst & Young led to the dismissal of the Chief Executive of the project authority, Mr. Masupha Sole. This in turn led to civil litigation against him in the course of which it was discovered that he had bank accounts in Switzerland. An application to the Swiss authorities followed from which it was discovered that he was receiving enormous sums of money, mostly through intermediaries, from contractors and consultants involved in the water project. I was then briefed to lead the prosecution of Mr. Sole and the others involved in what was clearly a bribery scandal unprecedented in Southern Africa.

Mr. Sole was the first to be charged. He was convicted and on appeal[2] sentenced to 15 years imprisonment. Acres International, a firm of consulting engineers from

[1] Lead counsel on behalf of the Lesotho government in the present bribery prosecutions relating to the Highlands Water Project.

[2] *M. E. Sole* v *The Crown,* Lesotho Court of Appeal, case number C of A (CRI) 5 of 2002, judgment delivered on 14 April 2003. Smalberger JA, Melunsky JA (both former judges of the South African Supreme Court of Appeal) and Gauntlett JA (Senior Counsel in South Africa and former Chairman of the South African Bar Council).

Canada, followed and also on appeal [3] it received a fine of R15 million (the exchange rate between the Dollar and the Rand is presently approximately 6.1 to 1). Lahmeyer International, the engineering consultancy from Germany, was then prosecuted, convicted and sentenced to a fine of R10.6 million. It appealed against the convictions and on appeal the fine was increased to R12 million. Judgment was delivered on 7 April this year.[4]

In June 2003 one Du Plooy, the intermediary who acted on behalf of Impregilo of Italy, the lead partner of the consortium that built the main dam, pleaded guilty to bribing Mr. Sole on behalf of Impregilo. In exchange for co-operation with the prosecution he was fined R500,000, coupled to a lengthy period of imprisonment which was conditionally suspended.

On 25 February 2004 Schneider Electric SA (formerly Spie Batignolles), the multinational French construction company involved in building the transfer tunnels, pleaded guilty to 16 counts of bribing Mr. Sole. A fine of R10 million was agreed with the prosecution and was paid.

Other prosecutions are pending.

International Assistance

The institution of these proceedings in 1999 was met with praise from the role players involved and the countries from where they came. This included a number of European countries as well as the United States and Canada. This praise was however coupled with a fair degree of skepticism. The thinking seemed to be that the prosecutions would be confined to the demand side, i.e. the Chief Executive, Mr. Sole. Once he had been duly punished the point would have been made and everybody could go on with their business. When, however, the prosecutions moved to the international contractors/consultants involved and it was shown that the Lesotho authorities were serious about prosecuting these companies there was a discernible change in attitude. This was even more so when convictions followed and these convictions were confirmed on appeal by the highest court in Lesotho.

The initial praise to which I have referred was also accompanied by offers of assistance. The extent and nature of such assistance, how it assisted us and what lessons can be learnt therefrom is what I propose touching on in this paper.

Offers of and actual assistance should firstly be seen against the mounting resistance to these pending prosecutions in Lesotho once word leaked out about the application to the Swiss authorities relating to Mr. Sole's bank records. The institution of these prosecutions was questioned by for instance suggesting that they were unlikely to succeed, that they were too expensive, and so on. Such resistance only quietened down once the convictions started coming in. These attempts to undermine the prosecutions in my view illustrate the very insidious nature of the crime of bribery. It may well be that certain prominent persons genuinely questioned the prosecutions because they thought they were too expensive or they thought that they were unlikely to succeed. It is also possible however that the criticisms stemmed from a desire to keep a lid on things. The point is that one simply does not know. When prosecuting bribery, and this is what these cases have taught us, one is met with an almost impenetrable wall of silence. Even Sole, who is now serving his time in prison, is still not willing to come forward and place it all on the table despite a clear indication to him that this could well result in a reduction of sentence.

The prosecutions were and still are largely based on bank records received in terms of the Swiss mutual assistance legislation. The Lesotho government approached the Swiss federal authorities in Berne for assistance which in turn referred the application to Zurich where it was dealt with. The prompt and efficient manner in which the Swiss authorities dealt with what eventually became a complex and multi-layered application contributed immeasurably to the successful outcome of these prosecutions. Without this prompt response and continued co-operation which kept the momentum going these prosecutions may well have been scuttled already at a very early stage.

Apart from the Swiss authorities, we also received considerable assistance from OLAF, the EU anti-corruption unit. Over the last year or so it has given us enormous support which support has to date for instance impacted directly on the conviction of Schneider Electric SA.

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[3] *Acres International Limited* v *The Crown,* Lesotho Court of Appeal, case number C of A (CRI) 8 of 2002 delivered on 15 August 2003. Steyn President of the Court, Ramodibedi JA and Plewman JA (a former judge of the South African Supreme Court of Appeal).

[4] *Lahmeyer International GmbH* v *The Crown,* Lesotho Court of Appeal, case number C of A (CRI) 6 of 2002, delivered on 7 April 2004. Steyn, President of the Court, and Grosskopf JA and Smalberger JA (both former judges of the South African Supreme Court of Appeal). (All three judgments referred to are electronically available.)

At about the time the bribery scandal surfaced in Lesotho several overseas companies that were involved in the water project changed their corporate structure. Despite what the companies may say, we believe that this may well have been done in order to evade prosecution. One such company was Spie Batignolles. OLAF helped us access its company records in order to ascertain the nature and effect of its merger with Schneider Electric SA on criminal liability. But for the help of OLAF we would not have been able to show that Spie Batignolles, which was involved as lead partner of one of the consortia, in fact survived the merger with Schneider Electric SA. Together with OLAF we are presently investigating other companies that we are considering prosecuting and good progress is being made here as well.

The point is that for a small country like Lesotho with its limited resources to investigate matters such as these without the assistance of institutions such as OLAF is quite simply not feasible.

The World Bank as a major sponsor of the water project took an interest in these prosecutions from early on, to the extent that there was World Bank funding involved, which was the case with among others Acres, Lahmeyer and Spie Batignolles. The interests of the World Bank and those of Lesotho largely coincided and this resulted in close co-operation between the Bank's investigation and ours. The World Bank lawyers visited Lesotho on a number of occasions to share our information and we did likewise when visiting Washington. The resulting benefits were considerable. On the one hand the World Bank lawyers had access to our documentation and witnesses which they could use in proceedings against the contractors/consultants involved, and we had similar access to World Bank documentation as well as any responses by the contractors/consultants in answer to the charges leveled against them by the Bank.

Assistance by the European Union and the individual countries from where the accused contractors/consultants came was far less encouraging. Initial approaches for assistance from the Maseru office of the EU came to nothing. In fact, our approaches were met with what bordered on suspicion.

As to actual financial assistance, I make mention of a meeting held in Pretoria at the commencement of these prosecutions in November 1999. This meeting was called by the World Bank in order to discuss the pending prosecutions in Lesotho and ways in which Lesotho could be assisted by the international community. It was attended by representatives from South Africa, Britain, the European Union, the European Investment Bank, individual banks in Europe, as well as others. Various promises of assistance were made by those attending. The official minutes of the meeting also record such promises, such as the representative of the EU undertaking to "contribute to the cost of the process" and the British High Commissioner in Lesotho saying "that DFID could possibly offer direct assistance, even though a part of the EU." The World Bank representative that chaired this meeting, Pamela Cox, assured the Lesotho Attorney General in the context of assistance that "the World Bank has deep pockets." Unfortunately none of this help has been forthcoming. I can only surmise that someone higher up in the World Bank did not share Pamela Cox's willingness to assist.

The EU did send out a team (not OLAF) a few years ago to investigate the involvement of European companies. We placed all our information and resources at its disposal. The team could find virtually nothing untoward and largely gave the European companies a clean bill of health (this included Lahmeyer which was convicted and Spie Batignolles which pleaded guilty). We also noted a reluctance on the team's part to give us the evidential material gathered by them which led to their findings. I regret to say that they left us with the impression that they were not so much concerned with helping us than with white-washing EU spending.

Apart from Switzerland, and to some extent France which helped with an application for mutual legal assistance, no assistance was received from any other overseas country. This despite the fact that these prosecutions have received considerable publicity overseas and interest groups such as NGO's have taken up the question of funding with various governments. When addressing the EU Committee on Development and Co-operation in June last year I also raised the question of assistance in the form of funding. Nothing has come of any of this. Faced with its own economic and social problems, such as a frightening AIDS pandemic, Lesotho cannot really afford the costs incurred in these prosecutions. But it did what it had to do and this involved the allocation of funds which could well have been used for such other purposes. This clearly illustrates Lesotho's measure of commitment to fighting corruption. From our vantage point we do not see any such commitment on the part of other countries, i.e. those whose companies were and still are involved in the water project.

There is a lingering impression in Lesotho, as well as in South Africa, that the interest of first world countries in the present prosecutions lies not so much in the successful outcome of these prosecutions but rather in protecting the interests of its companies that are involved. Hopefully this impression will in time prove to be not correct.

There is a close working relationship between South Africa and Lesotho in matters such as these and here we also received considerable assistance from South Africa, particularly in the form of bank records.

The actual assistance I have referred to, particularly that from overseas, apart from the direct impact it has on the actual prosecutions, has also had a wider beneficial effect in Southern Africa. It is this. Lesotho is a member of SADC, the Southern African Development Community. This assistance and encouragement coming from institutions such as the World Bank and OLAF has been a subject of discussion at various meetings of SADC. I have no doubt that this will serve as encouragement to other Southern African countries when deciding whether or not to tackle high level corruption.

Lessons Learned

Corruption is a world wide industry. What Lesotho has shown is that something can indeed be done about it. All that is required is real and not merely token resolve.

Such resolve pre-supposes a prosecuting arm that is not hamstrung by political considerations or, more importantly, skeletons in cupboards of persons in a position to influence prosecuting decisions. After all, the one sure way to get away with bribery is to compromise those that make the decision whether or not to prosecute. This may explain why in so many countries, i.e. in Africa, little seems to be done about what appears from the outside to be obvious corruption. My team and I were fortunate in that we did not have this problem. We were given an open mandate by the Lesotho Attorney General to do what we considered had to be done and throughout he gave us his full support.

International bribery is notoriously difficult to detect. It is clearly not in the interests of those involved to have their conduct known. The injured parties, i.e. the State and the public at large, would then not normally get to know of it. Having said that, however, where bribery is actually discovered, prosecuting it is not that difficult, that is once the prosecution gets past all the various legal hurdles placed in its way. On the one hand you have a contractor seeking a contract and on the other a State official who is in a position to exercise his influence in the award of the contract. There is no relationship between them other than this fact. If money then passes between them, particularly in suspicious circumstances such as through Swiss banks, then, in the absence of some or other convincing explanation, the only inference to be drawn is that this money constitutes a bribe. In law we would call this compelling circumstantial evidence. To everyone else, it would simply amount to common sense.

Bribery involves two parties, the briber and the bribee. In a given situation it is normally difficult to establish who initiated the corrupt transaction. There seems to be a perception in the first world that in the context of construction contracts in the third world the initiative comes from the bribe taker rather than the bribe giver. In the African context this has been described as an "African problem." No doubt corruption can be initiated by the bribe taker. This has however not been the evidence in the present prosecutions in Lesotho. The evidence has shown that Mr. Sole's first Swiss accounts were opened for him by the intermediary acting on behalf of French contractors, whereafter the payments commenced. Also that the payments were then normally linked to so-called representative agreements between the contractor/consultant and its agent (to which I will return below). Only once these agreements were in place were funds transferred to the intermediaries who in turn transferred the funds wholly or in part to Mr. Sole. This would suggest that the initiative came from the briber and not the bribee.

The sophistication of the way in which it is done, and by for Instance ensuring that the bribe payments come out of the receipts that the bribe giver receives as payment for its services for its contractual services under its contract with the employer, suggests an established practice and fine tuning by the bribe giver so as not only to protect itself but to also suit its financial accounting purposes. This will hardly come from the bribe taker.

The purpose of these prosecutions has not only been to obtain convictions. The objective has also been to get to the bottom of this problem and to seek to prevent it from recurring. To this end overtures have been made to various of the persons or entities involved to rather co-operate with the prosecuting authorities, in return for possible exemption from prosecution. All this has fallen on deaf ears. Even Mr.

Sole, now languishing in prison, has chosen to remain silent. At the time when all the accused were still together (they were initially charged together but the Court ordered a separation of trials) there also seemed to be a clear conflict of interests between them. Despite this they presented a unified front. What precisely it is that makes persons involved in the shadowy world of bribery stick together is not clear. Perhaps it is akin to some sort of honor among thieves. The more likely explanation would seem to be that once you get involved in bribery particularly of this magnitude you are not at liberty to simply look after your own interests when things go wrong.

The Use of Agents

Multi-national contractors/consultants almost invariably it would seem rely on so-called representative agreements. In terms of these agreements the contractor/consultant would engage a local agent ostensibly to perform various services in the country where the contract is sought. Included among these is then also the obligation to secure the contract coupled to a stipulation that unless the contract is obtained the agent will not be paid.

I have heard and read various presentations at conferences and the like as to how contractors should seek to prevent corruption by its officials. Without wanting to sound too simplistic, at the heart of the problem lies the control of the agent. Certainly an agent can serve a legitimate purpose. However, if he is given carte blanche to obtain a contract and especially on the basis of a contingency fee, he is almost invited to obtain the contract through corrupt means. In this context the presiding judge in the Sole case had the following to say, thereby really stating the obvious as judges are sometimes obliged to do (at pp. 203–204 of the judgment):

> If the consultant is bribing a public official, then he is doing so for a purpose: either he is securing confidential information leading to an award of a contract, or he is securing such award outright. Surely, in that case, the results produced by the consultant speak for themselves? How can the principal be unaware of the consultant's activities, particularly where they are extended over a period?
>
> It will be seen that under the consultancy agreement between HWV and Mr. du Plooy, the latter undertook to supply not alone the necessary information, but also undertook in effect to secure the award of the contract that is, to the extent that his fee would only become payable with the award of the contract. How can a consultant give such an undertaking *bona fide*? Surely the consideration which he offers and which he executes is the services which he renders and not the results thereof. In some jurisdiction legal practitioners have been known to offer their services on a result basis; while the system does not gain general approval, it cannot be said to be *mala fide:* there the confidence of the practitioner is based upon the strength of his client's case. The construction industry gives rise to different considerations, however. Where many tenderers are involved, vying with one another for the award of a contract at an undisclosed sum, there is little basis for confidence, and any agreed undertaking by a consultant to secure the award, is then surely suggestive of bribery on the part of both consultant and principal: indeed it suggests that the consultant has already prepared the ground for such undertaking.

Although in Lesotho we are only dealing with the involvement of construction and consulting companies in the water project, it would be naive to think that the use of representatives to hide bribery is confined to the construction industry. Instead and as a matter of overwhelming probability this is the way it is done in other large contracts involving public officials.

Preventative Steps

The Lesotho Court of Appeal (Lesotho's highest court) in the Lahmeyer appeal judgment observed as follows, at page 55:

> However, it is also incumbent on the international community and particularly the funding agencies to revisit those practices and procedures it has in place and to use those sanctions it has the power to impose whenever contraventions of the kind proved in respect of this project occur. One of the devices employed in various cases that served before this Court was the use of "representative agreements." They were used extensively as mechanisms through which payments intended as bribes were clothed with contractual respectability. They were in fact, in all the cases before us, used as cloaks to disguise and obfuscate the money trail. It required intensive research, expensive court procedures across international boundaries and

> tiresome and time-consuming efforts to obtain the necessary information to unravel the complex evidential strands required to determine and thus to provide the necessary evidence. Above all it required political will and the provision of the necessary resources. To their credit the Lesotho authorities did this in full measure. They should be commended for their resolve.

And in paragraph [65] at page 56 it stated as follows:

> This Court trusts that the various funding agencies will have regard to the above comments; that it will revisit its practices and procedures in general, but for present purposes, more particularly the practice of the employment of representatives who can play the obfuscating role played so frequently in this mammoth project. But also, that it will be firm and resolute in enforcing its disciplinary proceedings on any agency, company, individual or institution who participates in the practice of bribing those employed on development projects.

These sentiments were obviously addressed at funding institutions such as the World Bank. Were the World Bank to act firmly against contractors and consultants involved in third world corruption, this would firstly have the effect of deterring corruption of the nature we are dealing with in Lesotho. Secondly, and equally importantly from the Lesotho vantage point, it would have the effect of encouraging a country such as Lesotho in its efforts to fight corruption. Lesotho would be told that it is not alone in fighting corruption which, after all, was largely initiated outside Lesotho and more particularly where the contractors come from. Perhaps most importantly what such action would be saying is that corrupting officials in a third world country such as Lesotho is not in any way condoned by the donor/lending agencies.

In the Lahmeyer case the Lesotho Court of Appeal remarked as follows on the World Bank's approval of the use of agents (at p. 19):

> The World Bank suggests that it may be helpful for a consultant operating in a foreign country to employ a local representative who knows the country and can keep the consultant informed, particularly in the early stages of a project cycle when most consultancy business occurs. Detailed information concerning the World Bank's approach to RAs [representative agreements with agents] was not placed before us. It obviously does not envisage the RAs being used for improper or unlawful purposes. But the potential for abuse, without proper control being exercised, is very real and, on the evidence, not unknown. Whether in a particular case a RA was intended for unlawful purposes, and put to unlawful use, is a matter for evidence and/or inference given the circumstances of that case. In short, a RA cannot simply be taken at face value.

As to steps that contractors can take to ensure that the agent does not act corruptly, the Lesotho Court of Appeal in the Acres case offered the following "advice" (p. 38):

> The genuineness of the agency contract would be best evidenced by proof that the services to be delivered by this mandate:
>
> (i) Were genuinely required by the consultant concerned;
>
> (ii) Could be delivered by the representative;
>
> (iii) Were in fact delivered; and
>
> (iv) Generated remuneration that was commensurate with the anticipated and the actual service delivery.

This, with respect, amounts to no more than common sense and the fact that contractors and consultants do not take such basic precautionary steps when engaging agents tends to militate against their professed good faith. In our prosecutions none of the consultants/contractors put up any invoicing, memos, faxes, correspondence or any other evidence pointing to a *bona fide* relationship with the agent.

In addition to the Court's above sentiments, it is suggested that the World Bank make greater use of the contractual provisions that entitle the beneficiary of World Bank funding to audit the entity that it is contracted with. These prosecutions have shown that the bribe in engineering/consulting contracts is normally built into the mark-up factor. That is one of the things that such an audit would then focus on. This in turn would assist in the prosecution in that prosecutors have great difficulties otherwise in obtaining access to company records.

Other Observations

There is one big difference between prosecuting a natural person and prosecuting a company and that relates to punishment. A company cannot be sent to prison and neither does it suffer the social stigma of a conviction. The best the courts can do is to impose a fine which in most cases the company involved can easily pay out of it profits.

Or the company simply does not pay the fine, as is the case with Acres which still owes a large portion of the fine which was imposed. Here the difficulty is that criminal sanctions (which fines are) are normally not enforceable in other countries. What the solution here is I do not know but something must be done to ensure that companies cannot simply walk away.

Another problem here is companies changing their corporate structure through for instance mergers in order to escape prosecutions. This practice also needs to be looked at. This the Italian authorities have indeed done by making the take-over company also criminally responsible for the acts of its predecessor.

The real punishment is sanctions by the international donor/lending agencies. By taking away the contractor/consultant's means of livelihood is the only real punishment which would match for instance the taking away of a natural person's liberty. Despite a somewhat inauspicious start, the World Bank seems to now be acting firmly against firms involved, starting with Acres. This is to be welcomed and hopefully the EU will follow suit.

Corruption has both a supply and demand side and in a country like Lesotho where international contractors/consultants are involved it is from the vantage point of the recipient of the bribe that one is able to view matters. This brings about obvious problems when having to deal with the payers of the bribes, such as bringing them before court and obtaining evidence from the countries where they are based.

Overseas prosecutions could then focus on the supply side. Countries on the demand side, such as Lesotho, could then obviously assist and it would then not be necessary for for instance Lesotho to also seek to prosecute the alleged payers. (Clearly when you prosecute the one you must also prosecute the other. As the Lesotho Attorney General is apt to say, "it takes two to tango.") Similar help could then also be extended in the other direction. This is what is already happening with OLAF.

The CHAIRMAN. Thank you very much, Mr. Penzhorn, for coming to our hearing today and offering that extraordinary insight from your experiences as a prosecutor in South Africa.

I want to call now upon Ms. Kimberly Ann Elliott. She is with the Institute for International Economics as a research fellow. Please proceed, Ms. Elliott.

STATEMENT OF KIMBERLY ANN ELLIOTT, RESEARCH FELLOW, THE INSTITUTE FOR INTERNATIONAL ECONOMICS

Ms. ELLIOTT. Thank you, Mr. Chairman, and thank you for inviting me to address you on this important topic. It's a striking contrast to just a decade ago that it's no longer necessary to begin such a statement by arguing that corruption impedes economic development and that addressing it should be a priority in international efforts to combat poverty.

Despite the change in attitudes, however, corruption does remain a serious problem, and I commend you and the committee for focusing attention on the important role that the multilateral development banks should and do play in combating in.

In assessing the performance of the development banks, I'd like to begin with three contextual issues. First, as others have emphasized, I think it is important to recognize that substantial progress has been made over the past decade in combating corruption. The MDBs have beefed up internal controls to prevent corruption in projects they finance, and more importantly, they now explicitly address corruption and governance issues as impediments to development.

Second, there's no excuse for the MDBs taking so long to confront corruption, but these institutions do operate in an environment that is influenced by the broader political and foreign policy priorities of major donor countries. During the Cold War, security concerns often trumped development objectives, and there is a risk of that happening again as part of the war on terrorism.

Finally, as Mr. Thornburgh mentioned in his testimony with respect to the triage approach to investigating cases, a zero tolerance approach to corruption is appropriate for framing institutional attitudes towards corruption, but it is also important to remember that efforts to control corruption divert time, money, and resources from other priorities. Rigorous cost benefit analysis, as Mr. Thornburgh suggested, is as appropriate for anti-corruption policies as it is in other areas.

Though not perfect, improvements in internal controls do appear to have been relatively effective in preventing large scale corruption in projects that development banks directly fund. The World Bank does appear to be ahead of the regional development banks in some areas, and the U.S. Treasury should continue, as Dr. Taylor emphasized this morning, to push for improvements in the other regional development banks, for example, mutual recognition of blacklists of firms involved in bid rigging. Perhaps the MDBs should also consider extending their procurement rules and disclosure requirements to parts of projects they don't directly fund.

But as you noted earlier, Mr. Chairman, procurement reforms may work less well for non-project lending or for smaller community-based projects, like building schools or health clinics. In these cases, competitive bidding, if possible, rigorous auditing, and other technical safeguards are still important. But the ultimate effectiveness of such projects depends on local stakeholders being able to monitor officials and hold them accountable for delivering services as promised. For example, Dr. Taylor mentioned the case of the PTA scrutinizing a local school and ensuring that books and other supplies were delivered as promised.

Enhancing accountability means having maximum transparency in government operations, independent media to uncover and disseminate information, organized civil society groups like the PTA. The World Bank has improved its disclosure policies and has implemented programs in some countries to strengthen the local media. It is also doing more to consult with local groups about its projects. Such consultations are typically focused on ensuring that local stakeholders support projects, but they should also be explicitly geared to transmit information about projects, to facilitate monitoring by local groups, and to provide mechanisms for feedback on potential corruption in projects.

In some countries, however, even the best safeguards will not be enough. Earlier this year, my colleague, Steven Radelet, testified before the House International Relations Committee on the need for a more comprehensive and coherent U.S. foreign assistance strategy. Among other things, he recommended that how well a country is governed and how effective its institutions are should determine the amount of money for which it is eligible and the discretion that the government is allowed in deciding how to spend it. Poorly governed countries then would receive relatively less money,

directed to particular agencies that have demonstrated effectiveness in the past, and mostly for specific projects with intensive monitoring. If the corruption risks are unacceptably high and cannot be mitigated, then the only option is to not lend.

The regional MDBs and the World Bank have been more selective in their lending decisions in recent years, but the World Bank's operations evaluation department just recently released its annual report and concluded that the World Bank could do even more in terms of selectivity.

Finally, the highest level of selectivity is needed in the energy and mining sectors. Extensive research has shown that countries rich in natural resources, if they also have weak political and social institutions, often do not develop economically and have high levels of poverty.

Recognizing these problems, the World Bank Group recently commissioned an independent review of its lending for extractive industry projects. In a draft response to that review, bank management promises to better assess corruption risks before providing support, to be more selective in lending to high-risk countries, and to require transparency in relation to the revenue from these projects as a condition for lending.

The bank's strategy depends crucially on the effectiveness of its anti-corruption mechanisms, and the results of its efforts to make the Chad-Cameroon pipeline project a model will be an important test of whether transparency and revenue control measures can be effective in controlling resource corruption in poorly-governed countries.

In addition to this, a Center for Global Development-sponsored Commission on Weak States recently recommended that the Treasury could play a role in coordinating with other U.S. Government agencies to ensure that our policies do not undercut any reforms adopted by the multilateral development banks in the area of extractive industries, for example, by requiring disclosure for Ex-Im Bank and OPIC funding.

To close then, the multilateral development banks have taken important steps to ensure that project funding is not diverted for corrupt purposes and to promote anti-corruption reforms in vulnerable countries. The U.S. Treasury should continue pressing the regional development banks to match the more far-reaching reforms of the World Bank, should support more ongoing independent evaluations of the effectiveness of bank lending, as Dr. Taylor mentioned, and take steps to ensure that U.S. Government support for extractive industries does not undermine efforts to increase transparency and improve governance in resource-dependent countries. Thank you, Mr. Chairman.

[The prepared statement of Ms. Elliott follows:]

PREPARED STATEMENT OF KIMBERLY ANN ELLIOTT

COMBATING CORRUPTION IN THE MULTILATERAL DEVELOPMENT BANKS

Chairman Lugar, Members of the Committee, I would like to thank you for inviting me to address the Committee on this important topic. In contrast to just a decade ago, it is no longer necessary to make the argument that corruption impedes economic development in many poor countries and that addressing it should be a priority in international efforts to combat poverty. Despite the change in attitudes,

however, corruption remains a serious problem, and the Committee is to be commended for focusing attention on the important roll that the multilateral development banks (MDBs) should play in combating corruption. I would like to begin by discussing the broader context in which assessments of that role should be placed. I will then discuss how different approaches could be tailored to different categories of lending and to different types of countries and conclude with some comments on the special problems related to extractive industries.

Assessing Multilateral Development Bank Performance on Corruption Issues

Since President Wolfensohn's 1996 speech emphasizing the need for the international development community to address the "cancer of corruption," substantial progress has been made in raising the profile of the issue and in developing strategies to combat it. The MDBs, led by the World Bank, have beefed up internal controls to prevent corruption in projects they finance, and, more significantly, they now explicitly address corruption and governance issues as impediments to development at the country level. Thus, estimates of how many billions of dollars have been lost to corruption since the World Bank was created must be adjusted to reflect more recent experience.

In addition, while the MDBs should not be excused for taking so long to confront corruption, these institutions operate in an environment that is influenced by the broader political and foreign policy priorities of major donor countries. During the Cold War, security concerns often trumped development objectives. For example, it was no secret that Zaire was pervasively corrupt in the 1980s under the leadership of Mobutu Sese Seko. But U.S. policymakers at the time were more concerned about maintaining Mobutu's cooperation against the Soviet Union and access to strategic resources in Zaire than they were about corruption or economic development.[1]

Since September 11, 2001, there is more recognition that economic development often is a security objective and that poorly governed and failed states can provide a haven for terrorists. Still, there is some fear that corruption and broader governance concerns are once again being put aside in some cases as part of the war on terror and that pressures are being brought to bear on the international financial institutions to lend to certain countries for foreign policy purposes, regardless of the likely development effects.

Finally, in assessing the MDBs' performance in combating corruption, there is a question as to the appropriate standard against which to measure progress. World Bank officials, as well as outside observers, frequently speak of a zero tolerance approach to corruption. This is appropriate for framing institutional attitudes towards corruption, particularly given the MDBs' past failures. But cost-benefit analysis should be applied to anti-corruption policies, just as it is to policies in other areas. This is not intended to revive the old arguments that some forms of corruption—for example, "greasing the wheels" of an unwieldy bureaucracy—are beneficial. (No one taking that position has ever explained how a political and social environment that permits "efficient" corruption can be structured to prevent other more pernicious forms also developing.) But it is also important to keep in mind that controlling and reducing corruption requires time, money, and other scarce resources that cannot be used for other priorities.

Addressing Vulnerabilities in Different Types of Lending and Countries

Despite the gains made over the past decade, corruption remains a serious problem in many countries where the MDBs operate. Much of the testimony presented to the committee in May noted this as well and emphasized that the opportunities for corruption, and for controlling it, differ by type of lending and by sector. Corruption related to non-project lending is harder to detect and to control than corruption in projects that the MDBs directly fund and oversee. More broadly, corruption will inevitably be harder to control in countries with weak institutions and governments that are able to avoid transparency and accountability to the public.

Although not perfect, improvements in internal controls appear to have been relatively effective in preventing large-scale corruption in projects that the MDBs directly fund. The World Bank generally requires international competitive bidding and has changed bidding documents to beef up anti-corruption provisions. It now posts on its website a list of firms that have been blacklisted because of corruption,

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[1] Several years ago, the *Financial Times* (May 12, 1996, p. 1) published a detailed report estimating that the International Monetary Fund, under pressure from the U.S. government and other western donors, lent Zaire more than $1 billion after a senior official warned that much of the money was being wasted through corruption (cited in Kimberly Ann Elliott, "Corruption as an International Policy Problem: Overview and Recommendations," p. 214, in *Corruption and the Global Economy,* edited by Kimberly Ann Elliott, Washington: Institute for International Economics, 1997).

and it has created hotlines for reporting corruption and whistleblower protections for staff who want to report corruption. The World Bank is often ahead of the regional development banks, however, the U.S. Treasury should push for further harmonization of anti-corruption procurement policies—for example, mutual recognition of blacklists. For large projects, exceptions to international competitive bidding should be rare and fully explained with as much disclosure as possible.

Thus, a great deal has been done to guard against corruption in project lending, and most analysts conclude that it is relatively rare in parts of projects that the MDBs directly fund. On many projects, however, the Banks provide only a fraction of the overall funding, and they do not monitor procurements for portions of projects that do not use MDB funds. But corruption anywhere in a project can undermine the effectiveness or raise its costs, so it makes sense for the MDBs to require competitive bidding and transparency in all parts of projects for which they provide even partial funding. To be effective, however, such a policy change would have to be coordinated with official export credit and investment insurance agencies in the United States and other OECD countries.

But these procurement safeguards may work less well for smaller, community-based projects, such as building schools, health clinics, or roads, where there may be fewer bidders in the initial construction phase and where ultimate effectiveness depends on ongoing monitoring to ensure that teachers show up and are qualified, that drugs and other supplies are not stolen, and that maintenance is adequate. In these cases, transparency in the procurement process, rigorous auditing, whistleblower protection, and other safeguards are still essential. But it is also crucial to engage local stakeholders to do ongoing monitoring and to hold officials accountable for delivering services as promised.

But in some countries, even the best safeguards may not be enough. Earlier this year, my colleague, Steven Radelet, testified before the House International Relations Committee on the need for further reform of bilateral development assistance to make it more effective in achieving U.S. goals.[2] In discussing the need for a more comprehensive and coherent foreign assistance strategy, he recommended that the government develop different approaches for different types of countries. In essence, he argued that how well governed a country is and how effective its institutions are should determine the amount of money for which it is eligible and the discretion that the government is allowed in deciding how to spend it.

Thus, high-performing countries, such as those that have qualified for the new Millennium Challenge Account, should receive more funding, most in the form of non-project lending and principally allocated to the central government. The client government would be responsible for demonstrating that the money was effectively used but would also have broad discretion in setting priorities and allocating the money accordingly.

Low-performing countries would receive fewer dollars, most of it for specific projects with intensive monitoring and directed to particular agencies that have demonstrated effectiveness in development projects. In the context of U.S. aid, Radelet recommends that in cases where the corruption risks of dealing with the government cannot be mitigated, aid should be channeled through non-governmental organizations. The only option in cases where corruption risks are unacceptably high is to avoid lending. The World Bank has already moved in the direction of more selectivity in its lending, but the Operations Evaluation Department just released its report on "development effectiveness" recommending that the Bank could do more.[3]

At the same time, the development banks have also increased the share of loans going to public-sector institutional reform in countries with weak governance. The World Bank website notes that "more than 40 percent of the Bank's lending operations now include public-sector governance components." In some cases the World Bank has also conditioned non-project lending on specific reforms, such as the creation of anti-corruption commissions or agencies. But externally imposed anti-corruption conditions are unlikely to be effective in situations where the political will to adopt fundamental reforms is weak or absent. Recent research by the World Bank's chief corruption expert, Daniel Kaufmann, also finds that narrow civil service and technocratic reforms have yielded relatively little in the battle against corruption. Kaufmann concludes that reforms should, instead, focus on "*external* accountability mechanisms, with new participatory approaches, providing voice and

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[2] "U.S. Foreign Assistance after September 11th," Testimony for the House International Relations Committee, February 26, 2004.

[3] World Bank, Operations Evaluation Department, 2003 Annual Review of Development Effectiveness, Washington, 2004.

feedback mechanisms to stakeholders outside the executive . . .'' (emphasis in original).[4]

Such external accountability mechanisms depend on maximum transparency in government operations, an independent media to uncover and disseminate important information, and organized civil society groups. The World Bank has implemented programs in some countries to strengthen the local media, and it is doing more than previously to consult with local groups that will be affected by its projects. Such consultations are typically focused on ensuring that local stakeholders support projects in their area, but they would also be useful in transmitting information about projects, facilitating monitoring by local groups, and providing mechanisms for feedback on potential corruption in projects, as well as other aspects of effectiveness. Kaufmann also recommends that the Bank develop ''citizen scorecards'' to help in the evaluation of projects and notes that ''Transparency-enhancing mechanisms involving a multitude of stakeholders throughout society can be thought of as creating millions of 'auditors' '' (ibid., p. 35).

The Special Problem of Extractive Industries

Finally, extensive research has shown that countries rich in natural resources, if they also have weak political and social institutions, often have poor growth and development outcomes and high levels of poverty. In these cases, corrupt governments often collude with corrupt investors, bankers, and other private sector actors to steal the proceeds of extractive industries, rather than investing them in the country's development. In many countries, weak governance and inadequate oversight by external funders have meant that publicly financed projects in extractive industries have led to environmental degradation, social problems, such as AIDS, and, in all too many cases, human rights violations and violent conflict to gain control over resources.

Recognizing these problems, the World Bank Group recently undertook a review of its lending for extractive industry projects, including creating an independent ''stakeholder consultation process,'' headed by the former Minister for Population and Environment from Indonesia. In part out of concern over global warming and other environmental problems associated with carbon fuels, and in part because of the well-documented problems in controlling corruption in extractive industries, the independent Extractive Industries Review (EIR) recommended that the Bank sharply reduce its lending for oil and gas, as it has already done for coal, and increase lending for investment in renewable energy sources (www.eireview.org).

In the draft response to the EIR, which has been released for public comment before presentation to the Board of Executive Directors, the Bank management promises to better assess the corruption risks before it provides support for extractive industries, to be more selective in lending to countries ''where the risks are deemed too great and cannot be mitigated,'' and to require transparency in relation to the revenue from these projects as a condition for lending. But, while Bank management accepted the EIR recommendations on selectivity, it rejected the recommendation to completely phase out support for oil production by 2008 for environmental reasons. But the Bank's strategy of continuing to finance such projects in resource-dependent countries depends crucially on the effectiveness of the mechanisms to guard against corruption. The success of the World Bank-supported Chad-Cameroon pipeline project will be an important test of whether transparency and intrusive resource revenue controls can be effective in controlling corruption in poorly governed countries. Careful evaluation of the results of this project should guide future decision-making in this area.

In addition, MDB policies in relation to extractive industries need to be coordinated with and supported by bilateral official credit and insurance agencies. The Commission on Weak States and U.S. National Security, sponsored by the Center for Global Development (CGD), recently recommended that the U.S. government take steps to ensure that Export-Import Bank and OPIC support for extractive industries be linked to transparency conditions. The Commission recommended specifically that the National Security Council should:

> . . . broker an interagency agreement that outlines basic principles of transparency and accountability in the handling of natural resource revenues that must be met by governments before the U.S. supports public-sector financing of extractive industry projects.[5]

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[4] Daniel Kaufmann, ''Rethinking Governance: Empirical Lessons Challenge Orthodoxy,'' Discussion Draft, World Bank, March 11, 2003.

[5] Commission on Weak States and U.S. National Security, *On the Brink,* Washington: Center for Global Development, 2004, p. 56.

The Commission recommends that the Treasury Department have responsibility for overseeing the implementation of this agreement.

For countries with extractive industries that do not need public financing, the report recommends that the Treasury Department coordinate an interagency review of the options for regulating multinational corporate payments to such countries. In particular, the Commission proposes giving "serious consideration" to the recommendations of the publish-what-you-pay campaign to have developed-country stock market regulators require full disclosure as a condition of being listed (ibid., p. 57). The U.S. Treasury and State Department could also do more to support British Prime Minister Tony Blair's Extractive Industries Transparency Initiative, which the World Bank Group has already endorsed.

Conclusions

In sum, the World Bank Group has taken important steps to ensure that project funding is not diverted for corrupt purposes, but continued vigilance is essential and some further improvements in transparency and accountability of Bank operations would be useful. The U.S. Treasury needs to continue pressuring the regional development banks to adopt similar reforms where they have not and use the U.S. voice and vote to ensure that increased selectivity in lending is used where anti-corruption safeguards are unlikely to be effective. The Treasury should also ensure that the development banks do more thorough and rigorous analysis of the effectiveness of various institutional and governance reforms they support. As recommended by the CGD-sponsored Commission on Weak States, the Treasury should also take steps to ensure that U.S. government support for extractive industries does not undermine efforts to increase transparency and improve governance in resource-dependent countries.

Mr. Chairman, Members of the Committee, I thank you for the opportunity to be heard on this important topic and look forward to your questions.

The CHAIRMAN. Thank you very much, Ms. Elliott. Let me begin questioning just by clarifying in my own mind, Mr. Penzhorn, exactly what happened in Lesotho. Essentially, are you saying that the agents for major firms offered money? In other words, they attempted to compromise officials in the Lesotho Government? And if so, how did all this come to public scrutiny? Who blew the whistle, and why was there a prosecution?

Mr. PENZHORN. Mr. Chairman, how this came about is that the chief executive of the project was disciplined and dismissed after an audit by Ernst & Young that discovered certain irregularities. He was then taken to court civilly and in the civil process it was discovered that he had bank accounts in South Africa, which in turn showed payments from Switzerland. An application was then made to the Swiss for these bank records, and these records then showed an elaborate system of payments by the contractors/consultants on the water project to middlemen in Switzerland, and then payment by those middlemen to the chief executive, also in Switzerland, and he then brought the money back to South Africa. So there was no whistleblower.

The case rested basically on those bank accounts, and it was simply that as a basis that formed part of the other evidential material. For instance, why would you use a Swiss bank account to pay this particular agent while you're paying your subcontractors in South Africa? Why didn't you tell anybody else that this man was your agent? Why was it never discovered, and so on? And it was this web of circumstantial evidence that made the case against the chief executive.

The companies came along and the companies all said, he was our agent, we trusted him, we vetted the agent, he was a very well-known man. In the case of Acres, for instance, he was Canada's honorary counsel in Lesotho. So we all trusted this man. But the

incontrovertible fact is that they paid him certain amounts of money over a period of time, which he then shared with the chief executive of the water project. Acres, for instance, said—I'm simply using Acres as an example—they said, show us anywhere where the tendering procedures were violated, show us anywhere that we didn't get the contract on merit. Now, we were not in a position to do so. We said, well, we assume you got the contract on merit, the same with Lahmeyer. But the fact of the matter is, you paid that person, he paid the chief executive, what on earth were you paying him for if not for him to help you in some way?

Then the question arose, how did he help us? We simply don't know. All we know is that the moment you pay a chief executive like that, you are undermining his ability to exercise an independent discretion, and that's corruption. And that is the level at which we proved our cases, and we proved it on the basis of circumstantial evidence, and I suggest to you circumstantial evidence that would be acceptable in any court in the United States.

The CHAIRMAN. Well, you've described a very sophisticated process. We of started this morning with the discussion with our own United States Treasury and their oversight. We then proceeded with Mr. Thornburgh's testimony about reforms that he and his associates have suggested to the World Bank, and which they have adopted. One of them is the debarment of companies.

But in this particular case, do you believe, Mr. Penzhorn, that the World Bank moved rapidly enough to debar the companies involved? On what basis would they have known all that you have found out through circumstantial evidence?

Mr. PENZHORN. Mr. Chairman, the World Bank took the information that it had at its disposal—I'm speaking as an outsider, this is what I understand happened—and the information at its disposal was supply-side information. It was the information that they had, the procurement process, et cetera, and what, of course, Acres and Lahmeyer and the other companies told it. And on the basis of that evidence, I'm not surprised that they were not able to come to a finding that there was indeed corruption, because the explanations given by these companies sounded reasonable.

It is from our vantage point where we were on the ground that we were able to establish all these other circumstantial facts, that together with what the World Bank already knew, could make then a conclusive case. And that probably is, and I was not party to the second hearing of Acres, that probably is then what persuaded, if it did persuade, the sanctions committee, because—and that is the sort of cooperation that we're talking about. In other words, we can do the work perfectly satisfactorily on the ground in Lesotho and in South Africa, we can prosecute the people there.

So from our vantage point it's not a question of strengthening the process, strengthening the transparency of the process and so on. This was all done in a perfectly transparent process. But running parallel to this transparent process, there was this separate agreement with this agent that would give you a second bite, as it were, at the chief executive around the tendering process. So from our vantage point, to strengthen the procedures and transparency and so on is not really the point. From our vantage point, it is simply

what that agent does, and it all goes back to that agent or that middleman.

The CHAIRMAN. What you have suggested, however, is that this was an expensive process for Lesotho. The World Bank did not assist with the financial problems that were involved in prosecution. This situation involved a developing country with vast problems. You cited the horrors of the HIV/AIDS pandemic. They would be sorely tempted to use the money for those purposes, as opposed to establishing an anti-corruption ethic.

Attorney General Thornburgh, can you give us any thoughts as to what thinking in the World Bank has proceeded with regard to the financing on the part of developing countries that are very poor, and yet whose skills, with regard to prosecution in these situations, may be critical to the whole process?

Mr. THORNBURGH. There is a general commitment within the Bank to supporting the strengthening of the rule of law and the independence of courts and the professionalism of prosecutors through program grants that are made by the Bank. But to my knowledge, I know of no discussion that has taken place with regard to the funding of individual investigations and prosecutions. But that may be true, it's just something I'm not aware of.

The CHAIRMAN. Do you agree that it is a consideration that the Bank ought to be thinking about?

Mr. THORNBURGH. It's an enormous problem, and I think one of the things that's peculiar in my understanding of the Lesotho case was that it kind of proceeded in reverse fashion. What generally is contemplated within the Bank is that they will develop a sufficient case to apply sanctions and then refer that to the particular country. To the credit of Lesotho authorities, they got ahead of the Bank and in fact outstripped the Bank in pursuing this, but it was of necessity at their own expense.

The CHAIRMAN. This is an important story because, as Mr. Penzhorn has pointed out, the normal process didn't happen. It worked the other way around in terms of supply and demand. I suppose this is perhaps always the case, as you get into discovery of how the world works. The dilemma, leaving aside Lesotho, is probably going to be there for a number of other countries, that may decide that this is simply not worth the time and trouble and the alienation of others who may be helpful, in terms of national objectives.

That's why I raise the question, maybe for some additional thought, as you counsel the World Bank. Let me just indicate that you've proceeded, I think, very comprehensively through the three reports. You have likewise stated that the World Bank adopted the recommendations in the reports. This therefore, I suppose, negates a question that I would have had, and that is, should the United States Government and our Treasury Department do more to encourage the steps to be taken? I gather you're indicating that the World Bank has already implemented all the steps you have advised at this point.

Mr. THORNBURGH. That's my understanding.

The CHAIRMAN. So it's a question now, I suppose, of witnessing the experience of how well those recommendations that have come

from the three reports work. Are you continuing your work with the World Bank, or are you of counsel to them?

Mr. THORNBURGH. I have no present connection with the World Bank. We completed our reports and we regard our engagement having been completed with the adoption of those reports. As I said at the outset, we have not been consultants on particular cases or on particular procedures. We were to take a look from a fresh vantage point of how their operations were proceeding and to make such recommendations as we felt might improve them.

The CHAIRMAN. Ms. Elliott, as an independent viewer of all of this, what is your judgment or those of your associates? Have you looked at this, as to how well each of the parties we've been talking about today are proceeding, and what more could they do to address the questions with regard to the Treasury Department, the Congress, and the World Bank? We've had some testimony, some question and answer with regard to the responsibilities of all three of these entities.

Ms. ELLIOTT. Well, my impression from my own research, from reading the other testimony that you've heard, and talking to colleagues, is that the problem with respect to bank procurement is relatively limited because of the various reforms, because of the work that Mr. Thornburgh and others have done, and while there is still more that can be done, that that's really not where the problem is. It's the problem of countries that are desperately poor that do need help but that don't have the internal mechanisms to deal with corruption, the sort of judicial system that Lesotho did have and was able to use to prosecute these things. A lot of countries don't have the will to even begin to prosecute, and that's really the problem—how do you deal with these countries?

And that is something where I think the Banks and the Treasury and with Congress' support are pushing in the direction of more selectivity. But you don't want to abandon countries, because you're abandoning people who are not to blame for the sins of their government. There is a need to try and find ways of either targeted lending that can be put behind a corruption-safe fence if possible. But there is also a need to work on—and there's some excellent research on this by Daniel Kaufmann at the World Bank—on external accountability measures, and Kaufmann doesn't mean by external, the international community, but he means going beyond narrow, technical, civil service reforms within governments to reforms that empower people to be able to monitor their governments and to be able to hold them accountable. And in the worst countries, that's not easy, and you have to have at least the acquiescence, if not the full support, of the government in those cases.

I think it's those broader issues where we need to have some more focus and some more creative thinking.

The CHAIRMAN. You make a very interesting point that I'll just follow for a second. Clearly in our work in the Congress, following the leadership of the President's proposal on the Millennium Challenge Account idea, the thought was that American foreign assistance by and large should go to countries that have adequate controls against corruption, and that have at least some democracy-building elements in them, even if they have not yet come to fulfill-

ment of all of that, as well as respect for human rights and some additional things that we believe are very important to support.

Sixteen countries have been nominated to come to the United States Government with proposals for the expenditure of money, not unlike the procedures of countries coming to the international institutions. But we've already drawn up a pretty rigorous set of requirements. Only 16 countries are going to be involved. We must consider the humanitarian person who comes into the committee and says, well, what about the other 147 or so that are eligible right now with the international banks, what happens to them? It is a very good question.

You can say, well, what happens to them is that they had better get their act cleaned up, get institutions there that don't have corruption, and get the authoritarianism out of their governments, as well as the scandals with regard to human rights and so forth. Easier said than done. For many citizens suffering in those regimes already, this becomes a very poignant dilemma.

So there's sympathy, I think, on the part of all of us for the problems of the international banks, because they are tackling 100 countries or more that are sort of beyond the pale of what we feel we can devote our taxpayer funds to, in terms of foreign assistance.

Having said that, however, it doesn't absolve all of us from the thought that we're making, as a country, contributions to these banks. Those funds are being utilized, along with those of others. They are being leveraged a great deal. So the question is, even if people don't measure up to our Millennium Challenge standards, what kind of standards can we try to bring about and enforce? How do we get cooperation from other nations? How do we share equitably, as in the case of Mr. Penzhorn's situation, with a very poor country that was trying to do a very good job, but became poorer in the process, having proved that at least they were able to fight corruption? I know you have a thought, Mr. Thornburgh.

Mr. THORNBURGH. I just wanted to take note of the sea change that's occurred in international attitudes toward this problem over the last 25 years. It is now an item, the problem of corruption is now an item that's center stage on the international agenda. I well remember when I came to the Department of Justice to head the criminal division in the 1970s was the very first encounter we'd had with this phenomenon in the Lockheed cases and the prosecution that took place of American corporations for making bribes abroad, followed by the enactment of the Foreign Corrupt Practices Act, which in many quarters around the world made us laughingstocks, that people thought that the FCPA was simply an attempt to impose American morality on business practices around the world. Many countries, as you know, allowed bribes to be deducted from their taxable income at that time.

When I came back as Attorney General in 1988, one of my first assignments was to go to Zurich and to meet with the leaders of the Swiss banks about more transparency and openness and following that paper trail that has been described so aptly in the Lesotho case. Once again, it was an attitude of derision and kind of condescension toward what we were trying to get done.

During the ensuing decade, however, extraordinary things have happened. We now have a UN Convention on Corruption. We have

the UN creating its own internal operation, which I recommended to them a decade ago, the World Bank beefing up their capability, the OAS having a convention, the European community having its own.

The stage is set for some real breakthroughs in this area, and it's the kind of problems that the chairman has suggested, the sophisticated problems that are going to have to require some further attention, and I commend you for putting those on the agenda, because it's the issues of implementation of all of these high-sounding conventions and plans and what-have-you that's going to occupy true center stage in this new century. And I hope that you and your colleagues persist in monitoring this and making the kinds of suggestions that can help countries rid themselves of the scourge of corruption.

The CHAIRMAN. I thank you for that institutional history, which is really very important. I remember vividly as a junior member of the Banking Committee in 1977, Senator Proxmire of Wisconsin was our chairman and Jake Garn of Utah our ranking member. We were trying to wrestle with problems that American business persons were having because they felt that our efforts at morality around the world were cutting them out of business. They simply came in to point that other competitors did not have any fastidious ideas about paying bribes. They routinely added these to their proposals. As a matter of fact, suddenly the fact that we were going to have criminal prosecutions in the United States because our business people were bribing people seemed to be grossly unfair.

Now, that is barely a quarter of a century or so ago. I trust there are still some people who feel that that's still unfair, and that bribery does go on, and that they are still disadvantaged in the international markets. But I would say that this is one reason why the work of this committee, the Banking Committee, and others in the Congress who have taken up this issue, is important. It provides reassurance to our own community that in fact the world is now working in a different way, and that the international community has been moving in the direction of integrity. This is certainly reassuring to poor people in these countries. One of the greatest problems we have in public diplomacy is often the feeling that we are feathering the nests of the rich and not really aware of what is occurring at the grassroots.

I appreciate the testimony of all three of you, and likewise your patience in going through a very unusual hearing schedule. You've proceeded with equanimity and with wisdom.

We thank you, and the hearing is adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

APPENDIX

RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED FOR THE RECORD BY THE COMMITTEE

RESPONSES TO QUESTIONS FOR THE RECORD SUBMITTED TO SECRETARY TAYLOR BY CHAIRMAN RICHARD LUGAR

Question. When allegations of corruption related to the MDBs are forwarded to Treasury, you noted that Treasury typically forwards the allegations to the U.S. Executive Directors at the relevant MDBs? What follow-up is done by Treasury to ensure bank's diligence in pursuing the specific allegation? Since the Treasury Inspector General is not investigating fraud and corruption related to the MDBs, what part of the administration is?

Answer. If an allegation were to involve a contractor, supplier, or consultant on an MDB financed contract or an MDB staff member, Treasury staff, in coordination with the USED office, would report the allegation to the institution through the Office of the U.S. Executive Director and inform the Treasury Department's Office of the General Counsel of it. The Treasury Department would, through the Office of the U.S. Executive Director, monitor the process, while maintaining sufficient distance from the investigation so as not to interfere, or be perceived to be interfering, in the process. If the allegation were to involve someone in the Office of the U.S. Executive Director, Treasury staff would report the matter to Treasury's Office of the General Counsel.

With respect to fraud and corruption related to the MDBs, as stated in the July 21 testimony before the Senate Foreign Relations Committee, we at the U.S. Treasury monitor the MDBs through a variety of practices and processes. On a regular basis we work with the U.S. Executive Directors (USEDs) on their participation in Board policy discussions and with the managements of these institutions. With respect to corruption, we urge the institutions to establish policies and mechanisms to reduce the opportunities for corruption and to detect and punish corruption when it occurs. Treasury reviews all loans, grants, and policy proposals to make sure they include fiduciary safeguards and measurable results. It is the responsibility of the individual MDBs to investigate specific allegations of fraud and corruption and it is the responsibility of the Treasury Department, through the USED's offices, to work with other shareholders to see that the MDBs have systems in place to investigate such allegations.

Question. In the past three or four years, the number of people working on MDB issues at the U.S. Treasury Department has reportedly declined from about 50 to about 30. The United States is one of the few countries that routinely monitor MDB lending and MDB operations. All told, the MDBs employ close to 17,000 people and in 2003 they loaned nearly $44 billion to almost 150 countries. Does the Treasury Department have enough people to effectively oversee the MDB program and to assure that taxpayers' money is used effectively and proposed reforms are being implemented appropriately?

Answer. In fact the number of professional staff working on MDB issues has been on the increase in recent years. This number was about 18 in 1998, went to about 24 in 2001 and is expected to reach bout 27 by late fall 2004. This number does not include administrative staff and Deputy Assistant Secretary level officials who devote all or most of their time to MDB issues. In addition, it does not take into account the offices of the U.S. Executive Directors at the MDBs, which number more than 20 professionals, including USEDs and Alternates, all of whom monitor MDB lending and operations. The professional staff in the offices in Treasury covering regions of the world also review individual MDB operations for the countries they cover. Finally, Treasury chairs an interagency working group that also reviews MDB operations. Thus, Treasury, assisted by a number of others in the U.S. Gov-

ernment, has an efficient process to ensure the effectiveness of MDB operations—both individual loans and grants and policy proposals/reforms. However, due to the growing responsibilities of Treasury, additional professional staff are needed. To further improve our ability to ensure the highest quality of MDB operations, Treasury is increasingly working "upstream" to monitor proposed operations and strategies long before they come to the Board for formal approval.

Question. Currently, the multilateral banks do not disclose how much money has been disbursed for individual projects and programs. Hence it is very difficult for those outside the Banks to know whether projects and programs are being implemented successfully. Likewise, one cannot tell if money is being disbursed—perhaps for corrupt purposes—even though little is actually being done on the ground. The World Bank's Moscow office made disbursement information available on its web site in order to promote public trust and dispel charges of clandestine corruption. Do you believe that the MDBs should make this kind of information public regularly and routinely?

Answer. We support making disbursement information publicly available, with the exception of business sensitive information. In fact, both the World Bank and the Inter-American Development Bank make disbursement information publicly available on their websites on individual projects. We are currently working with our Executive Directors in the other MDBs to get them to implement similar disclosure practices. It is important to note that all the institutions have in place a variety of supervisory mechanisms and practices that are intended to prevent the fraudulent and corrupt use of MDB resources and ensure that money is spent for the purposes set out in the loan contract.

Question. The multilateral banks are often faulted for having a "loan approval culture" where staff is rewarded for the amount of money they move in new loans rather than the quality or effectiveness of the activities funded by those loans. Many argue that this leads to less emphasis on corruption control. Is this a fair criticism? If so, how do you think the MDBs should alter their internal staff incentives in order to lessen this problem?

Answer. Historically, there has been an institutional focus on lending volumes at the MDBs. However, this culture of lending has diminished in recent years largely as a result of concerted efforts by donors such as the United States to focus on delivering measurable results. For example, due to strong U.S. leadership, the IDA-13 replenishment agreement called for the development of a results measurement system. The Bush Administration is now working with other donors in the course of negotiating the various MDB replenishments to expand upon the important recent progress. Among other things, we are pressing for: (1) results frameworks for each project and program including specific, quantifiable indicators connected to a timeline with baseline data and periodic assessments of project and program performance; (2) standardized country indicators covering governance, human development and economic growth topics that will be used to monitor progress and assess achievement of results; and (3) a set of institutional-level indicators with results to be independently verified.

To further promote the development of a results-focused culture, we are also working in the course of negotiating the MDB replenishments to create a stronger link between MDB staff incentives and these efforts for broader and measurable results.

Question. What is your assessment of the magnitude of the corruption problem at the MDBs? How much MDB funding has been siphoned off due to fraud and corruption?

Answer. Corruption clearly reduces the effectiveness of countries' economic development and poverty reduction efforts through the diversion of scarce resources away from productive activities benefiting the poor. Consequently, the Bush administration does not tolerate any corrupt activities involving MDB projects. In an attempt to minimize these activities to the greatest extent possible, we are actively pursuing an ambitious anti-corruption and transparency agenda:

- At the institutional level, we focus on improving the functioning of the MDBs' internal control processes for preventing and responding to corruption and fraud.
- At the project level, we focus on encouraging the MDBs to conduct analysis and design projects and lending policies that help to reduce opportunities for corruption and ensure that funds will be well spent.

- At the country level, we are pushing for greater transparency and disclosure of MDB operations and analysis. This is something that we have worked hard on in concert with Congress.

This comprehensive agenda builds off the significant efforts already undertaken by the World Bank and other MDBs, which I elaborated upon during my recent testimony on corruption and the MDBs.

Question. Though borrowing countries bear the ultimate responsibility for MDB loans because they must repay the funds to the MDBs, not all borrowing country parliaments have oversight authority over MDB borrowing. Of the 147 countries eligible for WB lending, 77 of them require parliamentary approval of multilateral development bank loans or a ceiling within which the executive branch can accept loans. What, if anything, is the U.S. government doing to encourage borrowing countries to promote legislative oversight over MDB borrowing?

Answer. The U.S. government has pushed all the MDBs to consult with a wide range of "stakeholders" on proposed MDB policies and operations, based on evidence that such consultations have been shown to improve the quality of the policies and operations. This includes the legislative bodies in individual countries, as well as private sector representatives, local representative bodies, NGOs, academics and others. We have also consistently supported modernization of the state programs that aim to increase the effectiveness of the legislatures in developing countries. The U.S. government has not specifically urged borrowing countries to promote legislative oversight over MDB borrowing.

RESPONSES TO ADDITIONAL QUESTIONS FOR THE RECORD SUBMITTED TO SECRETARY TAYLOR BY SENATOR JOSEPH R. BIDEN, JR.

Question. Under Secretary Taylor, one project that has raised significant environmental and social concerns is the Camisea gas pipeline project in Peru. I am aware that the IDB is poised to move to final closure on the loan, and that officials from USAID and your department have been reviewing compliance with social and environmental loan conditions. What actions are you taking to ensure full compliance with all environmental and social loan conditions prior to financial closure?

Answer. My staff has reviewed the documentation provided by the IDB regarding compliance with the conditions precedent to loan closure. While there has been substantial progress on meeting these conditions, we are still working with IDB Management to resolve remaining issues. Since loan closure is not a subject for formal discussion by the Board of Directors, we will seek to address what we perceive as deficiencies in certain loan conditions on an informal basis.

Question. I also understand that the IDB is in the process of revising its 25-year-old environmental policy and that a draft of the new, proposed standards have been released for comment. What actions are you taking to support a thorough review of the IDB's core policies and the strengthening of the Bank's environmental and social standards? What actions are you taking to support that the new social and environmental policies will be in line, if not exceed, those of the IDB's peer institutions, such as the World Bank and the International Finance Corporation?

Answer. My staff is undertaking a process that seeks to shape both the draft environment and safeguard policy as well develop a U.S. position on the version that is presented to the IDB Board. As part of this process, we will solicit the views of other U.S. government agencies and civil society, as well as engage with Bank staff responsible for drafting the policy. We will also compare the draft proposed by the IDB with best international practices for public and private sector lending. Social and environmental policies of the World Bank and IFC, however, are themselves in flux and new policies at these institutions will not be finalized for several months.

ADDITIONAL INFORMATION SUBMITTED FOR THE RECORD

STATEMENT SUBMITTED BY THOMAS DEVINE, LEGAL DIRECTOR, GOVERNMENT ACCOUNTABILITY PROJECT

WHISTLEBLOWER PROTECTION POLICIES OF MULTILATERAL DEVELOPMENT BANKS

Thank you for considering written testimony by the Government Accountability Project (GAP) for this Committee's second hearing into corruption at the Multilateral Development Banks (MDBs). The Committee's leadership is badly needed for institutions that should be a cornerstone of civility, integrity and stable markets necessary for globalization to strengthen rather than destroy community development. Unfortunately, due to lack of internal checks and balances, secrecy and corruption, all too often the MDBs undermine their mission instead of serving it.

Over the last year the Ford Foundation commissioned GAP to conduct in-depth research on one key element of accountability at MDBs—the free flow of information from whistleblowers, those employees who exercise free speech rights to challenge abuses of power that betray the public trust. Unfortunately, our organization found that all of the MDB whistleblower policies flunk minimal standards of legitimacy, both in terms of providing a safe channel to bear witness, and having a realistic chance to make a difference against corruption. Our organization could not responsibly recommend that employees risk retaliation by trusting the current whistleblower policies as administered at any of the MDBs. That means the current programs are ineffective both inside and outside institutional walls at ending abuses of power sustained by secrecy, the breeding ground for corruption.

Our credentials for assessing whistleblower policies are grounded in some 27 years of experience. GAP is a nonprofit, public interest law firm dedicated to whistleblower advocacy. The organization's mission is to advance governmental and corporate accountability by promoting whistleblower rights, investigating their claims, litigating their cases, sharing our expertise through publications, and developing legislative and regulatory reforms. We have led the campaigns to enact or defend virtually all national whistleblower laws in the United States. On the international front, GAP works with national governmental bodies, and with colleagues from American University Law School co-authored a model whistleblower law approved by the Organization of American States to implement its Inter-American Convention Against Corruption.

The analysis below explains how whistleblower protection is relevant for the Committee's oversight, and summarizes our findings from the published studies already provided to Committee staff.

Relation to Hearing Testimony

At the July 21 hearing we were gratified that expert testimony generically highlighted that strengthened whistleblower protection means strengthened accountability. Four specific conclusions from that day's testimony further reinforce the importance of an active role by this Committee in achieving that goal.

- *Nearly all major reform recommendations to date have been implemented, but corruption is still a significant problem.* Whistleblowers are the human factor to provide the free flow of information that is the life-blood of anti-corruption campaigns. Without their active participation, the campaigns are lifeless, empty magnets for cynicism. The Banks badly need visible proof that employees who participate can safely make a difference. It will take breakthroughs of organizational leadership and structure before that kind of trust could be based in reality.
- *The Banks' progress against corruption must be assessed through objective, measurable results.* This conclusion applies with an exclamation point to the Banks' whistleblower policies. At every major institution, their track record at best is a secret. None of the institutions have published a track record detailing either (1) meaningful results when employees risk harassment to testify against corruption; or (2) a reasonable rate of alleged reprisal victims successfully defending their rights through MDB policies. Last year in the No Fear Act for U.S. agencies with merit system duties, Congress unanimously required transparency for results of employment discrimination and whistleblower protection programs. That basic "show me" principle needs to be extended to MDBs.
- *A major challenge for MDBs is corruption within member nations receiving Bank loans.* The risk of corruption is inherent to all institutions—government, corporate and even non-profit. Even the most vigilant institutions cannot effectively oversee all the potential opportunities for corruption, which are limited

only by the imagination. This is why GAP has urged the Banks to (1) extend their own whistleblower policies to cover anyone making disclosures about spending Bank funds throughout the life of a project, whether or not the whistleblower is a Bank employee; and (2) make effective whistleblower protection a precondition for receipt of MDB funding. Continued congressional leadership will be necessary to encourage this expansion of policies that too often only cover MDB employees challenging corruption that threatens institutional self-interest rather than the Banks' public service mission.

- *The Treasury Department Office of Inspector General does not believe it has jurisdiction to investigate fraud, waste of abuse of taxpayer funds appropriated for the Banks.* This accountability vacuum places increased responsibility on Congress and the Treasury Department's Office of Development Policy. Continuing, stepped up congressional oversight is badly needed, both to defend the taxpayers' investment generally, and to enforce the accountability reforms passed by Congress this January as appropriations requirements. The provision, known as the Leahy-McConnell amendment, requires:

  - greater transparency, from project preparation to publication of Board minutes;
  - resources and conditions in each loan and strategy to ensure that applicable laws are obeyed;
  - public summaries of independent audits of the institutions' operational effectiveness, policy compliance, and internal control mechanisms;
  - effective complaint mechanisms that also protect employee and other whistleblowers from retaliation, consistent with standards in national and international law;
  - website postings of case summaries resulting from internal corruption investigations;
  - reports by the Treasury Department to Congress on these and all other aspects of the section by September 1, 2004 and March 1, 2005; and
  - completion of listed goals by June 2005.

  (*Administrative Provisions Related to Multilateral Development Institutions,* Sec. 581, Title XV of the International Financial Institutions Act, 22 USC 262o–262o-2.)

Based on GAP's experience to date, there will be a direct relationship between the extent of Congress' oversight of Treasury on this issue, and the extent of Treasury's oversight of the Banks.

Overview Summary of GAP Findings

The GAP study was prepared by our MDB project team of John Fitzgerald, Charly Moore, Sophia Sahaf, myself and law students from the University of District of Columbia Law School who participate in our legal clinic. We found substantial deficiencies in each of these Banks' whistleblower protection policies, affording insufficient protection to those who seek to bring fraud, mismanagement or other wrongdoing to light to protect the institution's integrity. Notably, none of the Banks recognizes the concepts of external transparency or external accountability, extending whistleblower protections only to internal disclosures. At present, GAP would not recommend that whistleblowers risk retaliation by utilizing the existing procedures. Instead, GAP hopes to work constructively with the Banks in the coming months to address these deficiencies in order to improve transparency and accountability.

Whistleblowing: An Emerging Global Phenomenon

GAP has long defended U.S. whistleblowers who challenge abuses of power that betray the public trust. Now, whistleblower rights are an emerging global phenomenon. A human rights activist Helena Kennedy explained in her foreword to the 2004 book *Whistleblowing Around the World: Law, Culture and Practice,* "[B]oth culturally and legally, things are changing. Whistleblowing is coming of age. There is a growing recognition around the world that people who encounter corruption and wrongdoing must be given as safe an environment as possible, to be able to tell someone in authority what they know." *See also,* Vaughn et al., *The Whistleblower Statute Prepared for the Organization of American States and the Global Legal Revolution Protecting Whistleblowers,* 35 GEORGE WASHINGTON INTERNATIONAL LAW REVIEW 857 (2003).

Whistleblower protection provisions have become standard in anti-corruption conventions and treaties, such as those adopted by the United Nations, Organization of American States and the Council of Europe. As a leader in whistleblower advo-

cacy, GAP has witnessed an upsurge in international interest in whistleblowing as an integral transparency measure in recent years. Governmental organizations across the globe increasingly demonstrate their desire to work with those who have witnessed abuses of power, and are eager to learn how best to protect them from reprisal.

Strong whistleblower protection policies give those who bring corruption to light a fighting chance to defend themselves, and serve the Banks' institutional interest in preserving integrity. Weak policies, on the other hand, will cause many individuals to remain silent observers to corruption, and may actually harm some whistleblowers by creating a false impression of adequate protections. MDB whistleblower protection policies have particular significance, because the MDBs can set the pace for anti-corruption standards in loan recipient nations. Working with governments and national and international businesses to implement development projects, the Banks' influences are far reaching. Unfortunately, the Banks themselves remain a focal point of corruption investigations. During the initial May 2004 Senate Foreign Relations Committee hearings, Chairman Lugar estimated that the World Bank alone has lost $100 billion to corruption. These problems significantly impede the MDBs' ability to advance their humanitarian mission of promoting community development and economic self sufficiency in developing countries.

GAP's Methodology

This study covered policies at the World Bank (WBG), Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), and Inter-American Development Bank (IDB). The African Development Bank was not included, because it did not have completed accountability policies relevant for whistleblowers. At each other MDB, GAP researched all available data on whistleblower protection policies and practices, and held at least one meeting with representatives from each Bank. GAP staff also studied academic research on the MDBs and interviewed whistleblowers, legislative staff, nongovernmental organization (NGO) leaders, critics and representatives from the four MDBs covered in the study. The resulting record was compared to a 24-point-checklist developed by GAP to evaluate whistleblower policies at each MDB. The checklists were distributed to each MDB for comment several months prior to the drafting of the reports. After completing the draft reports, GAP submitted them to each bank for comment.

The 24-point-checklist evaluates whether the MDBs' policies (1) are comprehensive in scope; (2) offer the chance for a hearing in an impartial proceeding; (3) provide modern legal standards for adjudication of claims; (4) provide sufficient relief for those who win their cases; and (5) allow whistleblowers to make a difference against abuses of power if they risk retaliation to speak out. Each bank received a pass/fail rating for each criterion, along with a rating system based on a 0–4 scale.

GAP's Conclusions

All four of the Banks surveyed received an overall failing grade when compared with the legal norms compiled in the 24-point-checklist. On a scale of 1–100, the scores were 45 at the EBRD, 49 at the IDB, 50 at the ADB and 60 at the World Bank. While the Banks have recognized the value of whistleblowing, by limiting protections to internal disclosures the Banks have effectively precluded external accountability and transparency. The full reports can be found on our website at www.whistleblower.org.

The good news is that the MDBs' policies and culture are evolving. The Banks are beginning to recognize the benefits of whistleblowing as an internal management tool, and have started the process of developing effective whistleblower protection policies. In preliminary discussions with MDB representatives, nearly all have expressed interest in upgrading their policies. It will take a sustained, broad-based effort, however, to establish fully effective whistleblower protection programs at these Banks. This institutional effort must be led by the Banks' presidents, whose leadership has been inconsistent to date.

Finally, while the Banks' overall efforts to date are deficient in many ways, each bank has scored some passing grades on various specific issues identified in the 24-point-checklist. These best practices, coupled with strong executive leadership, can serve as a starting point for the MDBs to improve their policies.

MDB Strengths

Common strengths among the surveyed MDBs' policies are summarized below:

- Except for the EBRD, the Banks GAP studied have embraced the notion of whistleblower protection. This is a significant prerequisite for developing a functioning whistleblower protection program.

- The MDBs have established a duty to disclose that helps prevent retaliation. There generally is less hostility against whistleblowers who act pursuant to a mandatory duty rather than on personal initiative.
- The MDBs have recently established anti-corruption units, a useful first step toward the development of full-scale whistleblower protection programs. These units are too new for GAP to recommend them to whistleblowers as a safe avenue for seeking relief from retaliation. (The only exception is the World Bank's Department of Institutional Integrity, on a case by case basis.)
- The Banks provide a realistic limitations period within which whistleblowers must act on their rights. Employees have at least 90 days to file a grievance through administrative processes.

MDB Challenges

The surveyed MDBs' policies contain numerous deficiencies in whistleblower protection. These areas for improvement are summarized below:

- The Banks' existing whistleblower policies only cover internal disclosures; external disclosures are not protected, including even those made by witnesses to third-party citizen complaint mechanisms. In fact, the Banks prohibit external disclosures that could be detrimental to the Banks, including disclosures to law enforcement agencies and legislatures of member nations.
- With the exception of the World Bank, the existence and quality of confidential hotlines are unpredictable and unreliable.
- None of the Banks studied offer independent due process. All of them limit enforcement of employee rights to in-house grievance hearings, potentially tainted by conflict of interest because the defendant institution acts as judge and jury.
- The Banks fail to support stated promises of protection with enforceable rights. While the World Bank adopts them on paper for informal investigations, its Administrative Tribunal consistently ignores such rights in formal hearings.
- Whistleblowers appear to lose even when they win, because none of the Banks has a record of returning them to their jobs even when they prove that their removal was illegal. In practice, the Banks limit relief to financial compensation, which is small comfort to an employee deported for losing MDB employment.
- With anecdotal exceptions, the MDBs have no record of protecting whistleblowers who rely on the MDBs' existing protections.
- MDB policies do not have credibility with would-be whistleblowers. As a result, many would-be whistleblowers remain silent about the fraud and mismanagement they have witnessed.
- The Banks fail to protect parties and witnesses who participate in the newly-created citizen complaint mechanisms. The MDBs created these mechanisms to give individuals who are negatively impacted by a Bank loan decision the chance to challenge that decision.

Recommended Actions for the MDBs

GAP recommends that each of the four MDBs take the following actions to improve transparency and accountability:

- Protect direct disclosures to external authorities when necessary to avoid a significant threat to public health and safety, damage to the Bank's mission or criminal violations of national or international law.
- Protect participation in the citizen complaint mechanisms for addressing harm caused by MDB-financed activities. Safeguards could be included to prevent public release of proprietary information.
- Provide a flow of information from secure hotlines to each bank's Boards of Directors.
- Offer alleged reprisal victims the opportunity to seek justice through third-party, independent, binding arbitration by a decision-maker selected through mutual consent.
- Institutionalize the legal burdens of proof from the U.S. Whistleblower Protection Act to judge whether a whistleblower's rights have been violated, as the World Bank does for reprisal investigations.
- Provide prevailing whistleblowers full make-whole relief from confirmed retaliation, including the right to reinstatement as necessary to maintain national residency rights.

- Establish performance standards for bank investigative agencies, to ensure that misconduct threatening the Banks' public service missions is given a high priority.
- Enfranchise whistleblowers to file complaints under the citizen complaint mechanism regarding misconduct that threatens the Banks' public service missions.
- Provide visible institutional leadership by the Banks' presidents, through broadly communicated policy statements, active employee outreach, training for staff and management, and personal intervention against retaliation.

GAP intends to continue its efforts to achieve genuine whistleblower protections atthe MDBs. Next steps include the following:

- Distribute GAP's MDB whistleblower protection assessment reports to members of Congress, senior U.S. and foreign government officials, the MDBs (including the U.S. Executive Directors), the media and interested nongovernmental organizations.
- Offer to work directly with the Banks to help upgrade existing policies, and to apply lessons learned for constructive solutions to legitimate confidentiality concerns.
- Keep the U.S. Treasury Department and congressional oversight agencies informed of progress, as well as equivalent ministries or legislative bodies from any other member nation that requests such updates.
- Analyze the U.S. Treasury's September 2004 and March 2005 reports to Congress on these issues, and provide feedback to the Treasury and to Congress.
- Monitor individual whistleblower cases, with consideration for "friend of the court" briefs or representation to test how the MDBs' policies are applied in practice.
- Maintain and update the assessments presented in this study, including the ultimate recommendation of whether or not to recommend that whistleblowers work within a particular bank system.

Whistleblowing is a concept whose time has come, as evidenced by institutional leaders' routine rhetorical embrace of the principle, and establishment of formal policies and structures. Now the challenge is to make it effective. GAP calls genuine policies "metal shields," because those who defend themselves with metal shields have a fighting chance to survive. Unfortunately, so far the Banks have what we call "cardboard shields," which guarantee doom to anyone relying on them. The latter is worse than nothing, because the net result of disingenuous whistleblower programs is to create victims and cynicism. GAP looks forward to working with this Committee to turn the rhetorical breakthrough for whistleblower rights into genuine, enforceable rights, a metal shield both for those who "commit the truth" and for the Banks' public service mission.

STATEMENT SUBMITTED BY NANCY ALEXANDER, CITIZENS' NETWORK ON ESSENTIAL SERVICES

MOVING MONEY IN MIDDLE-INCOME COUNTRIES (MICS):

THE BANK'S PROPOSED STRATEGY AND IMPLICATIONS FOR THE ISSUES OF CORRUPTION AND INFRASTRUCTURE DEVELOPMENT [1]

I. INTRODUCTION

The U.S. Senate's Foreign Relations Committee is in the midst of holding hearings on corruption at the multilateral development banks (MDBs). The Congress wants to know where these institutions' money is doing and whether it's going into some hidden pockets. However, in the future, it may be difficult or impossible to answer that question. The reason is that the World Bank's Board of Directors is moving toward approval of a new strategy[2] for middle-income countries (MICs), which would move billions of dollars to certain governments with little "red tape."

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[1] By Nancy Alexander, Citizens' Network on Essential Services, Silver Spring, Maryland, USA, with assistance from Bea Edwards, Public Services International and Tim Kessler, Citizens' Network on Essential Services.

[2] The working document describing the strategy is entitled "Enhancing World Bank Support for Middle-Income Countries."

As is common practice, the regional development banks may follow the lead of the World Bank and adopt similar policies.

Middle-income countries[3] produce 20% of the world's goods and services, but have more than 80% of the world's population. They borrow at near-market rates from the World Bank's International Bank for Reconstruction and Development (IBRD). In categories from most to least prosperous, middle-income countries include: (1) Korea, Mexico and Hungary; (2) Poland, Malaysia, and Costa Rica; (3) Brazil, Turkey, Colombia, Iran, and Egypt; and (4) the Philippines, Syria, the Ukraine and Iraq. A few poorer countries obtain a blend of market-rate and concessional resources, including Pakistan, India, Uzbekistan and Indonesia.

The MIC Strategy is intended to reduce or eliminate fiduciary and safeguard (e.g., environmental and social policy) "barriers" to borrowing to World Bank-certified countries, If the MIC Strategy is approved, the institution will provide "certification" to those MIC governments with acceptable national policies that are "equivalent" to the fiduciary and safeguard policies of the Bank. (The certification process is described in part III.) It will also determine whether borrowing countries follow appropriate macroeconomic and development policies required to ease or eliminate specific loan conditionality.

The proposed MIC strategy poses three important questions for borrowing countries:

1. Will national policies be enforced? It is true that standards that curb corruption and protect vulnerable populations and ecosystems may be inconvenient for borrowers to implement. However, it is unclear why, when borrowers resist implementing the Bank's standards, they should be expected to enforce their Own.

If approved, the MIC Strategy would increase the pace and volume of lending to certified countries. As described in part H, the new approach to lending to MICs would make it much more difficult, within certain borrowing countries, to investigate where the Bank's money goes or how it is used. The new strategy is particularly troubling in light of findings by the Bank's own internal evaluators, who conclude that the institution has had "only modest success" in curbing corruption.[4]

2. Could the MIC strategy create a conflict of interest? Given that the World Bank would both certify and profit from the increased volume of lending, there is a potential for conflict of interest arising from implementation of the MIC Strategy. The Bank's ability to avoid such a conflict may determine its capacity to address corruption among borrowers. Before they consider the MIC proposal, the U.S. government and other shareholders should ask whether corruption and conflicts of interest might be stemmed if an independent process for certifying MICs is established. Such a process might include an agency that would be accountable for monitoring and evaluating "equivalence" between the fiduciary and safeguard policies of creditors and developing country governments.

3. Is more debt good for borrower or lenders? It is worth asking whether lower levels of lending could benefit MICs—especially those in which excessive amounts of hard currency debt hamper growth and development potential. By increasing the volume and pace of Bank lending, the MIC strategy seems to address the World Bank's current predicament as much as, if more than, the situation facing most middle income borrowers. At present, the institution is a kind of debt collection agency, collecting more in debt service than it lends. This situation has emerged largely as the result of a sharp drop in overall lending and years of poorly-performing loans.[5] While more new lending could reverse that situation in the short term, unless it leads to significantly higher growth rates, borrowing countries will eventually face higher debt service burdens again—possibly worse than those experienced today. Unfortunately, while the Bank is correct that faster growth is one of the keys of poverty reduction, it has not shown that Bank resources (and associated policies) lead to higher growth. In short, expanding MIC lending represents a

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[3] The World Bank defines middle-income countries as those with a specified per capita income range (less than $9360 and more than $745 per year). High middle-income countries performed much better than low-income countries, according to Bank measures.

[4] *Annual Report on Development Effectiveness 2003* (ARDE), OED, World Bank, p. 34.

[5] Bank lending to MICs has dropped precipitously; lending in the 2000–2003 period is only half as high as in 1999. According to the Bank's US Executive Director, Carole Brookins, during the 1990s the Bank's infrastructure investment lending declined by 50 percent, and even more steeply in the middle-income countries. In 2002, Bank lending for water and sanitation projects was only 25 percent of its annual average during 1993-1997. Notwithstanding the World Bank's efforts to bolster the legitimacy of private infrastructure and press borrowing governments into adopting it, interest of private investors declined sharply. From a 1997 peak of US $50 billion, private investment in developing country energy projects dropped to $7 billion in 2002. *See* Transition Newsletter (World Bank), Volume 14/15, April 2004.

gamble that borrowing countries will leverage new resources to grow much more quickly and sustainably than they have over the last thirty years.[6]

II. The Proposed MIC Strategy

A. Corruption and Adjustment Loans

The primary defense against corruption is openness in the borrowing and the repayment process. Any loan operation should provide factual, quantitative and qualitative information to the public throughout the loan cycle. How much is to be borrowed? What does it pay for? What is the interest rate? From whom is it borrowed? How much is owed? To whom is it owed? The answers to these questions allow the representatives of the public to determine whether it is reasonable to conclude that borrowed funds will be effectively used and that investments using borrowed funds can produce the returns necessary for a sound repayment program. Structural adjustment (or "policy-based lending") evades these basic considerations.

Structural adjustment lending breaks the link between the loan and its repayment. It makes the most relevant question about any loan—What does it pay for?—a moot point. Through structural adjustment lending, the Banks simply require that certain policies be implemented as a condition for budget support in hard currency. No one is responsible for producing any proof that the policies implemented have produced the returns necessary to repay the loan. Nor do adjustment loans need to generate hard currency for debt repayment. For example, the World Bank claims that it is fighting poverty by requiring the protection of certain social programs as a condition of a structural adjustment loan (SAL). But the social programs are financed with local currency.

Rather than fortifying these programs, the infusion of capital in hard currency to a central bank, in the absence of capital controls, fuels capital flight and benefits corrupt insiders.[7] Thus, loans presented to the public as funds to "fight poverty" can actually discourage economic growth by accelerating the loss of capital and increase the debt, the worst possible scenario for a developing country.

Further, we this consequence may be deliberate rather than an unanticipated side effect of large-scale policy based lending because increasingly these loans are "fast-disbursing." The loans have become like an insiders' signal to investors that it is time to withdraw. In addition, the funds lent as structural adjustment programs become "pork barrel" spending because they are not tied to concrete objectives. Funds that are not used to underwrite capital flight disappear in bogus contracts and consultancies, or corrupt privatization schemes.

Hence the debt crisis: after decades of SALs, there is deeper debt. The required policies did not produce the returns—otherwise known as sustained economic growth—necessary to repay. This occurred uniformly across almost all borrowing countries and not in just a few.

To reduce corruption and politically-motivated legal spending on activities that do nothing to stimulate development, the Banks should eliminate the grace period attached to borrowing. With a grace period on repayment of 3–5 years, the administration that negotiates the loan is almost never responsible for repaying it. In the terminology of the Bank, this is a "perverse incentive."

If the performance of certified countries does not measure up to expectations, the consequences could be severe. Heretofore, there has been little effort on the part of the Bank to monitor structural adjustment loans. This could be an open invitation to corruption, particularly countries such as Brazil. In 1992 the President of Brazil was impeached for massive corruption and the last President, Henrique Cardoso, narrowly avoided a broad Congressional probe into central bank insider trading. According to Dow Jones, "The original probe failed after the government released some 80 million reals ($1=BRR2.325) in budget funds to finance pet projects that were proposed by coalition legislators between 1999 and 2000 but never materialized. This last-ditch effort by President Fernando Henrique Cardoso and his allies helped weaken support for the original request for the probe." (*Dow Jones Newswires,* May 21, 2001)

Conditionality. If the MIC strategy is approved, policy conditions will not be attached to SALs if the World Bank finds adequate conditions in a few broad areas:

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[6] In addition, the Boards of Governors of the IMF and World Bank are considering the adoption of a "Debt Sustainability" Proposal at the upcoming Annual Meeting of the institutions that will limit the Bank's ability to lend to certain debt-distressed countries. The MIC could compensate for any loss of business stemming from implementation of the Debt Sustainability Proposal and reverse the Bank's decline in infrastructure lending.

[7] Joseph Stiglitz made this point in *Globalization and Its Discontents.*

the quality of a government's macroeconomic policy framework,[8] the quality of its development policies at the sector and country le levels, and its institutional capacity.

The Bank conducts several assessments to discern whether it is necessary to attach any conditions to adjustment loans. To ascertain the quality of policies and institutions, the Bank conducts routine assessments for each of 130+ borrowers. Two important annual assessments are: the Country Policy and Institutional Assessment (CPIA) and the Investment Climate Assessment. The Bank's ratings of the costs to investors of "doing business" in a particular country are a principal input to the country's Investment Climate Assessment. The Bank's determination of whether to provide certification for a MIC will de end significantly upon whether the country is creating an attractive investment climate. (See Annex 2 and following section.)

"Doing Business" Ratings. The Bank's "Doing Business" project to eliminate the regulatory barriers in borrowing countries is problematic because it does not seriously take into account that fact that certain regulations are necessary to protect the public interest and the interests of employees, including the right to collective bargaining. Appropriate levels of regulation are also necessary to ensure against corruption.

Each year, the Bank produces a "Doing Business" report for each borrowing country. The recommendations of the Bank often constitute violations of the Articles of Agreement, which prohibit the institution from interfering in the internal political affairs of its borrowing states. How can the Bank claim to promote "good governance" while undermining regulations that have been established through national political dialogue? How can the Bank claim to fight corruption while weakening regulation on private sector activity, a locus of large-scale corruption in both the developed and the developing world during the 1990s?

A 2001 Bank publication states, "At a general level, it is possible to say that the weaker the government system, the stronger the case for choice for citizens (by means of private sector development (PSD)) and free entry for entrepreneurs."[9] This suggests that where capacity for regulation is weakest, markets should be most open, (See Annex 2.) and is clearly a broad-brush, openly ideological statement.

The "Doing Business" project puts greater emphasis on the lowering the "cost of doing business" than lowering the "cost of living." The Bank's system of certifying MICs will put an emphasis on the degree to which these countries are willing to create an investment climate that is friendlier to investors, if current practice is any indication, certification will encourage deregulation to attract investors rather than regulation to protect the public interest, such as the U.S. has established over the years and still, to some degree, maintains.[10]

Each year, the Bank profiles the cost of regulatory barriers faced by potential investors in each of 130 countries, including industrialized countries. Each country's profile assigns a rating to its labor regulations, credit markets, entry regulation (ease of establishing a business), contract enforcement, and bankruptcy procedures. These ratings are a significant input to the Investment Climate Assessment, which the Bank conducts for each borrowing country.[11]

B. Expanding of Lending for a Failed Infrastructure Model

For investment projects, the MIC strategy proposes attaching policy conditions to loans only if they are proven necessary for the success of the project. (By implication, the Bank seems to admit that is has long made a practice of attaching unnec-

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[8] With respect to the quality of policies, the IMF consistently puts countries at a serious disadvantage because the wildly over-optimistic growth projections. The actual and inevitably disappointing growth rates reduce revenues I sharply curb expenditures. The Director of the IMF's Independent Evaluation Office (IEO), Marcelo Selowsky's that, in studying the IMF's record, "We found very significant (IMF staff) optimism in projecting private-sector activity and growth, particularly when the program commences in very adverse situations . . . optimism about growth means that expenditure ratios end up higher than programmed ... Negative growth occurred 10 times as often as projected." For full transcript, see: http://www.imf.org/external/np/tr/2004/tr040608.htm

[9] *PSD: Entrepreneurship, Markets and Development,* The World Bank, May 9, 2001.

[10] For instance, the proposed MIC Strategy says that "Loan conditions are thus a means to an end, which is the fostering of good policy environments, rather than the ends in themselves." Once upon a time policies themselves were a means to an end, namely poverty reduction.

[11] To see how the Bank rates any country along these dimensions, see http://rru.worldbank.org/DoingBusiness/. A chart that displays the degree of rigidity or flexibility in labor markets in 130 countries can be viewed at: http://rru.worldbank.org/DoingBusiness/ExploreTopics/HiringFiringWorkers/CompareAll.aspx. To see an example of a major country, see Brazil's "Doing Business" report at: http://rru.worldbank.org/DocumentslDoingBusiness/EconomyProfiles/BrazilReport.pdf. To understand how "Doing Business" ratings influence lending programs, see http://rru.worldbank.org/Documents/PSDForum/2004/klein.pdf

essary conditions to its lending.) However, the Bank's underlying models for infrastructure lending are deeply flawed. The Bank should be asked to account for its systemic failure in a range of areas identified by the institution's evaluators in their "Annual Report on Development Effectiveness" (2003) which include systemic failures (many of which contribute to corruption) to:

- tailor operations to country circumstances and policy preferences;
- monitor and evaluate operations during and especially after project completion;
- correct systemic problems with project performance in sectors, such as water and sanitation, where two of every three loans fail to succeed over the long-term;
- correct a commercialization and privatization model that has retarded development of the power sector and resulted in price hikes that make infrastructure services unaffordable to poor groups.

In addition, environmental sustainability is not adequately integrated into Bank operations. This is due to basic differences among member countries about the appropriate role of the World Bank. Indeed, the burst of Bank interest in environmental sustainability in the years just before and after the 1992 Earth Summit has almost entirely fizzled. Now, for instance, a government can achieve an excellent country performance rating even if it has ruinous environmental policies. At best, the Bank has a mixed record in addressing systemic problems in implementing policies and programs that protect the natural environment and certain vulnerable groups. If the Bank itself cannot comply with social and environmental safeguards, how can it ensure that borrowers do?

Given the Bank's emphasis on extractive industries and infrastructure, its lack of concern for the environment could be calamitous, not only for the environment, but also for the poor and vulnerable groups that are directly affected by Bank-financed projects. This disregard is also seen with respect to the institution's gender policy, even though the Bank cites very high performance ratings for borrowers' gender policies.

Additional concerns include:

1. Commercializing infrastructure is not a strength of the Bank. According to the institution's evaluators, Bank-financed "(C)ommercialization turned out to be incompatible with the kinds of potential and social considerations to which many governments gave higher priority than commercial success." In the water and sanitation area, the evaluators see the risk that the Bank will "advocate or be perceived to be advocating practices that may not turn out to be "best" or even "good"—at least in all cases."

Water and Sanitation. This problem is one of many that lead to abysmal sustainability rates of water projects. Half of IDA resources to Africa go through (mostly rural) community-driven development (CDD) mechanisms, although all CDD resources do not reach communities and only 24% of the water components of these projects are sustainable. Only 40% of urban water supply projects are sustainable. Water supply projects undercut the role of local governments in delivering services and, often, in monitoring and regulating them.

Widespread opposition to water privatization exists throughout Peru, but notwithstanding the will of the people, the management of the Inter-American Bank will ask for Board approval of a loan to privatize water in 54 municipalities in Peru. As privatization of "model" water privatizations supported by the World Bank and the Netherlands move toward the bidding stage, the Bank is not requiring that public private contracts be disclosed to the public, even though they will bind the municipalities for generations. Finally, the Peruvian water regulator, SUNASS, does not have the capability to regulate privatizations. Even if it did, the Bank's new operational guidance note for water and sanitation lending instructs the Bank's staff to avoid giving any central government regulator authority over subnational service delivery.

Non-transparent and unaccountable policy and project lending fosters corruption. When such lending results in populations being deprived of their right to affordable water, it will be cause for revolution, as has been the case in Bolivia.

Power. Evaluators find that the Bank's privatization model may have "retarded the development" of the power sector. In sum, they find that "The risks of promoting inappropriate policies appear to be most pronounced in policy areas where progress on reform has been difficult . . . as is the case in many in infrastructure sectors . . .[12]

[12] ARDE 2003, p. 35.

In short, the Bank has a long and embarrassing history of unholy alliances in its infrastructure lending. At best, project teams looked the other way while corrupt governments looted investment projects. At first, the Bank actively collaborated with the most unsavory political and economic interests in the theft of national patrimonies.[13]

2. Financing of commercialized infrastructure will boom, if proposed accounting practices are adopted. Although the removal of most policy conditions from project loans is intended to facilitate the financing of projects, many governments cannot borrow large sums and continue to comply with IMF and World Bank budget targets. A solution to this problem is being explored by the IMF in about ten cc unties where it is piloting an approach that changes accounting standards so its borrowers aren't forced to count commercialized infrastructure investments as current expenditures in formulating budget targets.[14] (The Presidents of Argentina and Brazil Summit proposed an approach, such as this, at the Copacabana Summit earlier this year. The issue also dominated the Inter-American Development Bank's annual meetings in Peru at the end of March 2004.)

In order to qualify for financing, governments would agree to institute full cost recovery (including the cost of borrowing) for infrastructure services. As a result of this policy, there is likely to be a boom in commercialized (and privatized) infrastructure in 2005 and beyond. This proposal seems to be proceeding toward approval in the absence of adequate (or in some cases, any) regulatory oversight in many countries. The proliferation of unregulated commercial and privatized services could be a disaster for poor people for whom water and electricity prices, among other things, could be prohibitively high.[15]

Moreover, approval of this proposal could significantly increase pressure to cut spending on health care, education, and other social purposes in hard budgetary times.

3. Expansion of Bank financing. The Bank estimates that there is a need to "potentially double" actual financing for infrastructure from the average of 3.5% of GDP in all developing countries to 7% of GDP.[16]

In FY 2005, the Bank is increasing infrastructure lending $7 billion, an increase of about $1 billion over FY 2004. (Infrastructure projects had a 35% economic rate of return during the period FY 1999–2003.) Expanding the financing for commercialization and privatization models that are failures and disregard the need for regulation for fiduciary and public interest purposes could doom efforts to curb corruption. These failures could also reduce inequality and increase poverty in much of the developing world.

Equally problematic is the fact that trade rules could "lock in" privatization and commercialization policies in and make many of them almost irreversible. Some of these policies are good for economies and good for people, but not in unregulated environments and not where people and their elected representatives are unengaged in shaping their own development future.

C. Providing "Flexible" Assistance to Certified Countries

Approximately every three years, the World Bank designs a CAS for each borrowing country that identifies the operations that it plans to finance and the rationale for these operations. The content of the CAS is determined by each government's CPIA rating, its "doing business" rating, and the government's own aspirations. In the proposed MIC Strategy, the CAS would function more as a "strategic compass than a detailed blueprint." Aspects of flexible CASs are described in Annex 3. While the Bank should not be rigid in its approach to governments, its Bank's track record in complying with its own policies do not merit expansion of lending. Nor does the

[13] The World Bank and the Inter-American Development Bank allowed the government of Alberto Fujimori in Peru to move authority over loan funds designated to reform the water sector in Peru to the newly created Ministry of the Presidency from which they disappeared.

[14] For further details, *see* "Public Infrastructure and Fiscal Policy" by Teresa Ter-Minassian and Mark Allen, IMF, 3/12/04: http://www.imf.org/external/np/fad/2004/pifp/eng/PIFP.pdf

[15] The IDB proposes an October approval for a loan to Peru that would promote private provision of municipal water services in 54 cities, yet Peru lacks the capacity to oversee such processes. Moreover, the World Bank-Netherlands Water Partnership is not requiring the Government of Peru to disclose public-private water contracts in Puira and Tumbes where bidding for water systems is currently underway. Puira and Tumbes are model projects intended to prove that private provision can reach the poor. The model was developed by donors and creditors in an extensive "Paris process" that engaged dozens of consultants. The citizens of Peru overwhelmingly oppose private provision of water, yet the Banks continue to support leaders that will even resort to force to suppress opposition to these policies.

[16] World Bank, "Infrastructure Action Plan," April 8, 2004, p. 3.

Bank's record in project lending (e.g., infrastructure) and adjustment lending merit expansion of lending.

D. Making Other Institutional Changes

The Bank is already making internal changes, including:

- A revision of promotion criteria. Although staff performance appears tightly linked their ability and willingness to "move money," the proposed MIC Strategy says that staff incentives reward complex lending programs that are divided into many small operations and that that must change. It also asserts that MICs also need simple, repeater operations to expand and replicate successful operations on a larger scale. Hence, promotion criteria will be revised and the evaluation criteria for proposed projects could be revised as well.
- Improvement in staff skills.
- Expanding the use of existing Bank financial services and products and the invention of new ones.
- Piloting of joint IBRD, IFC and MIGA offices. For instance, the Bank is establishing joint IDA IFC offices in several African countries.
- Development of a framework for lending to financial institutions (including municipal development funds) and for advisory services.

III. Certification of Qualified MICs

A. Identifying MICs as First Class or Second Class

Should the MIC Strategy be approved, the political stakes for the World Bank and the U.S. could be high. As the major shareholder of the World Bank, the U.S. could be seen as facilitating the assignment of middle-income countries to first class or second class status depending upon whether the institution grants or withholds certification.

If the World Bank denies certification to an MIC government and, thus, disqualifies it for streamlined lending, the international financial community could see that government as a bad bet. If their debt burdens are not too high, MIC governments with World Bank certification will obtain significant, streamlined loans with few strings attached. This may produce competition for World Bank certification or it may produce tensions and resentments. Poorly done, the MIC Strategy could exacerbate economic and political crises and corruption among first and second class MICs.

B. Other Certification Issues

As noted above, if the MIC Strategy is approved, the World Bank would "certify" governments with acceptable national policies that are "equivalent" to the fiduciary and safeguard policies of the Bank.

The Bank's Board has expressed concern about what kind of "equivalence" should exist between national fiduciary, environmental and social standards and the standards still embodied by the Bank's own (watered down) operational policies. In addition, there is concern about whether or how the World Bank's Inspection Panel would investigate compliance with safeguards with regard to operations that the Bank finances in credentialed low- and middle-income countries. The Bank, itself, has been largely unable to provide adequate project supervision. Examples are legion: around the developing world, privatization projects financed and promoted by the World Bank and the regional development banks produced poor quality services, corrupt insider deals, bogus debt swaps, and political uproar. Vast infrastructural investment projects, such as the Yacireta project or Cana Brava in Latin America became internationally notorious. If the Bank's record of compliance with its own safeguards was better, one could have more confidence in the Bank's supervision of each borrower's compliance.

Prior to country certification, the Bank's Board would examine the methodology and results of management's assessments of the country's willingness and capacity to comply with safeguards. The proposed MIC Strategy says that "Board approval of an operation relying on a certified safeguard system implies that the national system constitutes the reference point for any Inspection Panel investigation." Then, the Bank's management signed a memo with the Inspection Panel that ensures continued use of the Bank's operational policies as the reference point. Given management's ambivalence or antipathy to the Inspection Panel, it could be important to monitor implementation of this policy.

IV. CONCLUSION

At best, it is premature to approve and implement the MIC Strategy. Before it is approved, the Bank's shareholders should ask questions about whether the MIC Strategy would exacerbate existing problems with corruption, accountability, and development effectiveness. For instance:

- Would it constitute a conflict of interest for the World Bank to both certify MIC governments and profit from the resulting surge in lending?
- How might it be possible to follow the money trail of large adjustment loans that the Bank is currently offering to most of its borrowers?
- Will the policy result in rampant non-compliance with fiduciary and safeguard policies—or, especially, their implementation? Already, the Bank has a mixed record of complying with the spirit, if not the letter, of its own policies. Thus, would it be equipped to help governments who, heretofore have viewed Bank policies as a barrier to borrowing, to upgrade and enforce their national policies and standards?
- What would be involved in judging whether fiduciary and safeguard standards are "equivalent" to it's the World Bank's standards? How compliance could be effectively supervised, as called for by the Strategy?
- How could country "ownership" of lending policies be improved? Most parliaments have little power over loan design or approval. (They may approve increases in the debt ceiling). The lack of country ownership can lead to unsustainable lending and corruption. Moreover, policy-based loans, untied to specific objectives, build in the possibility of pork barrel spending to buy loan approval from potentially corrupt parliamentarians.
- How will democratic, fiduciary and safeguard controls be created or maintained at the subnational and regional level? An increasing number of loan/grant operations are being executed at the subnational lending where consultation consists of citizens being asked whether they want money for commercializing/privatizing services or no money at all. (This is the process in 54 municipalities in Peru and countless other places.) An increasing number of loan/grant operations are also being executed at the regional level, *e.g.,* the Balkans Infrastructure Development (BID) Facility, which is supported by USAID, among others. Indeed, the World Bank has divided each geographical region into infrastructure grids for infrastructure lending purposes. However, it is unclear the kinds of democratic governance, fiduciary and regulatory structures and processes could govern regional infrastructure development.
- What will be the outcome of orchestrated pressure to undercut labor rights and standards? The degree of labor rigidity or flexibility in 130 countries is displayed here: http://rru.worldbank.org/DoingBusiness/ExploreTopics/HiringFiringWorkers/CompareAll.aspxT The large adjustment programs will create much stronger pressure to liberalize investment (which implement the Bank's "Doing Business" project) than currently exists.
- Will the U.S. and other large shareholders join in the implementation of the MIC Strategy? To implement the Strategy, the Bank seeks to strengthen its relationship with partners, particularly bilateral donors, since half of all bilateral aid flows, about $25 billion, support MICs.

Such questions should be answered before the World Bank cast itself as a "partner of choice" in development knowledge and finance for MICs.[17] The Bank should be obliged to account for its past failures.

As democracies have emerged in borrowing countries, corrupt, non-democratic regimes have been obliged to respond to questions about corruption and repression, at least to some extent. In Latin America, Argentina, Chile, Guatemala and Peru

[17] The situation is particularly dire for the Bank because new lending to many "debt distressed" countries will slow or stop if, at the 2004 Annual Meeting of the IMF and World Bank, the Governors of the institutions approve the "debt sustainability" (DS) proposal advocated by the U.S. government and its allies. If the DS proposal is approved, the IMF and World Bank would assign a debt threshold to each borrowing country corresponding to its debt burden, its vulnerability to shocks and, especially its policy and institutional performance.

Except in emergencies, governments could not borrow after they reach their debt threshold. Instead, they would rely upon a scarce supply of grants that would be primarily directed to the governments considered to have gone farthest in adopting policy and institutional reforms prescribed by the World Bank. How will the U.S. government deal with situations in which the World Bank will cease lending to governments that have reached their debt thresholds? In some cases, fiscal transitions can be maintained with grant flows, but the IMF and World Bank acknowledge that the supply of grant resources will be too meager to meet the demand.

have established "Truth Commissions" to investigate corruption and repression, which often went hand-in-hand. The Banks, which comfortably did business with these governments, have never been asked about their lending under past dictatorships: what did the loans pay for? Who benefited? How much is this debt worth now?

Particularly since Reagan and Thatcher revolutionized the goals and functions of the World Bank about 25 years ago, the history of the institution has been marked by waves of struggles between those who would focus on the quantity of lending and those concerned with the quality and impacts of lending. The year 1991, when Bank VP Willi Wapenhans chaired a commission investigating the quality of Bank lending, was historic in this regard. The eminent German's commission exposed the miserable quality of most Bank lending. For many years, the Bank diligently strove to improve its portfolio.

However, since 1990, there has been considerable conflict over the institution's direction among the Bank's Board.[18] In 1992, the U.S.-led effort to have a Private Sector Development (PSD) Strategy adopted as the overarching purpose of the World Bank and the regional development banks overcame fierce opposition.

Under the appropriate conditions, the role of the private sector needs can be usefully expanded. But if appropriate conditions are lacking—particularly in the regulation of the pricing and delivery of basic services—the adverse implications are significant. The current lack of regulation for fiduciary and public interest purposes should stop consideration of the MIC strategy in its tracks.

The time to ask questions and get answers about the MIC strategy's likely impacts is before, not after it is approved. There is still time to donors, other creditors, parliaments, citizens, and the media in industrialized and developing countries to pressure the Bank's Board into considering the risks and costs of the proposed strategy, and to search for ways to make the Bank more, not less accountable for the results of projects and policies that its resources help finance.

ANNEX'S

ANNEX 1

THE BANK'S DRAFT CAS FOR INDIA: WHAT IS THE FUTURE OF BASIC SERVICES FOR THE POOR?

In adjustment lending, policy impacts may not be taken into account. Top priorities in the draft Indian CAS include reforming power and water policies. In the area of water, the Bank promotes reallocation of water from low-value users (subsistence farmers) to high-value users (agribusiness, industry, cities). This policy will hit the most vulnerable people the hardest, since the overwhelming majority of poor people are subsistence farmers who rely on affordable drinking water and, sometimes, access to water for irrigation.[1]

The Bank would help those Indian states that meet "guidelines for engagement" by implementing a comprehensive reform effort. Eligible states could receive up to 15% of total lending as adjustment lending over five years (governments that are off-track will have their loan disbursements suspended). Adjustment lending will be particularly appropriate for states with a good track record, but problems with debt sustainability.

In the cities, the Bank is working to make cities less dependent on financial transfers from the central government, obtain more access to finance, and facilitate private sector participation in the delivery of basic services. At the state level, the Bank will bolster service provision programs that improve cost recovery and shape regulatory systems that will encourage private sector participation. Such policies have a poor rate of expanding affordable basic services.[2]

Since its adoption of the Private Sector Development Strategy (PSD) as the overarching strategy of the World Bank Group in February 2002, the World Bank has

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[18] Significant conflict led up to the Bank's approval of the Private Sector Development (PSD) Strategy in February 2002 and has continued since.

[1] In the Bank's water project in Senegal, reallocation is facilitated by raising water prices higher for rural consumers of water from standpipes than for any other classification of rate payers.

[2] The Bank often argues that simply increasing access to piped water reduces poverty, since the poor are more likely to have no connection at all, and are forced to rely on higher-priced (per unit) alternatives, such as water from private tankers. However, for cost recovery programs to affectively address poverty, they must ensure network investment in poor areas, and also include some kind of subsidy component for household connections and, where incomes are below poverty levels, consumption itself.

accelerated privatization of basic services—health care, education and water, despite the facts that, for low-income countries: 55% of PSD projects were likely to be sustainable; the distributional impact of PSD projects were frequently negative; and that benefits depend on how well the state regulates private behavior. Strong claims are also made that these shortcomings are equally apparent in MICs, where poverty and, especially distributional, problems are often exacerbated.[3]

ANNEX 2

THE COUNTRY POLICY AND INSTITUTIONAL ASSESSMENT (CPIA)

Over the period of 1999–2003, Bank lending was concentrated ... with 89.4% of Bank lending going to countries with average or above average CPIA ranking.

The World Bank performs CPIA ratings annually for its 136 borrowers that produce an overall performance ranking for each borrowing government. The ratings are based on assessments of each country's governance as well as its economic, structural, social, and public reform policies.

Poor performance on the part of a borrower is assumed to be the borrower's fault rather than the flawed application of "indicators like the CPIA—which are based implicitly on the premise that their underlying criteria reflect good policies at all times and in all places," as the Bank's evaluators put it. (ARDE, p. 41)

The whole strategy for providing aid to developing countries was revolutionized by the claim of "Assessing Aid" (2000) by World Bank economist David Dollar. Dollar said that aid only produces results in good policy environments. In order to prove this, he used a rating system—the CPIA—to judge the policy and institutional performance of borrowing governments. However, the CPIA is not transparent. The ratings and the methodology for all MICs are secret, even from bilateral and other multilateral donors. Reportedly, Brazil received relatively high CPIA ratings, yet its growth was below average for developing countries during the period 1998–2002. But, without access to Brazil's CPIA, observers are at a loss to understand the signals that the Bank is sending to the country.

The content, methodology and secrecy in which most of the CPIA is shrouded is a matter for hot debate among the World Bank's management and Board.[1] Some Board members claim that the CPIA is a reasonably accurate system that rates performance of borrowing countries in critical areas—namely, with regard to governance, including the effectiveness with which governments disburse and manage Bank loan resources—and with regard to economic, structural, social and public sector reform policies. Other Board members accuse the CPIA as being a one-size-fits-all instrument imposed on governments in a top down manner replete with subjective judgments about their performance.

Interestingly, the ratings of those government that are eligible for the U.S. Millennium Challenge Account (MCA) are usually different from those of the World Bank's CPIA, sometimes remarkably so.

ANNEX 3

FLEXIBLE COUNTRY ASSISTANCE STRATEGIES (CASS) FOR BRAZIL AND INDIA

In the past, the Bank provided scenarios for lending at low, medium and high lending levels, dependent upon the degree of borrower compliance (or non-compliance) with "trigger conditions"—that is, reforms that the Bank identified as necessary. For MICs with certification, the Bank will permit flexibility in the CASs prepared for each borrower with respect to the composition of the lending program, determination of loan sizes for good performers, and possible increases in the volume of lending. Among other things, new policies on supplemental financing could expedite enlargement of Bank-financed operations. In sum, the CAS would function more as a "strategic compass than a detailed blueprint." In the future, the CAS may be

[3] In the last three years, the Bank has tripled lending for the water sector, despite the facts that: (a) urban water projects have a 40% sustainability rate and the water components of rural loans have a 23% sustainability rate. This means that, by a substantial margin, water projects fail after the Bank stops financing them. And, (b) according to World Bank evaluators "substantial room remains for targeting the poor and vulnerable populations within water sector operations. Of most concern across the Bank is the scant attention given to the direct impact of these operations on the poor ... and tailoring project design to meet the needs of target populations." From "Bridging Troubled Waters ..." OED, The World Bank, 2002, p. 11.

[1] For a description of the CPIA, see: http://www.servicesforall.org/html/worldbank/sheep—into—goats.shtml

called a "Country Partnership Strategy" (CPS). In the Bank's view, the CAS for Brazil (2004–2007) and the draft CAS for India demonstrate a desirable flexibility.

Brazil. Over the 2005–07 CAS timeframe, "understandings" between the Bank and the Government of Brazil (GOB) will determine the level of access the GOB has to Bank financing. Excellent performance will qualify the Government of Brazil (GOB) for support over in the range of $6 to $7.5 billion over the 3 years with adjustment lending up to half of the total amount. Reasonable performance will qualify Brazil for access to $4 billion to $6 billion. The CAS does not include trigger conditions. The Brazil CAS is a model for forthcoming guidelines to staff on "good practice" with regard to flexible lending programs. The Bank is also giving the GOB greater flexibility in providing counterpart funding, to help match the Bank's resources, for implementing investment projects. Difficulty in providing counterpart funding has been a barrier to lending in the past.

India. The Bank identifies the ceiling for IBRD lending as $2.15 billion per year or $6.45 billion in the three-year, 2005–08 timeframe of the draft CAS. Access to resources will depend upon how quickly India prepares projects and the quality of its project implementation, particularly the timeliness of disbursing loan resources. The access to loan resources by India's 24 states will depend upon the seriousness with which they apply "self regulating" reform policies (*i.e.,* "trigger" policies). While the states may "self-regulate" their adoption of reforms, there will be little ambiguity with regard to the types of reforms required by the Bank, as these will be designated in the Bank's "guidelines for engagement." In another departure from past practice, the Bank's CAS does not designate a specific fiscal policy target, or "trigger." Instead, the Bank will periodically review India's macroeconomic situation and, particularly, its stability.

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