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GOOD GOVERNANCE IN SUB-SAHARAN AFRICA

Opportunities
and Lessons

Editors

**MONIQUE NEWIAK
ALEX SEGURA-UBIERGO
ABDOUL AZIZ WANE**

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Foreword

REAPING THE BENEFITS OF GOOD GOVERNANCE IN SUB-SAHARAN AFRICA

*Book edited by Monique Newiak, Alex Segura-Ubiergo, and
Abdoul Aziz Wane*

FOREWORD BY THE MANAGING DIRECTOR

As the world continues to deal with the challenges of the COVID-19 pandemic and associated economic uncertainties, good governance and transparency have never been more important. Countries with stronger institutions have been able to mount more effective responses to the pandemic—this is true at any level of development. No doubt, institutional strength and accountability will also prove instrumental in how effectively countries recover and build more resilient post-pandemic economies.

This book attempts to assess the importance of good governance and transparency in sub-Saharan Africa. The region has made tremendous progress in recent years to improve the standards of living of its citizens. However, millions of people still face extremely difficult conditions, living in poverty and without access to sufficient public services, especially health care and education. These challenges have intensified in the wake of the pandemic due to unequal access to vaccines and limited policy space. The task of policymakers will become even more complex as they contend with the effects of climate change, digitalization, and the fourth industrial revolution associated with automation and new technologies.

While many developments in the world economy depend on external factors that are hard to influence, steadfast leadership from African policymakers can help improve domestic governance and ensure that public resources are well used and thus contribute to shared and lasting prosperity. These interlinkages are indeed the topic of this book: how can sub-Saharan Africa reap the dividends of good governance?

The book offers further evidence of the crucial importance of governance and public integrity, adding the IMF's voice to those of other institutions, such as the World Bank, the African Union, and many others. It contributes to the debate by providing a practical assessment of the benefits of those aspects of governance at the center of IMF work in this area: fiscal institutions, financial sector oversight, central bank operations, market regulation, and the rule of law.

The book also builds on the IMF's advice to "spend what is necessary to contain the pandemic, but keep the receipts." Keeping the receipts means that

policymakers are ultimately responsible to their citizens, to demonstrate that they act with integrity in pursuing shared economic and social goals for their countries, and to do their utmost to ward off corruption and prevent the abuse of public office for private gain. This commitment requires developing robust institutions that promote good governance and effectively ensure that political leaders are accountable for the actions they take on behalf of their citizens.

As countries in sub-Saharan Africa pursue reforms that serve these goals, the IMF will remain their steadfast partner. We will leverage the full range of our toolkit—capacity development, policy analysis and advice, and financial assistance—to support these efforts. At the heart of this lies a fundamental goal to ensure that macroeconomic policies and institutions are better able to promote resilience and inclusive economies that benefit all citizens of the region.

Kristalina Georgieva
IMF Managing Director

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Abdoul Aziz Wane wishes to thank his co-editors and co-author for the excellent collaboration. He is grateful to all the authors for their patience and professionalism in the editing process. He is confident their efforts will provide sub-Saharan African policymakers the tools and a framework to promote good governance in their respective countries.

Reaping the Dividends of Good Governance

Monique Newiak, Alex Segura-Ubiergo, and
Abdoul Aziz Wane

Governance and corruption issues have taken the center stage in international discussions, especially after most international organizations re-emphasized their importance in their engagement with their members. Sound institutions that guarantee integrity in the management of public affairs are critical on the path toward higher and more inclusive growth. Corruption undermines the quality of institutions, weakens the effectiveness of government programs, and compromises social trust in government policies. Indeed, countries around the world that improved their governance systems are reaping a “governance dividend”, and governance-enhancing reformist countries in sub-Saharan Africa include Botswana, Rwanda, and Seychelles. In addition, other countries in the region demonstrate that important reforms are possible, including in fragile environments. Good governance acquired even more importance as countries try to introduce policies to fight the COVID-19 pandemic. Special attention to governance in an emergency context, including situations associated with conflict, health crises and natural disasters, is therefore essential. Innovation and new technologies are critical instruments that policymakers can use in their efforts to improve governance and transparency.

WHAT IS NEW?

Since the middle of the 2010s, governance and corruption issues have taken center stage in international fora. Recognizing the importance of institutions and the fundamental concept that governmental corruption—the abuse of public office for private gain—is a global problem that requires global solutions, most international organizations have revamped their approach to governance and corruption. In 2018 the IMF introduced a new framework, its “Review of 1997 Guidance Note on Governance—a Proposed Framework for Enhanced Fund Engagement,” to facilitate a more candid discussion with member countries on governance and corruption and to promote good governance in its lending conditionality. The World Bank also launched anticorruption initiatives to help countries address corruption. In 2017 the OECD adopted a new *Recommendation on Public Integrity*, calling for a comprehensive public-integrity system (OECD 2017). The momentum to improve integrity was also strong in Africa. The African Union

named 2018 “the African anti-corruption year”¹ and approved a continental strategy to anchor national ones. The continental strategy advocated for more international cooperation to stem illicit cross-border transactions as a follow-up to the work led by the former South African president, Thabo Mbeki. Voices for better governance have been even more audible amid the suffering from the COVID-19 pandemic.

The momentum rides on the evidence tying growth and stability to institutions and the difficulties countries experience in rooting out corruption amid growing public awareness. After the publication of North’s (1990) first comprehensive framework integrating institutional analysis into economics, empirical analysis led by Acemoglu and others (2003) documented the causal impact of governance and institutions on macroeconomic performance. This strand of economic literature reinvigorated calls for institutional reform to enhance integrity in public affairs. New surveys and indicators documented the importance of good governance for development and the need for faster progress, especially in sub-Saharan Africa. In its 2017 *Recommendation*, the OECD found that corruption was citizens’ number-one concern, ahead of globalization or migration. The results of the 2020 Corruption Perceptions Index showed that countries made little to no progress in tackling corruption in almost a decade (Transparency International 2020). Africa is no exception: Some 20 years ago, Afrobarometer reported that 8 out of 10 Africans believed their government officials were involved in corruption, and a 2018 Afrobarometer survey revealed that 7 out of 10 still considered corruption to have increased or stayed the same.² Social media are echoing news on governance failures and calls for reforms.

The COVID-19 crisis exposed governance weaknesses that prevented the development of a resilient health system and numbed the response to the pandemic. At the other end of the spectrum, many countries that have made progress in implementing governance measures have addressed the pandemic well. In a report titled *The Ignored Pandemic: How Corruption in Healthcare Service Delivery Threatens Universal Health Coverage*, Transparency International documented how corruption was threatening the capacity of countries to provide universal health care to their people. During the pandemic, governments were required to make difficult choices to save lives and protect livelihoods. Governments who could afford to do so responded by scaling up spending to foster a rapid provision of health and disease-containment services and assistance to affected households and businesses. The extent to which the surge in spending translated into improvements in people’s protection and support depended greatly on the integrity with which public affairs were managed—and it continues to depend on this integrity at the present time.

¹ <https://au.int/en/pressreleases/20180122/african-union-launch-2018-african-anti-corruption-year%E2%80%A6>

² Authors’ calculation based on online analysis tool: <https://afrobarometer.org/online-data-analysis/analyse-online>

The unprecedented increase in international financial support to back the surge in COVID-19 spending drew the attention of civil society to governance weaknesses. The IMF, for example, pledged to use its \$1 trillion lending capacity to help countries cope with the crisis. A year into the pandemic, the IMF disbursed \$110 billion to 85 countries worldwide and approved about \$700 million in debt relief, while advocating for progress on transparency and accountability for a more effective crisis response within countries. The call for more transparency reflects relentless work from civil society organizations in pointing at governance lapses and calling for more international pressure on governments to address corruption. In March 2020, 97 civil society organizations located around the world wrote to the IMF's Managing Director to request that the IMF consistently and formally include anticorruption measures in its COVID-19 pandemic-related emergency funding. Social media facilitated the work of these civil society organizations, which helped disclose to the world corruption cases amid global suffering from the disease. Reflecting these calls and the implementation of the IMF's 2018 framework on governance (IMF 2018), out of the countries supported by the IMF, 65 included governance conditionality in their program. In sub-Saharan Africa, about three in five countries that received funding from the IMF committed to publishing procurement information, four in five committed to publishing information on beneficial ownership, and all of them committed to some kind of audit (IMF 2021).

This book adds its voice to re-assert the critical importance of governance and integrity.³ It posits that the establishment of sound institutions that guarantee integrity in public affairs may be one of sub-Saharan Africa's most important milestones in its journey to sustainable development. The book leverages extensive analysis at the cross-country level, global evidence, and country case studies to focus on the macro-governance links in sub-Saharan Africa.⁴ Beyond a special focus on governance in an emergency context, several chapters bring in the COVID-19 pandemic perspective. This makes this book the first attempt to provide a comprehensive view of the relationship between the quality of institutions and the management of the COVID-19 pandemic. The book argues that

³ In line with the guidance note entitled "The Role of the Fund in Governance Issues" (IMF 1997) and the "Review of 1997 Guidance Note on Governance—a Proposed Framework for Enhanced Engagement" (IMF 2018), the book focuses on economic aspects of governance. This includes an analysis of state functions that are particularly important for the control of corruption (that is, fiscal governance, financial sector oversight, central bank governance and operations, market regulation, rule of law, and anti-money laundering and combating the financing of terrorism). Political aspects of governance, such as the nature of the political regime (for example, democratic versus authoritarian, presidential or parliamentary) are beyond the scope of our analysis. However, given that the economic and political dimensions of governance cannot always be separated with precision, several chapters include an analysis of political economy factors (and the interaction between economic and political institutions) that have affected progress on governance.

⁴ Many chapters rely on third party indicators that score performance on governance and corruption based on surveys and perceptions. Interpreting results across countries and over time based on such data requires caution.

the approach to institutional reforms needs to consider the starting position of countries and calls for tailored approaches in fragile countries to consider capacity constraints and societal preferences. It shows how successful reform paths in normal settings become systematically inefficient in fragile environments. This path dependency also applies to the adoption of technological innovations in public affairs. Finally, the book brings in new governance reforms supported by the IMF in sub-Saharan African resource-rich countries.

GOVERNANCE: GOOD FOR THE MACROECONOMY, GOOD FOR GOVERNMENT OPERATIONS

Enhancing governance and integrity in public affairs is probably sub-Saharan Africa's most urgent challenge to sustainably root poverty out of the region. Sub-Saharan Africa grew by 4½ percent over the decade preceding the global COVID-19 pandemic, and volatility of growth declined substantially. This performance reflected a more benign international environment (for example, debt relief, higher international liquidity, low interest rates, and high demand for commodities, especially from China) and sounder macroeconomic policies. It is, however, far below the region's potential and what is needed to eradicate poverty sustainably. Poor governance, including lack of basic freedoms, such as citizens' rights to hold their government accountable, has held back most countries in the region from entering the club of emerging middle-income countries, and has prevented others from escaping the fragility trap. For the region's average GDP per capita to move to upper-middle-income status, growth will need to increase sustainably by 2 percentage points to 7 percent over a minimum of 15 years. This is about the increase in growth that studies estimate better governance can bring to the region (Chapter 1). Improvements in governance will also reduce inequality substantially. The combined impact of better governance on growth and inequality will accelerate the eradication of poverty in the continent.

Global evidence of the benefits of eradicating corruption for macroeconomic outcomes is vast. A large body of literature has shown that corruption impacts economic growth and therefore development through multiple channels, including those that relate to macrofinancial stability, investments in physical and human capital, productivity and its impact on public trust, and the efficiency of government. Corruption is also likely to undermine the inclusiveness of growth, increasing income inequality and poverty (Gupta, Davoodi, and Alonso-Terme 1998)—with negative feedback loops to the sustainability of growth (Ostry, Berg, and Tsangarides 2014). Chapter 1 shows how corruption hampers domestic resource mobilization and distorts public spending, moving it away from priorities; hampers central bank operations and financial supervision; weakens the quality of market regulations; and undermines the rule of law. Several examples confirm that governance reforms and aggressive anticorruption strategies can lead to significant improvements in growth and other measures of macroeconomic performance. Singapore epitomizes the benefits of governance reforms on people's

living conditions. In sub-Saharan Africa, Rwanda offers evidence of the impact of governance reforms on domestic revenue.

Corruption introduces inefficiencies into the economy through its negative impact on government operations, preventing macroeconomic policies from being effective. Most components of tax revenues relate negatively to higher levels of corruption, as they particularly undermine compliance (Baum and others 2017) because taxpayers escape tax or customs payments through payment of a bribe or other unofficial compensation, or because companies do not join the formal economy when tax exemptions are perceived as the result of a bribe (Dreher and Herzfeld 2005; IMF 2016). Corruption can diminish the efficiency of public spending and investment. In countries with weak institutional quality, governments may use capital spending as a vehicle for rent-seeking, leading to inefficient public investment (Albino-War and others 2014; Gelb and Grassman 2010; Grigoli and Mills 2014). As a result, investment efficiency is likely to be lower because project and contractor selection is less likely to be based on merit, and project costs are inflated because of poor procurement processes.

These channels highlight a substantial potential to boost macroeconomic outcomes in sub-Saharan Africa and the urgency of action. The literature suggests a significant dividend from governance and anticorruption reforms in sub-Saharan Africa. As indicated in the preceding discussion, according to empirical studies, increasing the average sub-Saharan African country governance level to the global average would boost the region's long-run per capita GDP growth significantly. This substantial potential payoff, which is two to three times larger than in the rest of the world, justifies prioritizing governance reforms in the region. The historical fact that reforms to reduce corruption may take considerable time and work is another reason to prioritize the reforms without delays. Another critical reason for the region to step up reforms is the worrisome degradation in measures of political stability and an increase in violence. This degradation finds its root in the combination of rapid population growth, poverty, inequality, and illiteracy, which can also be affected by governance reforms. Given the implications on migration of a growing young population and associated security risks, the international community has an obvious interest in undoing the status quo and supporting strong governance reforms.

DRAWING LESSONS FROM A WIDE RANGE OF COUNTRY EXPERIENCES

Countries around the world that have reformed their governance systems are reaping the dividends. New Zealand, some Nordic countries (Finland, Iceland, Norway, Sweden), and Singapore consistently feature amongst the 10 best performers on most indicators of the quality of public institutions and corruption perception. They hold transparency as an overarching principle in public affairs, and their governments typically provide adequate information to citizens on how public resources are levied and spent. In these countries, inequality measured by the Gini coefficient

is also lower than the world's average. These countries are enjoying a low level of conflict, stable and sustained positive per capita growth, a low level of uncertainty, and a high resilience to shocks. Against this backdrop, emerging economies are reflecting their aspirations for better living standards for their populations in deep-rooted reforms to improve the quality of institutions and eradicate corruption. Over the past 20 years, most of the countries that have achieved the fastest progress on the measurements of governance and corruption are middle and low income countries. Some of them are still grappling with the inheritances of fragility and conflict, and pervasive corruption was a common trait before governance reforms were initiated (for example, Georgia).

Many good examples are from sub-Saharan Africa. This book features three country cases (Botswana, Rwanda, Seychelles) that are among the countries in the region that are leading in the effort to improve governance. Each country has leveraged its unique combination of societal preferences and resource endowments to formulate a vision for better management of public resources. Botswana developed a good policy framework to help prudently manage its wealth from mining resources. Rwanda rebuilt itself from a devastating conflict by adopting more advanced institutional models. Seychelles, a small island state, responded decisively to its 2008 debt crisis by embarking on a comprehensive program of economic and institutional reforms. Beyond their individual circumstances, decisive political will and leadership strong enough to build a societal consensus underpinned the drive for governance reforms in all three countries. Common characteristics of their governance frameworks are the transparency of their economic policies and supervision, sound protection of economic rights, and criminalization of corruption. While these countries have successfully established key pillars of governance, the book makes the case that further reforms—including strengthening and improving information on government-service delivery performance—would help ensure accountability and sustained implementation.

Other countries in the region are following this path. Angola, Liberia, and Sierra Leone have been encouraging examples of countries outside the club of the 20 best performers on the Worldwide Governance Indicators⁵ that improved the overall quality of their institutions. All three countries, which are emerging from economic fragility, were afflicted by conflict and had dismal governance performance twenty years ago. They are now faring better on political stability and have reduced civil strife, including by boosting the population's voice and participation in public affairs through elections and by strengthening mechanisms to hold public officials accountable. The way Sierra Leone's supreme audit institution has been promoting a sound management of Ebola and COVID-19 resources through its real-time audits is a telling example. This book provides further illustrations of the power of accountability, narrated by stakeholders who led or participated in the reforms of the management of public funds in sub-Saharan African countries. These countries are, however, still below the global average standards on the perception of corruption and have a long journey to reach the

⁵ <https://info.worldbank.org/governance/wgi/>

sub-Saharan Africa region's average performance on the effectiveness of government, the quality of regulations, and the rule of law.

A good understanding of the political-economy context is necessary for successful governance reforms. This is particularly important in fragile states and resource-rich countries, where stakes are high because of extreme scarcity or abundance of resources. A strong social consensus through which stakeholders acquiesce to the process and substance of change is a critical building block of a successful governance strategy. The book discusses how analyzing indicators of fragility and natural resource management could be helpful in framing the social dialogue and how international partners can help. Featuring three fragile countries (Comoros, Democratic Republic of Congo, Madagascar), two resource-rich countries (Nigeria, Republic of Congo) and one resource-rich currency union (Economic and Monetary Community of Central Africa, CEMAC), it discusses how the political settlement, the main fault lines in society, broad social expectations, and the capacity of the state should be brought together in charting governance reforms. Insights from these countries suggest that the societal consensus should aim to secure adequate laws and regulations and improve the capacity of the civil service to enforce them. Priority areas to boost revenue mobilization and enhance the state's ability to deliver good-quality public services include the rule of law, transparency in anti-money laundering and combating the financing of terrorism, external controls, and internal audit systems. Countries should also leverage membership to regional bodies to advance reforms as evidenced by some successes in the CEMAC zone.

GOVERNANCE IN AN EMERGENCY CONTEXT

The COVID-19 pandemic has intensified the call for good governance and transparency in an emergency funding context. As established in the economic literature, poor governance and corruption undermine resilience and leave countries more vulnerable to crises. Similarly, crises are times when vested interests profit from the relaxation of governance standards to foster a rapid deployment of emergency public help. In its 2020 Corruption Perception Index, Transparency International argues that “COVID-19 is not just a health and economic crisis, but a corruption crisis,” because countries with lower perceived corruption invest more in health care and could thus rely on more resilient health and public financial management systems when the pandemic struck (Transparency International 2020, page 8). In combating the disease, they were better able to test, provide universal health coverage, and deploy help to the needy, while upholding democratic norms and institutions.

Lessons from the COVID-19 crisis extend more broadly to emergency contexts, such as conflict, other health crises, and natural disasters. In countries with inefficient and ill-prepared public financial management systems, the need to respond quickly in emergency situations creates governance vulnerabilities, which can be overcome only through transparency and external scrutiny. Some countries (Botswana, Ghana, Kenya, Mauritius) created funds under their general budget law to support emergency spending, which can underpin good governance in the

use of these monies, while others took longer to establish a legal basis for the funds to operate. These experiences offer lessons and guiding principles by which countries may benefit from these funds, while mitigating the risks from the relaxation of the normal budgetary processes. Other countries bolstered supreme audit institutions, which leveraged agile compliance audits (real-time audits) to ensure accountability and prevent and detect corruption, including in the execution of emergency funds. A sound legal framework that safeguards central bank autonomy and establishes strong transparency and accountability practices should supplement the efforts in the public financial management area. The book presents lessons from emergency situations and the role of the IMF in helping its members foster a culture of accountability supported by strong audit capacity in public financial management systems and in central banks through its safeguards assessment.

SPOTLIGHT ON INNOVATION

In moving toward meeting their individual governance strategies, countries in the region are exploring a range of innovative options. Over the past 10 years, governments have intensified the use of internet-based innovations to provide digital government services, such as business registrations and applications for business licenses and birth certificates. In June 2020 International Telecommunication Union experts concluded that IT infrastructure could cut by up to half the pandemic's adverse economic impact by enabling more flexible employment models, digital delivery of services and products, and e-commerce to connect firms to consumers amid travel restrictions and by minimizing the loss of human capital via online learning. Consumers and businesses alike seem to have internalized this approach according to surveys that show that the pandemic accelerated digital transformation by several years (ITU 2021). Globally, the adoption of these innovations is tightly linked to wealth, with the sub-Saharan Africa region lagging all others. However, within the region, there are high performers in harnessing digitalization and big data analytics to improve their populations' living conditions, including through their impact on the quality of public institutions.

Indeed, the evidence across countries suggests that digital solutions can support the good governance agenda and macroeconomic performance. This book presents insights into the potential of these innovations to improve government effectiveness and reduce corruption through transparency, checks on government officials' discretionary powers, and more accurate policymaking. It discusses causality between technological innovations in public services and the quality of governance and suggests research directions to settle the debate on the direction of causality. Based on available insights, good sequencing of innovations is critical to maximize their impact on governance and macroeconomic performance. Indeed, through better governance and integrity, e-government can boost government revenue mobilization and enhance public spending effectiveness. The book offers empirical analyses of the negative association between governments' digital adoption and public perception of the corruption of tax officials. The book finds

as well that intentional shutdowns of the internet weaken the link between efforts to improve governance through digitalization and views toward corruption, as shown through perception indicators. This is especially important in countries where a culture of “gift-giving” coexists with low public-sector wages. In light of these findings, the book calls for reforms to digitize revenue collection processes and publish government spending.

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The Macro-Fiscal Benefits of Eliminating Corruption in Government

Paulo Medas

ABSTRACT

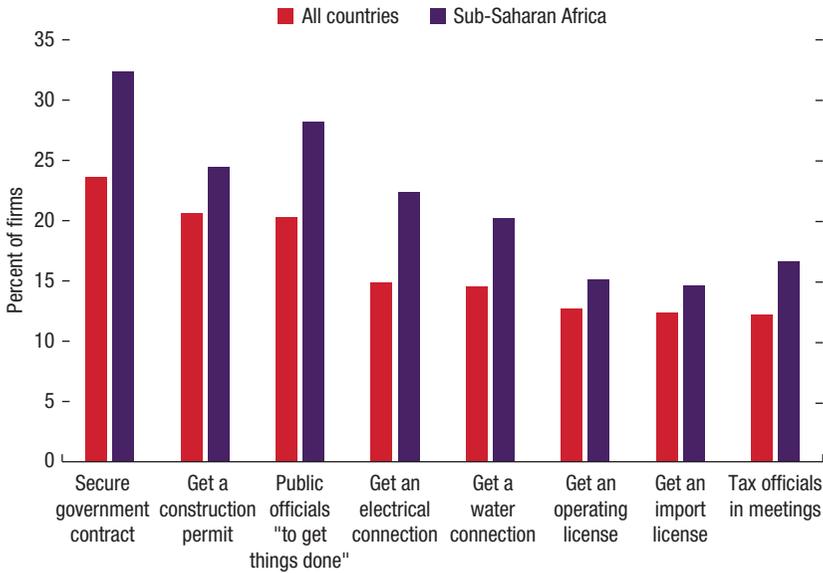
Corruption remains one of the main obstacles to sustainable and inclusive economic development. Its consequences for the functioning of the economy and people's lives can be large. When prevalent, corruption undermines the core activities of the state through several channels. It distorts fiscal policy and operations, including the collection of taxes and how those taxes are used; hampers central bank operations and financial supervision; weakens the quality of market regulations; and undermines the rule of law. Corruption is particularly harmful for fiscal policy as it undermines the ability of governments to deliver effective policies and services that promote equitable and long-term economic growth. Governments need to invest in comprehensive and persistent efforts to strengthen institutions and adopt aggressive anticorruption strategies.

INTRODUCTION

Corruption is defined as the abuse of public office for private gain (IMF 1997; 2018). Such corrupt practices change government choices to the detriment of the public interest. They can involve administrative corruption (to circumvent existing laws) but also cases in which elected officials or civil servants accept bribes in exchange for altering legislation or regulation to favor private interests—known as state capture (Hellman, Jones, and Kaufmann 2000). The payment of bribes to get government contracts or avoid paying taxes is a common example among a large share of firms worldwide, including in sub-Saharan Africa (Figure 1.1). Other forms of corruption include embezzlement and public service fraud, nepotism or cronyism to benefit family or a particular group, or influence-peddling and conflicts of interest. In an extreme case, within a kleptocracy, the state is managed to maximize the personal wealth of its leaders.¹

¹ See Rose-Ackerman and Palifka (2016) for a discussion of the different forms of corruption.

Figure 1.1. Share of Firms Expected to Pay Bribes to . . . (Percent)



Source: World Bank, Enterprise Surveys.

There is wide recognition that containing corruption is critical for economic development. This is why tackling corruption is among the United Nations' Sustainable Development Goals. Corruption distorts the activities of the state and ultimately undermines economic growth and people's lives. It weakens key functions of the public sector, including the collection of taxes and allocation of resources based on a country's priorities. For example, government subsidies may be stolen through fraud, and public infrastructure may be more expensive or of poorer quality due to bribes or cronyism. In addition, firms may engage in unproductive activities to capture economic rents (for example, by paying bribes to get favorable regulatory treatment).² The state and the country may also lose when corrupt officials use opaque financial centers to hide corrupt gains.³

Measuring the impact of corruption on economic growth is difficult due to the hidden nature of corruption, but there have been increasing efforts to shed light on the prevalence of corrupt activities and their pernicious impact.⁴ These include

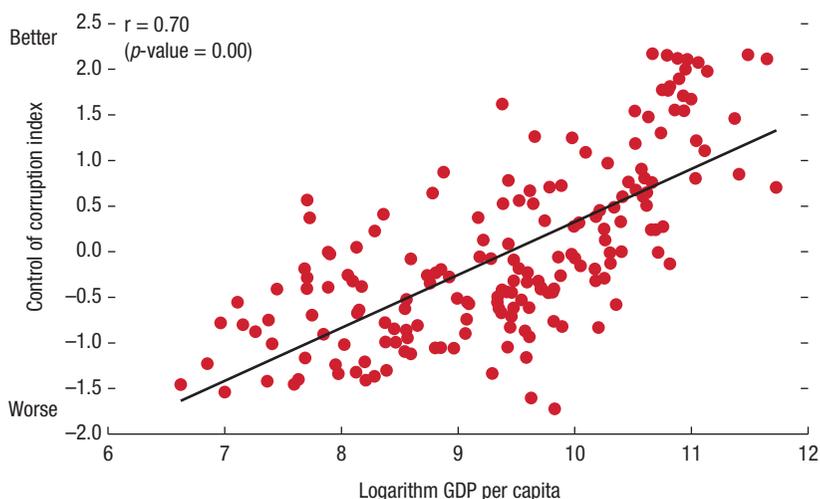
² For example, excessive government restrictions (such as price controls) can create economic rents. People or firms may then engage in corrupt acts to capture such rents (Krueger 1974).

³ Corruption is facilitated by the ability to hide illicit gains in opaque offshore financial centers. These are estimated to hold about \$7 trillion in hidden wealth deposited by individuals (Damgaard, Elkjaer, and Johannesen 2018), although not all of these assets are linked to corrupt activities.

⁴ See, for example, Fisman and Golden (2017) and IMF (2019).

cross-country indices on the perceptions of corruption, such as the Control of Corruption Index (Kaufmann, Kraay, and Mastruzzi 2007) and Transparency International's Corruption Perceptions Index (CPI) among others.⁵ These measures reveal that perceptions of the control of corruption correlate positively with GDP per capita (Figure 1.2). This correlation between economic development and corruption raises the question of whether reduced corruption is a cause or a symptom of economic development, or whether both reflect stronger institutions or other factors. This question has been a topic of significant debate especially after the publication of the seminal work by Mauro (1995), documenting the significant impact that corruption has on economic growth. A recent review of the literature (IMF 2018) includes evidence that improvements in controlling corruption typically correlate with higher growth. An improvement in the corruption indicator from the 25th percentile to the 50th percentile of the distribution is associated with an increase in GDP per capita growth between

Figure 1.2. Perceptions of Corruption at Different Income Levels (2019; GDP per capita expressed in US dollars)



Sources: IMF, World Economic Outlook database; and Worldwide Governance Indicators.

Note: The Control of Corruption Index provides a relative measure of perceived corruption and ranges from -2.5 (high corruption) to 2.5 (low corruption). For logarithm of GDP per capita in purchasing power, parity US dollars, r = coefficient of correlation.

⁵ These surveys rely on perceptions by experts or surveys of the experiences of firms or people. In this chapter, the indicator used is the Control of Corruption Index from the Worldwide Governance Indicators (WGI), which tracks data from 1996 to the present and aggregates information from a variety of sources (Kaufmann, Kraay, and Mastruzzi 2007, 2010). Caution is needed in interpreting scores for any individual country, as the quality of underlying data can vary across countries and data sources.

0.4 and 0.5 percentage points.⁶ In addition, higher corruption also tends to be associated with lower investment (including foreign direct investment) and more inequality. A growing number of microlevel studies add to the evidence on the relationship between corruption and the macroeconomy, including on the channels of transmission (IMF 2019).

Measuring the impact of corruption on economic growth is not only difficult but also likely to provide limited lessons on how to fight corruption. A more promising and practical exercise is identifying how government policies are affected by corruption. The remainder of this chapter focuses on this issue, starting with a discussion of how corruption can undermine inclusive growth and then providing evidence on the impact of corruption on government actions and policies, with an emphasis on the fiscal costs.

CORRUPTION CHANNELS

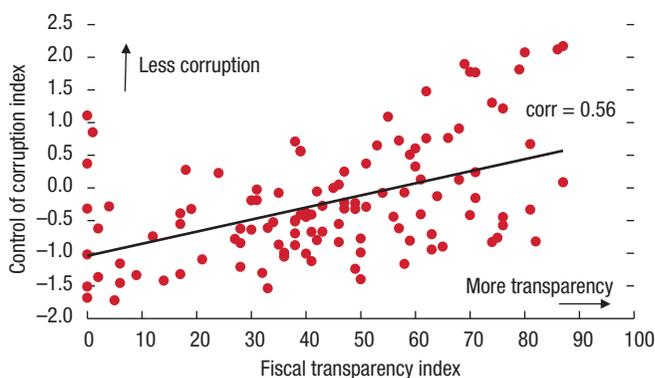
Corruption can affect inclusive growth through different channels. Depending on how pervasive it is, it can impact the normal functioning of the economy by undermining macro-financial stability, public and private investment, human capital accumulation, and total factor productivity. How corruption affects the state functions and through which channels depends to a large degree on the quality of institutions. An emblematic example is the degree of transparency in government actions. Lack of transparency reduces scrutiny of and accountability within government activities and state functions, creating greater opportunities for corruption to prosper (Figure 1.3). However, transparency is not enough. Countries need to cultivate robust governance frameworks to reduce corruption vulnerabilities. Otherwise, corrupt firms and individuals will exploit the channels with weaker governance.

The key channels can be broadly grouped as follows (see also IMF 2016; 2018):

Fiscal: Weaknesses in fiscal governance provide a conducive environment for corruption, which could increase tax evasion, distort budgetary choices in detriment of social and economic priorities, result in public spending waste; and translate into loss-making and inefficient state-owned enterprises and public banks.⁷ Ultimately, corruption can result in larger deficits and increase the likelihood of debt defaults (Fournier and Béтин 2018; IMF and World Bank 2012; Kraay and Nehru 2006). Key areas of mutually reinforcing good fiscal governance include (1) sound legal frameworks (for example, budget and tax laws), including a professional and merit-based civil service and use of digitalization to support integrity and transparency; (2) sound institutions and processes for revenue

⁶ This is based on a meta-analysis of 149 estimates of the relation between growth and corruption that suggests that improvements in corruption are typically correlated with higher growth.

⁷ Tax evasion is more likely if corrupt officials facilitate it (Alm, Martinez-Vazquez, and McClellan 2016).

Figure 1.3. Transparency and Control of Corruption (2019)

Sources: International Budget Partnership (IBP); and Worldwide Governance Indicators.

Note: The Control of Corruption Index provides a relative measure of perceived corruption and ranges from -2.5 (high corruption) to 2.5 (low corruption). The fiscal transparency index reflects the Open Budget Index from IBP.

collection and procurement; (3) effective internal and external controls (including audits); (4) fiscal transparency; and (5) a robust enforcement system enabling effective detection and sanctioning of acts of corruption.

Central bank governance and operations: Weaknesses in central bank governance (for example, in terms of the accountability and transparency framework or the internal control environment) can impair the bank's ability to manage its operations, including monetary policy.⁸ In addition, corruption in the fiscal area may lead to central bank financing and seigniorage to offset revenue lost to corruption (Blackburn and others 2008). Such financing may eventually undermine the independence and credibility of the central bank and lead to higher inflation.

Financial sector oversight: Weaknesses in the quality of the financial sector regulation and supervision framework may facilitate high-level bribery and influence-peddling, hinder financial development, and lead to financial instability (Kane and Rice 2000).⁹ Such weaknesses can increase nonperforming assets in the portfolio of the banking sector and diminish banks' willingness to provide credit.

⁸ For example, Liberia's central bank is undergoing a process to strengthen transparency and accountability following scandals regarding an alleged disappearance of funds and cases of unauthorized printing of new banknotes. See Liberia elicits help of USAID to restore integrity of Central Bank, RFI, 07/02/2020; <https://www.rfi.fr/en/international/20200205-liberia-elicits-help-usaid-hiring-auditing-firm-restore-integrity-central-ban>.

⁹ Countries with higher levels of corruption tend to have lower bank deposits from the public and to offer less credit to the private sector, undermining financial sector development and inclusion (Detragiache, Gupta, and Tressel 2005).

Capture, by corrupt agents, of regulatory agencies can undermine the ability to identify and manage risk. Mismanagement, lending to related entities, and corruption of prudential authorities can also lead to large fiscal costs associated with subsidizing or bailing out of banks.

Market regulation: The strength of a country's regulatory and administrative frameworks is crucial to achieving a balance between encouraging private sector development and promoting the public good. However, complex, inaccessible, or opaque regulatory frameworks can create opportunities for public officials to exploit discretionary authority in return for bribes or other forms of corruption, resulting in uncertainty and discriminatory treatment. Examples include granting licenses and business permits (for example, licences for oil and mining exploration) and authorizing exemptions from existing regulations.

Rule of law: The rule of law enables the protection of property and contractual rights, which are important for well-functioning economies. One of the most important determinants of the enforcement of economic rights is the quality of the judiciary, including its independence from private influence and public interference. Weaknesses in this area can undermine the availability of credit and investment more generally (for example, if property rights cannot be enforced, banks will be less willing to lend). The quality of the anti-money-laundering framework is also relevant in this context. First, money laundering and related crimes can undermine the stability of a country's financial system or its broader economy. Second, these crimes can facilitate corruption by allowing perpetrators to conceal the proceeds of corrupt acts.

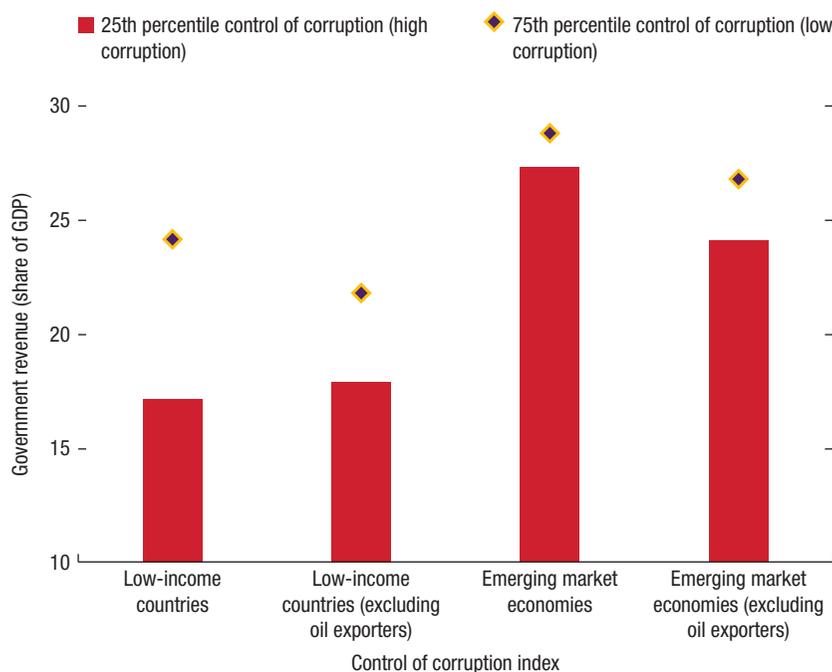
FISCAL COSTS OF CORRUPTION

This section presents evidence on the impact of corruption on government actions, focusing on the *hotspots* of corruption, defined as the fiscal areas in which corrupt activities are especially prevalent and damaging. The costs include large leakages, as revenue is lost and resources are misused or stolen, but also poorer quality of policies and efficiency of public services. Corruption also distorts the actions of the private sector and can lead to inefficiencies, and lower productivity and growth, which ultimately reduces tax revenues and increases public spending pressures. This occurs because firms direct resources to rent-seeking activities instead of productive ones (Krueger 1974) or because corruption imposes a cost on firms. For instance, Sequeira and Djankov (2010) estimate costs incurred by firms due to corruption by comparing two ports (Mozambique and South Africa) that have similar operating costs but different levels of perceived corruption. They find that companies prefer to double their transportation costs to avoid the port where a public bureaucrat coerces a private agent into paying an additional fee, above and beyond the official price, just to gain access to the public service or good. The cost for a firm to reroute is eight times higher than the cost of the actual bribe requested, suggesting an extreme aversion to the uncertainty and ambiguity of bribe payments.

Corruption Leads to Lower Revenue Collection . . .

Cross-country evidence confirms that government revenues are significantly lower in countries perceived to be more corrupt. The pattern holds among the different-income country groups (Figure 1.4). Among low-income countries (excluding oil exporters), a country in the top 25 percent in terms of control of corruption collects 4 percent of GDP more in revenues, on average, than a country in the lowest 25 percent.¹⁰ The gap is 2¾ percent of GDP among emerging market economies. This relationship between corruption perception and revenue collection is confirmed by other studies that also control for the level of economic development and other factors. For example, IMF (2019) finds that an improvement in the Control of Corruption Index by one-third of a standard deviation (equivalent to the average improvement for those countries that

Figure 1.4. Government Revenues and Corruption



Sources: IMF, World Economic Outlook database; and Worldwide Governance Indicators.

Note: The figure shows the five-year average government revenues as a share of GDP (excluding grants).

¹⁰ When including oil exporters, the gap is even higher, around 7 percent of GDP, likely reflecting that the oil sector is especially vulnerable to corruption given the high profits.

reduced corruption between 1996 and now) is associated with an increase of 1.2 percentage points in government revenues as a share of GDP.

Corruption can harm revenue collection through both tax legislation and administration. The introduction of tax exemptions or tax loopholes, which can be exchanged for bribes, reduces revenue potential. Furthermore, a complex and opaque tax system allows more discretion in its administration (Asher 2001) and facilitates hidden corrupt dealings. Customs administration is particularly vulnerable to corruption because customs officials often enjoy discretionary powers with limited supervision. The distortion of tax laws and the corruption of tax officials¹¹ reduce trust in the state and weaken tax compliance.¹² For example, recent data from 36 African countries suggest that if people believe the government is corrupt, they are more likely to disagree that governments have the right to make people pay taxes, undermining a culture of voluntary compliance (Boly, Konte, and Shimeles 2020).

Rwanda stands out as a country that significantly reduced corruption and subsequently enjoyed a surge in tax revenues. Over the past two decades, its government enacted several legal and institutional reforms to fight corruption. Strengthening fiscal institutions has been an integral part of these reforms, which included major civil service modernization through the establishment of a competitive and merit-based recruitment system. Rwanda also undertook tax administration reforms, with significant improvements in collection efforts, auditing procedures, and scrutiny of large taxpayers. As corruption declined, tax revenues rose from around 9–10 percent of GDP in 1996–2000 to 15–16 percent of GDP in 2016–18. Another example is Georgia, considered in the 1990s as one of the countries with the largest corruption challenges worldwide. In particular, corruption in tax administration decimated revenue collection. In 2003 a new government launched an anticorruption campaign, strengthened fiscal institutions, and made significant improvements on governance. As a result, compliance was fostered by renewed trust in government as public services improved, and tax revenues more than doubled to 25 percent of GDP in 2008.

Extractive industries stand out as a hot spot of corruption, reflecting the large profits associated with oil and mining exploration. Moreover, because these government revenues come from export receipts and multinationals, and do not involve taxing citizens, there is a tendency for less scrutiny and accountability. For example, Andersen and others (2017) find that petroleum windfalls translate into significant increases in wealth hidden abroad by residents of some oil-rich countries. The risks of corruption are also particularly high around the design and award of exploration rights contracts. Indeed, the terms of these contracts are

¹¹ Examples include bribery to reduce taxation, undervaluation or underdeclaration of goods at customs, and extortion by tax or customs officials who threaten to use their powers to administer ambiguous tax laws against taxpayers (Martini 2014).

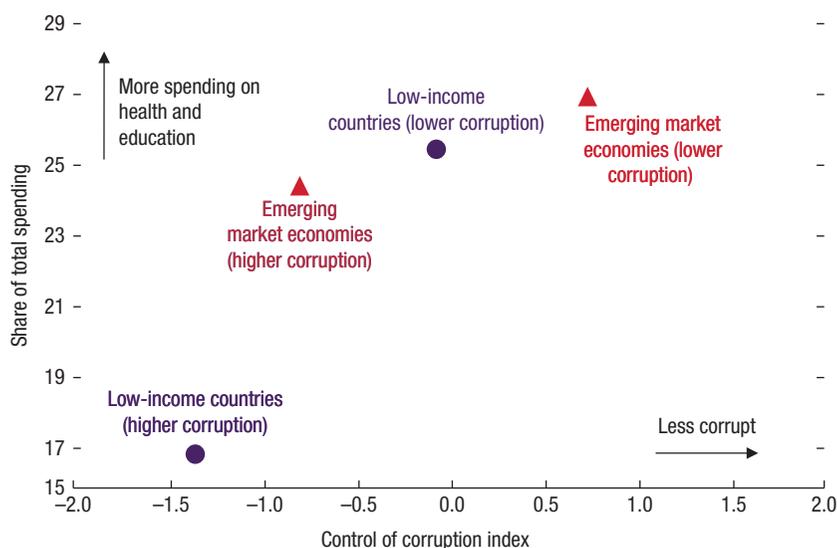
¹² Alm, Martinez-Vasquez, and McClellan (2016) find that the presence of tax inspectors who request bribes results in a reduction of sales reported for taxes by 4–10 percentage points. Additionally, larger bribes result in higher levels of evasion.

often secret, preventing external scrutiny of the actions of public officials and firms (including state-owned oil companies). The industry also faces heightened risks in revenue collection, partially due to the complexity in assessing and monitoring taxes due, which facilitates the negotiation of lower tax payments in exchange for bribes.

... And Distorts Spending Choices and Reduces Effectiveness of Policies

Corruption can affect spending choices in the government budget, with implications for the economy and the quality of services to the population. One pernicious example is that corruption is associated with fewer resources allocated to education or health, especially among low-income countries (Figure 1.5). The countries where corruption is least prevalent tend to spend almost 10 percentage points more on education and health than those with the highest levels of corruption. One reason for this relationship may be that these are areas where it is more difficult for policymakers to extract large bribes (Mauro 1998)—these areas may have more petty corruption at the implementation stage (for example, teachers not showing up to work or charging bribes for grades). Instead, resources may be diverted to projects that offer opportunities for larger kickbacks or where there is

Figure 1.5. Control of Corruption and Public Spending on Education and Health (Percent)



Sources: IMF, Government Finance Statistics database; and Worldwide Governance Indicators.
 Note: Graph based on 2016 data on share of spending on health and education for countries with the lowest levels of corruption (top 25 percent of control of corruption) and highest levels of corruption (bottom 25 percent) for each country group.

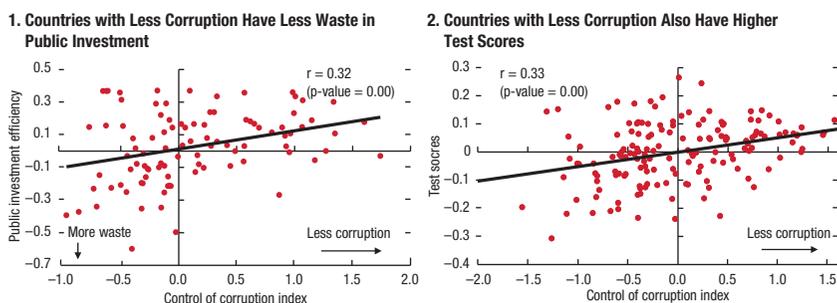
less scrutiny, such as large investment projects or defense-related equipment purchases.

Procurement of goods and services is an area where corruption risks are exceptionally high. This is not surprising as procurement accounts for a large share of government budgets in most countries, with some estimating it at 10–15 percent of GDP among sub-Saharan African countries (UN 2017; World Bank's global public procurement database). Lack of transparency and competitiveness (for example, having only one bidder) make countries especially vulnerable to corruption. More generally, corruption risks in procurement are usually associated with contracts with large tenders, a lack of transparency and collusion among bidders, complaints from nonwinning bidders, shortened bidding times, multiple contracts below procurement thresholds, unusual bid patterns, inflated agent fees, suspicious bidders, failure to select the lowest bidder, repeat awards being given to the same contractor, changes in contract terms and value, and poor quality of works and services (see Ferwerda, Deleanu, and Unger 2017 and World Bank's common red flags). The direct losses due to corruption are reflected in cost overruns, implementation delays, and poor quality. For example, a study of Hungary's procurement process (Szucs 2017) finds that abandoning an open auction for a negotiation procedure increases corrupt rents, raises the price of every dollar of public spending by eight cents, and results in a drop in the productivity of selected contractors.

Among types of procurement, public investment is particularly vulnerable to corruption. Investment projects often have unique characteristics, and they tend to be complex, reducing competition and making it easier to conceal corruption (for example, it may be difficult to compare costs to help identify bribes). In addition, projects may require numerous licenses and permits, providing an opportunity for bribery. Some estimates suggest that for construction projects, the losses due to corruption range between 10 and 30 percent of the overall value (Matthews 2016).

Other areas of corruption at the budget execution stage could involve wage and pension bills (for example, for so-called ghost workers) or extortion of bribes in providing public services or subsidies. Lack of effective controls can also lead to fraud and embezzlement. For example, the “cashgate scandal” in Malawi involved the misuse of funds totaling 1.3 percent of GDP in 2013. In contrast, in India, the adoption of an electronic platform for managing a social assistance program reduced opportunities for discretion and fraud and resulted in a 17 percent decline in spending with no corresponding decline in benefits (Banerjee and others 2016). Greater opportunities for corruption exist in off-budget spending where transparency, controls, and external scrutiny are often laxer (see Chapter 12).

Another harmful consequence of corruption is the poorer quality and effectiveness of government policies. In particular, core public services, such as the provision of good-quality public infrastructure and education, can be severely hampered (Gupta, Davoodi, and Tiongson 2000). There have been many cases of infrastructure projects plagued by corruption allegations in Africa (UN 2017).

Figure 1.6. Impact of Lower Corruption

Sources: IMF (2019); Patrinos and Angrist (2018); and Worldwide Governance Indicators.

Note: Variables adjusted for GDP per capita. Test scores for school-age students are harmonized across sources. 2015 data.

Examples include the construction of dams in Kenya (1986) and Uganda (2010), and the Lesotho Highlands Water Project (1980s). Ultimately, this can lead to lower economic growth and higher poverty and inequality.

Cross-country comparisons suggest that countries with higher levels of perceived corruption are significantly less efficient, or have higher waste, in undertaking public investment in infrastructure (Figure 1.6.1).¹³ The difference between a given country and the most efficient one within the same income-level group—the efficiency gap—provides a measure of waste, which reflects corruption and other factors. For instance, the data indicate that an emerging market economy in the top 25 percent of the control of corruption scale wastes half as much as one in the bottom 25 percent (IMF 2019).

Corruption is also associated with lower human capital. Countries in which corruption is higher, tend to have a lower quality of education, measured by test scores (Figure 1.6.2). This can reflect several factors. In some countries, bribes or connections, rather than merit, influence access to teaching positions in public schools. In addition, teacher (and health worker) absenteeism is a widespread form of petty corruption in several developing economies (Chaudhury and others 2006). There is also evidence that corruption leakages in education grants have a negative impact on test scores and are associated with higher dropout rates (Ferraz, Finan, and Moreira 2012). Uganda provides an example of the benefits of instituting reforms in this area. In the late 1990s the Ugandan government

¹³ Public investment efficiency is estimated using efficiency frontier analysis and measures inefficiency as the distance to the frontier—that is, the maximum level of output for given levels of inputs. Output is measured by a physical indicator of the volume of economic infrastructure and social infrastructure. Inputs include capital stock and income. The efficiency measure considers the level of GDP per capita because countries at different levels of development have different technologies with which to invest and varying initial capital stocks. A country's level of efficiency is relative to the most efficient country with a similar level of income (IMF 2015).

initiated a newspaper campaign to boost the ability of schools and parents to monitor local officials' handling of a large school-grant program. As a result, the diversion of funds decreased from 80 percent in 1995 to less than 20 percent in 2001 (Reinikka and Svensson 2005).

Weak Governance Severely Undermines State-Owned Enterprises' Performance

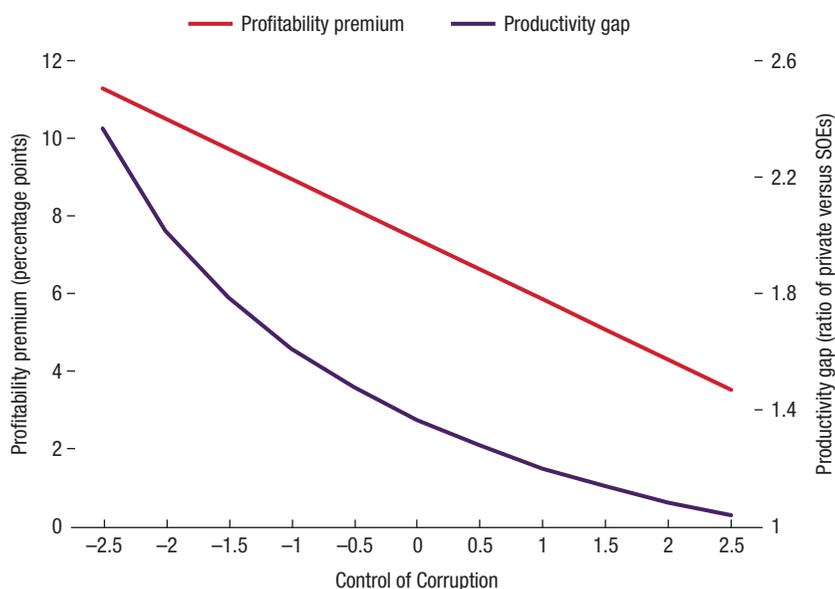
Public sector activities extend beyond the central budget via the operations of state-owned enterprises (SOEs). In many countries, SOEs play a role in building infrastructure and providing public goods and services. For example, they account for about one-third of infrastructure investment in Sub-Saharan Africa (World Bank 2017). Many SOEs are also involved in the provision of core services, such as water and electricity, and are key players in extractive industries (oil and mining). As such, how well these firms operate can have significant budgetary and economic consequences.

Corruption has been one of the main challenges faced by SOEs in many emerging market and low-income economies. The risks of corruption tend to be higher because these firms operate under weaker controls and transparency. Civil servants or elected officials may unduly influence SOEs' operations for personal benefit. The high degree of corruption may also reflect the sectors where SOEs operate. For example, national oil companies have a particularly high risk of corruption because they can generate large profits, and rents for corruption (see Section 3 of this book). Some may directly negotiate the terms of exploration with foreign corporations (for example, in the case of subcontractor services) with limited oversight. This is one of the most common areas of international corruption.¹⁴ Noncommercial activities of SOEs can also be an area of revenue leakage in the absence of proper vetting. Recent corruption examples include Angola's Sonangol and several of the largest South African SOEs (for example, Eskom and Transnet).¹⁵

International experience shows that weak governance is one of the main reasons behind poor SOE performance. SOEs operating in countries with high levels of governance are almost three times more efficient (in terms of higher labor productivity) than SOEs operating in countries with poor governance

¹⁴ Available evidence suggests that 80 percent of foreign bribes go to SOE officials, many of whom operate in the oil sector (OECD 2014).

¹⁵ For example, in Angola, President Lourenço indicated that at least \$24 billion was lost to corruption (see "Angola Sharpens Fight to Recover Stolen Cash as Debt Pressure Mounts, *Financial Times*, November 2020; <https://www.ft.com/content/5ebceb76-5e3f-4e08-98b8-3345b86a3482>). Sonangol has also announced in recent years actions to improve governance (see *Ver Angola*, November 2020, <https://www.verangola.net/va/en/112020/Energy/22809/Sonangol-approves-review-of-anti-corruption-policies-to-protect-and-enhance-the-company>). The problems are also common outside Africa and among advanced economies. In an OECD survey, 42 percent of SOE respondents reported that corrupt acts or other irregular practices had occurred in their company during the past three years (OECD 2018).

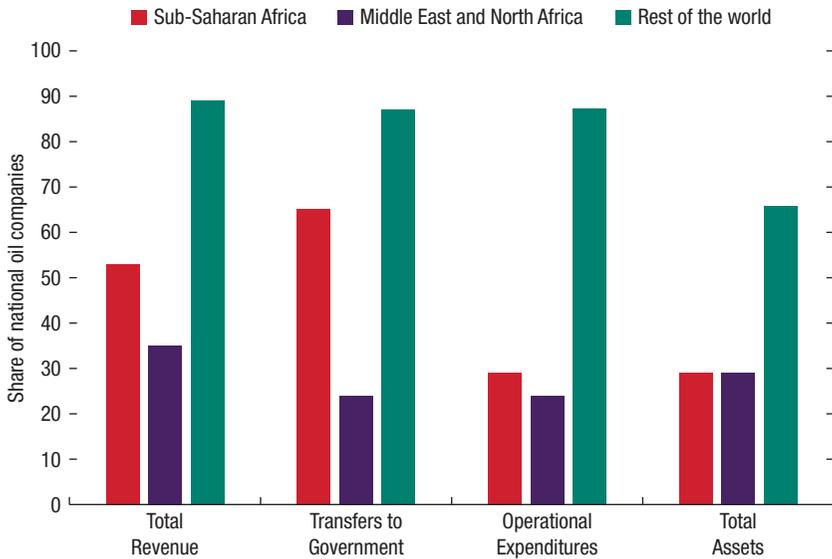
Figure 1.7. Corruption and Firm Performance

Sources: IMF (2020); and Worldwide Governance Indicators.

Note: The figure shows the difference between profitability (return on equity) of private firms and SOEs, and productivity gap, measured by the ratio between productivity of private firms relative to SOEs.

(Figure 1.7). The difference in terms of profitability (return on equity) between private firms and SOEs is close to 12 percentage points in countries with high corruption. However, in countries with good governance, the performance between private firms and SOEs is comparable, with a very small productivity gap on average.

Lack of transparency regarding SOE operations can significantly impede external scrutiny. For example, financial information on SOEs remains very uneven across countries. This is especially the case for national oil companies in the Middle East, North Africa, and sub-Saharan Africa (Figure 1.8). In sub-Saharan Africa, fewer than one-fourth of the companies provide comprehensive and detailed information on their operations and balance sheets, despite controlling large assets of the country. Publishing regular reports with detailed information and analysis of the performance of the SOE sector at the aggregate and company levels is a needed step toward greater transparency and accountability (see Section 4 of this book). Some sub-Saharan African countries provide information on SOEs (for example, Angola, Ghana, and South Africa), but the information is not always timely or sufficient for a comprehensive analysis. Another challenge has been implementing and enforcing good corporate governance standards even when there is a legal framework for SOEs. Countries also

Figure 1.8. National Oil Companies That Report . . .

Source: Natural Resource Governance Institute; and author calculations.

often lack the institutional capacity to effectively monitor SOEs, especially the larger ones, which are typically involved in complex activities. Baum and others (2019) show, when comparing different SOE reforms, that improvements in governance can result in some of the largest improvements in the performance of SOEs (for example, by raising productivity and lowering costs).

CONCLUSION

Corruption can impose large negative budgetary, economic, and social costs. Importantly, corruption takes advantage of governance vulnerabilities in the different areas where the state operates. For example, weak transparency creates a fertile ground for corruption. Corruption undermines the ability of governments to collect taxes, leads to unnecessary and expensive public projects that often are fueled by bribes, and leads to poorly performing SOEs. When corruption is more pervasive, governments also spend less, in areas like education, health, and spend with worse quality on public infrastructure, areas that are critical to address development needs. While difficult, fighting corruption and strengthening governance and accountability are crucial to achieve sustainable and inclusive development. Despite some progress, governments in sub-Saharan Africa need to invest more in good institutions. This needs to be a comprehensive and continued effort, as corruption will evolve to exploit institutional vulnerabilities.

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Pathways to Reaping a Governance Dividend in Sub-Saharan Africa¹

Marshall Mills, Nelson Sobrinho, and Vimal Thakoor

ABSTRACT

This chapter studies the key channels through which improvements in governance and anticorruption measures can boost macroeconomic performance, particularly long-run economic growth.² It estimates the relationship between economic growth and both corruption and aggregate indicators of governance, the latter reflecting several dimensions of institutional quality, including not only a measure of corruption, but also voice and accountability, effectiveness of government policies, regulatory framework, and rule of law. It also discusses the extent to which improvements in these areas can benefit governance, including institutions responsible for fiscal policy and monetary and financial management. The empirical and policy discussions focus on developing countries, with a special emphasis on sub-Saharan Africa. The empirical findings suggest that, on average, sub-Saharan African countries lag other regions in terms of governance and perceptions of corruption. The region's dividend from governance and anticorruption reforms could therefore be particularly high. Historical experience suggests that improving governance and reducing corruption may take considerable time and work, but the large potential payoffs would justify the effort.

INTRODUCTION

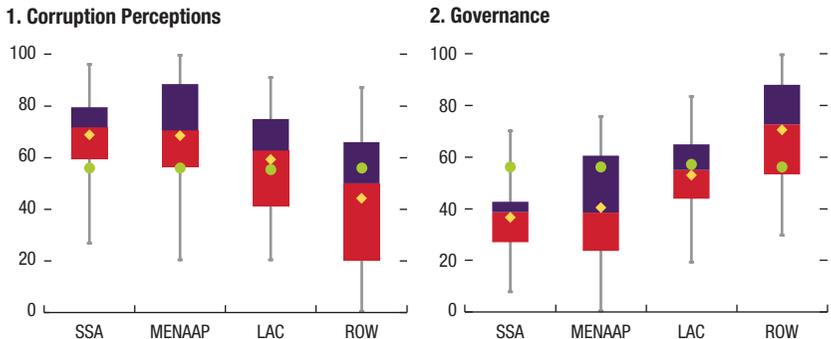
Improving governance and fighting corruption remain critical ingredients in boosting growth and development in sub-Saharan Africa. The African Union chose “Winning the Fight against Corruption” as its theme for 2018. Many incoming leaders in countries in the region routinely place good governance at the top of their agenda. Historical data suggest that sub-Saharan African countries generally lag those

¹ This chapter draws heavily on joint work done with Amine Hammadi and Ricardo Velloso as presented in Hammadi and others (2019), which was part of the IMF's broader effort to study the economic and policy implications of the quality of governance worldwide, especially in developing countries.

² We view corruption as one important manifestation of governance weakness, hence the significant emphasis on corruption in this chapter.

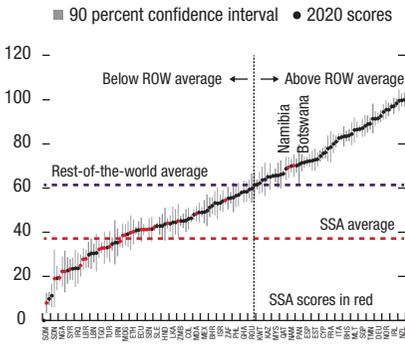
in most other regions in terms of corruption perceptions and governance. Sub-Saharan Africa’s average scores on corruption and governance are similar to those for the Middle East, North Africa, Afghanistan, and Pakistan region (MENAAP) but lower than for other regions (Figures 2.1.1 and 2.1.2). Thirty-six out of 45 sub-Saharan African countries score below the global average in Transparency International’s Corruption Perceptions Index (CPI) and only two of the 30 sub-Saharan Africa countries included in the International Country Risk Guide’s (ICRG) governance indicator have above-average scores (Figure 2.1.3). There is, however, significant intraregional variation in scores across sub-Saharan Africa (Figure 2.1.4).³

Figure 2.1. Corruption Perceptions and Governance in Sub-Saharan Africa and the World (2019–20)

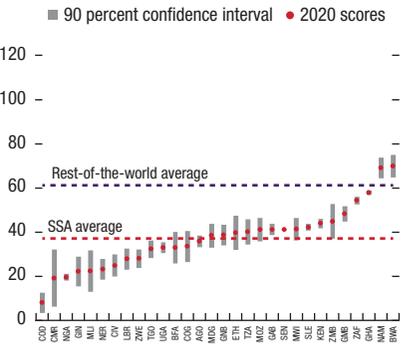


Note: The red and blue areas are middle quartiles. The orange diamond and green dot represent regional and world averages, respectively.

3. Governance across the World



4. Governance in Sub-Saharan Africa



Sources: Transparency International; ICRG; and authors’ calculations.
 Note: All indicators are normalized 0–100, lower (higher) score better for anti-corruption (governance). Confidence intervals are estimated around 2020 scores using standard deviations for the five-year period 2016–20.

³ Similar results hold across a range of corruption and governance indicators. Corruption is defined as “the abuse of public office for private gain.” Governance is defined as follows: “Institutions, mechanisms,

This chapter investigates the relationship between economic performance and governance/corruption, with a special focus on sub-Saharan Africa. The main goal of this investigation is to test whether weak governance and corruption have any impact on economic growth. The chapter posits that corruption and weak governance undermine growth, thus acting more like “sand in the wheels”⁴ than “oil in the engine.”⁵ The chapter also examines the “grease in the wheels” view—which argues that some amount of corruption could increase bureaucratic efficiency and improve growth by mitigating red tape—by testing a nonlinear relationship between corruption and growth. Of course, low corruption and good governance are not the sole drivers of growth. There are various examples of poorly governed countries that have had episodes of strong growth driven by other factors (for example, natural resources), while others have not necessarily experienced strong growth despite their good governance.

The rest of the chapter is organized as follows: The first section, “Measurement, Stylized Facts, and Channels for a Governance Dividend,” discusses the indicators used as proxies to gauge the effectiveness of governance and some of the challenges associated with these measures, as well as the main channels through which governance can impact macroeconomic outcomes. The following section presents the empirical approach, discusses the baseline findings, and shows the various robustness checks. Finally, “Policy Implications” discusses some of the policies that could support efforts to improve governance and political economy considerations in implementing such policies.

MEASUREMENT, STYLIZED FACTS, AND CHANNELS FOR A GOVERNANCE DIVIDEND

Measuring Governance

Governance is a multifaceted issue that cuts across politics, economics, and institutions. The indicators with the most significant economic ramifications include corruption (abuse of public office for private gain), government effectiveness (quality of public policies and services), regulatory quality (ability of the government to formulate and implement business-friendly policies and regulations), the rule of law (respect for contract enforcement, property rights, and law

and practices through which government power is exercised in a country, including for the management of public resources and regulation of the economy. This includes processes at the country level, including institutions-level structural arrangements” (IMF 2017). Governance indicators are normalized to range from 0 (worst) to 100 (best). Corruption perceptions indicators are also normalized to range from 0 (best) to 100 (worst). Given the degree of uncertainty around point estimates of governance and corruption indicators, we report confidence intervals and standard errors instead. We also note that these indicators, especially of corruption, are based on perceptions and may not be readily comparable across countries, regions, or time.

⁴ See, for example, Mauro (1995); Shleifer and Vishny (1993); and Ugur and Dasgupta (2011).

⁵ See, for example, Cerqueti, Coppier, and Piga (2012); Saha and Gounder (2013); and Saha, Mallik, and Vortelinos (2017).

enforcement), and voice and accountability (the extent to which citizens participate in selecting their government, as well as freedom of expression, freedom of association, and a free media).⁶

Bringing the various governance dimensions into one indicator can be challenging because aggregating subjective measures may not fully capture the reality on the ground—since distinct attributes of governance are lumped together in one indicator. While corruption perceptions tend to be the main component of interest, many measurements of governance are broad enough to be useful proxies for determining the quality of political institutions, government regulations, and policies.

Stylized Facts

Weaker governance and higher corruption are associated with the following features:

- *Lower levels of development:* The data show an unconditional positive (negative) correlation between governance (corruption perceptions) and real GDP per capita both in sub-Saharan Africa and the rest of the world. Similar correlations have also been found or implied in an extensive body of literature, including seminal work by Mauro (1995) and meta-analysis by Ugur and Dasgupta (2011).
- *Lower growth in sub-Saharan Africa:* The data show a positive (negative) unconditional correlation between governance (corruption perceptions) and growth in sub-Saharan Africa.⁷ These correlations look weaker for the rest of the sample.
- *Worsened fiscal performance, as seen in expenditure levels and composition:* Higher corruption perceptions are negatively associated with education spending and quality of public investment in the overall sample and more so in sub-Saharan Africa.⁸
- *Higher inflation and increased risks of financial instability:* These can arise from monetary financing pressures on a central bank lacking independence, or the allocation of loans based on political connections.⁹

Sub-Saharan Africa lags peers in most granular measures (that is, channels) of governance. Sub-Saharan African countries have low scores across most dimensions of governance (Figure 2.2), including voice and accountability, government effectiveness, regulatory quality, and rule of law, as well as business environment.

⁶ See, for instance, Kaufmann, Kraay, and Mastruzzi (2010).

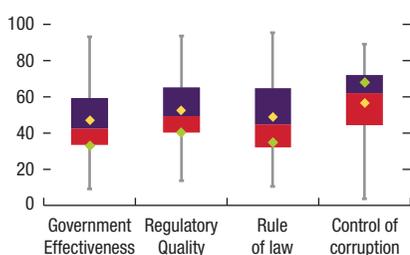
⁷ See Collier and Gunning (1999); Gyimah-Brempong (2002); and Gyimah-Brempong and de Camacho (2006).

⁸ See, for example, Baum and others (2017) and Tanzi and Davoodi (1997).

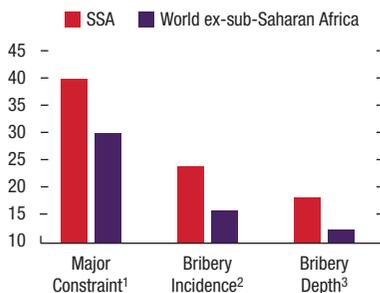
⁹ See, for example, IMF (2016; 2018).

Figure 2.2. Sample Distribution of Governance and Corruption Perceptions

1. Distribution of Governance and Corruption Perceptions (Average percentiles, 1995–2015; higher=better governance, less corruption)



2. Corruption Perceptions as Obstacle to Doing Business (Corruption perceptions by firms in sub-Saharan Africa; average percent of firms answering the survey)



Sources: WGI; and authors' calculations.

Note: Red and purple areas are the second and third (from the bottom) quartiles of the sample distribution, respectively. The orange and green diamonds are the sample and sub-Saharan African averages, respectively.

Source: World Bank Enterprise Survey (most recent since 2010).

Notes:

¹Major or very severe constraint to doing business.

²Bribe payment request.

³Gift or informal payment request in public transactions.

These channels are also strongly correlated with corruption perceptions. Thus, improving governance channels could reduce corruption and therefore mitigate the costs of corruption.¹⁰ Overall, this evidence for sub-Saharan Africa suggests that governance and corruption problems are both acute and endemic in the region. Weak institutions and resource intensity could be linked to the higher incidence of weak governance and corruption in sub-Saharan Africa. The large economic rents generated by resource-rich sectors such as oil—often controlled by state-owned companies subject to political interference—can expose resource-rich countries to higher levels of corruption, especially when institutions are weak (OECD 2014; 2016).

Channels for a Governance Dividend

Sub-Saharan Africa's governance scores do not necessarily reflect a lack of legislative and institutional frameworks, as many countries have adopted legislation that criminalizes corruption and related offences, improved their AML/CFT frameworks, and established specialized anticorruption agencies. Instead, they likely reflect limited institutional capacities, weak enforcement of existing frameworks, and a perverse interaction between weak institutions and resource intensity.

¹⁰ The strong correlation between corruption perceptions and overall measures of governance also arises by construction as corruption perceptions are included in most aggregate governance indices.

Hence, in many cases, adhering to well-designed rules and regulations can represent a major step in the right direction.

Improved policies that strengthen governance through multiple channels can enhance economic performance and support social inclusion indirectly by positively affecting revenue, investment, and the financial sector. These positive impacts, and the policies that enable them, include:

- *Enhanced revenue mobilization through improved tax compliance:*¹¹ Customs and revenue authorities are better able to fight smuggling and illicit flows when tax officials adhere to strong governance principles. Citizens are more likely to pay their taxes when they trust the effectiveness of government spending.
- *More efficient government spending due to stronger budgetary processes:*¹² Good governance reduces the risks of deleterious shifts in the composition and quality of government spending towards items that allow for greater graft opportunities (for instance, “white elephants”). Strict adherence to public procurement and public financial management laws reduces the risk of expensively tailored contracts, thus lowering overall spending inefficiencies and fiscal risks.
- *Improved investment composition and business environment:*¹³ Addressing weakness in investment procedures improves public investment management and efficiency. Removing red tape and regulations reduces the opportunities for corruption and the cost of doing business, thus supporting private investment. Streamlined regulations also reduce policy uncertainty and the risk of state capture, whereby agents pay for regulations to be tailored to their business needs. Leveling the playing field is generally conducive to firm entry, competition, and innovation.
- *Better central banking governance and reduced price and financial stability risks:*¹⁴ Improved fiscal governance translates into reduced fiscal pressures and supports price stability by reducing the need for central bank financing or a raid on the central bank coffers. Strengthened financial supervision supports financial stability by reducing the likelihood of lending irregularities and crony capitalism.
- *Improved developmental outcomes and social inclusion:*¹⁵ Improved spending composition and investment are likely to benefit the poor disproportionately, as they rely more on social services. Hence, improved spending on education and health can better support economic and social inclusion and reduce social vulnerabilities, as well as mitigate income inequality and poverty.

¹¹ See, for example, Baum and others (2017).

¹² See, for example, Tanzi and Davoodi (1997).

¹³ See, for example, Mauro (1995) and (Tanzi and Davoodi 1997).

¹⁴ See, for example, IMF (2016; 2018).

¹⁵ See, for example, Gupta, Davoodi, and Alonso-Terme (2002).

EMPIRICAL APPROACH AND FINDINGS

A standard growth model, augmented for measures of governance or corruption, is estimated in order to assess the impact on GDP per capita growth for 190 countries, using five-year observations over the period 1984–2015 in a system of generalized method of moments (SGMM) model. Box 2.1 briefly describes the methodology, and Annex 2.1 summarizes the data and data sources. In the baseline regressions, the following variables of interest are used: (1) two measures of governance—the ICRG’s Political Risk Rating and an aggregate measure based on Kaufmann and Kraay’s Worldwide Governance Indicator (WGI) (Kaufmann, Kraay, and Mastruzzi 2010); and (2) two indicators of corruption perceptions—Kaufmann and Kraay’s Control of Corruption Indicator (CCI) and Transparency International’s CPI. The discussion that follows focuses on sub-Saharan Africa, but it also explores the correlation between governance/corruption and growth in other regions and country groups; it further considers whether the correlation is stronger in sub-Saharan Africa compared to other regions.

All estimated growth dividends presented in this chapter are long-term gains. Measuring the exact time that is required for these gains to materialize is beyond the scope of this chapter, but it will depend to a large extent on the starting point of the countries and the overall political commitment to the process. Giavazzi and Tabellini (2005) estimate that economic and political liberalization, which is typically associated with improved governance, takes at least three years to affect governance and corruption perceptions.

Box 2.1. Estimating the Impact of Corruption and Governance on GDP per Capita Growth

A standard growth regression is estimated, augmented for governance or corruption and using an unbalanced panel comprising of 190 countries over the period 1984–2015. The baseline specification is the following:

$$g_{it} = \beta_0 + \beta_1 GOV_{it} + \beta_2 GOV_{it} SSA + \beta_3 SSA + \mathbf{B}'\mathbf{X}_{it} + \tau_t + \mu_i + v_{it} \quad (1)$$

where g is real GDP per capita growth, GOV is governance or corruption perceptions, SSA is a dummy variable for sub-Saharan Africa, X is a column vector of country-specific explanatory variables that are assumed to be strictly exogenous in the baseline specification, τ denotes time-fixed effects, and μ and v denote unobserved country fixed effect and error term, respectively. Subscripts $i = 1, 2, \dots, N$, and $t = 1, 2, \dots, T$ index country and time, respectively. The baseline variables included in vector X have been typically considered by similar studies in the literature: initial GDP per capita (in log); physical investment (measured by gross capital formation as percent of GDP); level of education (per capita years of secondary and tertiary schooling); inflation (dummy variable if inflation is larger than 15 percent and zero otherwise); and

(continued)

terms of trade (percent change). See full data description in Annex 2.1. The robustness of the model has also been tested against alternative choices of controls (see following discussion).

The baseline model was estimated using a robust two-step SGMM model (Blundell and Bond 1998; Roodman 2009). The system includes the level and difference versions of specification (1). Investment and lagged growth (included in alternative specifications) have been treated as endogenous and the remainder (initial income, education, inflation, terms of trade, governance/corruption, and time and regional dummies) have been considered as exogenous in the baseline specification. For the differenced equation, the estimator uses as instruments lagged values of endogenous and predetermined variables and current and lagged values of differenced exogenous variables. For the level equation, it uses as instruments lagged values of differenced endogenous and predetermined variables and current and lagged values of exogenous variables. The absence of second-order serial correlation of the error term and validity of instrument (Hansen test of overidentifying restrictions) have also been tested for.

The coefficients of interest are β_1 and β_2 . Both are expected to be positive for governance and negative for corruption perceptions. The stylized facts set forth in the preceding discussion suggest that $\beta_1 + \beta_2 > \beta_1$ (in absolute terms) for sub-Saharan Africa; that is, governance or corruption perceptions could potentially have a stronger marginal effect on growth in the sub-Saharan Africa region than in other regions. The interaction term would appear to encapsulate this feature. Interaction terms, including categorical variables, have also been used in the literature in a somewhat similar setup to that used in this chapter.¹

Because weak governance and high corruption distort social and capital spending and worsen government policies overall, the covariates gross capital formation, education, and inflation already capture some of the indirect impact of governance and corruption on growth. Therefore, β_1 and β_2 would measure only the direct effect on growth, after controlling for human and physical capital and the quality of macroeconomic policies.

The baseline model survives several robustness tests, including: the use of alternative estimation methods (for example, difference GMM, OLS); inclusion of additional controls (for example, a 20 percent threshold for inflation dummy, resource intensity, agriculture intensity, openness, and government consumption); and choice of the averaging window (for example, one year and three years). Furthermore, several tests were performed for potential endogeneity problems in the relationship between governance/corruption and growth. The baseline results pass most of these tests, including lagging governance and using several alternative instrumental variables such as ethnic fractionalization, settler mortality, years since independence, and a country's latitude.²

A nonlinear relationship is also estimated between corruption and growth, which allows for testing of the "grease in the wheels" hypothesis. The finding here is that corruption seems to be more harmful to growth in sub-Saharan African countries where corruption perceptions exceed 60 in the normalized scale used in this analysis, that is, about three-quarters of all sub-Saharan country-years in the sample. The impact of corruption perceptions on growth seems less harmful if corruption problems are perceived to be small to moderate.³

¹ See, for example, Gyimah-Brempong and de Camacho (2006).

² See Hammadi and others (2019).

³ See, for example, Saha, Mallik, and Vortelinos (2017).

The main findings point to an adverse correlation between weak governance/corruption and growth that is both statistically and economically meaningful and has a higher impact in sub-Saharan Africa. These estimates are generally robust to various sensitivity checks, including to alternative measures of governance, sample period, country groupings, and specifications that control for omitted variables bias and mitigate potential endogeneity problems.

While the estimated correlations between governance/corruption and growth do not prove causality, they do suggest the following:

- *The impact of weak governance on GDP per capita growth is stronger in sub-Saharan Africa relative to the rest of the world.* Based on the baseline estimates (Table 2.1), this study suggests that improving sub-Saharan Africa's governance by about one-standard deviation¹⁶—which for an average sub-Saharan African country would result in governance converging to the world average—is associated with an increase in GDP per capita growth of about 1–2 percentage points, depending on the governance indicator, with WGI (or ICRG) at the low (or the high) end of this range. This impact is two to three times larger than for the average country in the rest of the world and stronger than that of other regions like Latin America and the Caribbean (LAC) and MENAAP, which are also perceived to have weak governance.
- *The impact of weak governance on GDP per capita growth in sub-Saharan Africa is comparable to or stronger than in other regions that are also perceived to face acute governance problems.* The sample was split in two distinct ways: first, the baseline model was run using the overall sample but including one region at a time (alternative 1); then we use only the samples for each region (alternative 2). Based on the estimates from these specifications (Figure 2.3), the finding is that improving governance by about one standard deviation in the sub-Saharan African sample is associated with an increase in GDP per capita growth of about a similar order of magnitude as in the baseline. As in the baseline, the estimated growth payoffs are stronger for ICRG compared to WGI. This is slightly larger than the impact for other regions such as LAC and MENAAP that are also perceived to suffer from acute governance and corruption problems. Overall, these findings suggest that weak governance appears to hinder growth in other regions, but apparently to a lower extent than in sub-Saharan Africa.
- *Corruption has a more deleterious impact on sub-Saharan African countries relative to the rest of the world.* Turning next to corruption, the baseline model is estimated by replacing the governance indicator with two measures of corruption perceptions, CCI and CPI.¹⁷ The results for the core part of

¹⁶ One standard deviation in the sub-Saharan African sample for both governance and corruption perceptions is equivalent to 10 percentage points if all scores are normalized to 0–100.

¹⁷ The corruption index from ICRG was also tested, but the correlation was estimated less reliably, reflecting data availability (for example, narrower country coverage than CCI and CPI in the first half of the sample).

TABLE 2.1

Governance and Growth: Baseline Results ^{1,2}					
Dependent variable:	(1)	(2)	(3)	(4)	(5)
Real GDP per capita growth	No	ICRG		WGI	
	governance	No interaction	Interaction	No interaction	Interaction
Governance		0.108 ***	0.107 ***	0.026 *	0.036 **
Governance x SSA			0.089 **		0.087 ***
Initial income per capita (log)	-2.031 ***	-2.435 ***	-2.765 ***	-1.929 ***	-2.554 ***
Investment (percent of GDP)	0.225 ***	0.128	0.039	0.150 ***	0.134 ***
Education (years)	0.622 ***	0.440 ***	0.354 **	0.478 ***	0.361 **
High inflation dummy	-1.351 **	-1.244 **	-1.562 ***	-1.901 **	-1.760 **
Change in terms of trade (percent)	0.046	0.069 **	0.064 *	0.077 **	0.080 **
Constant	13.49 ***	13.27 ***	19.46 ***	13.27 ***	20.00 ***
Observations	470	470	470	470	470
Number of countries	119	119	119	119	119
Number of instruments ³	14	15	17	15	17
Serial correlation test (p-value) ⁴	0.003	0.141	0.456	0.41	0.458
Hansen test (p-value)	0.031	0.327	0.283	0.22	0.255
χ^2 -test for H0: $\beta_1 = 0$ and $\beta_2 = 0$ ⁵			47.44 ***		18.96 ***

Notes: ¹ ***, **, * significant at 1, 5, and 10 percent, respectively. P-values are estimated with robust standard errors.

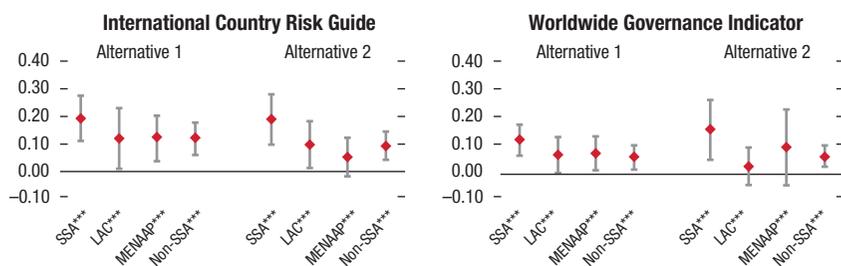
² The regressions are estimated using robust two-step system GMM estimator and include country and time fixed effects.

³ The instruments are the right-hand side controls (as shown above), lagged values of the dependent variable, and a dummy for resource intensity.

⁴ The serial correlation test is for second-order serial correlation and the Hansen test is for overidentifying restrictions.

⁵ The χ^2 -test shows the test statistics and significance level from testing the null hypothesis that the coefficients on governance are jointly zero.

Figure 2.3. Overall Effect of Governance on Growth across Regions



Source: Hammadi et al. (2019).

Notes: The charts show $\beta_1 + \beta_2$ (red diamonds) and 95-percent confidence intervals.

***, **, * denotes significant at 1, 5, and 10 percent, respectively. LAC = Latin American and Caribbean; MENAAP = Middle East, North African and Afghanistan and Pakistan; Non-SSA = Developing and emerging non sub-Saharan African countries.

the model are roughly in line with those for the governance indicators (Table 2.2). The specifications also pass the tests for serial correlation and validity of instruments, as well as most robustness tests. Unlike the findings for governance, no supporting evidence was found for a statistically significant correlation between corruption perceptions and growth for the average country in the overall sample. However, both corruption perceptions indicators point to a stronger and negative correlation with economic performance in sub-Saharan Africa. As mentioned earlier, these correlations should not be interpreted literally as causation; however, a simulation shows that a 10-point improvement in the sub-Saharan African sample—enough to move a sub-Saharan African country from the bottom quartile to the median of the sub-Saharan African distribution or bring the average sub-Saharan African country to the world average—would be associated with higher growth by 0.4–0.6 percentage points in the long run. These estimates are in the ballpark of other empirical investigations (for example, Gyimah-Brempong 2002; Gyimah-Brempong and de Camacho 2006; IMF 2018; Ugur and Dasgupta 2011).

- *A nonlinear correlation was found between governance/corruption and growth for both the overall and sub-Saharan African samples, with stronger correlations associated with weaker governance or higher corruption perceptions.* The linear relationship between governance/corruption and growth has been disputed in the literature. For instance, the “grease in the wheels” view argues that some amount of corruption could increase bureaucratic efficiency and improve growth by mitigating red tape in developing countries. To test for a nonlinear correlation between governance/corruption perceptions and growth, a squared term was added for GOV in the vector of explanatory variables (see Hammadi and others 2019 for full estimation details). Next,

TABLE 2.2

Corruption Perceptions and Growth: Baseline Results ^{1,2}							
Dependent variable:	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Real GDP per capita growth			WGI CCI		Transparency International CPI		
	No corruption	No interaction	Interaction	Joint	No interaction	Interaction	Joint
Corruption		-0.012	-0.020 *	-0.002	-0.002	-0.012	0.0046
Corruption x SSA			-0.093 ***	-0.112 ***		-0.090 ***	-0.106 ***
Governance x LAC				-0.037			-0.031
Governance x MENAAP				-0.073 **			-0.057 **
Initial income per capita (log)	-1.654 ***	-1.607 ***	-2.118 ***	-1.942 ***	-1.420 ***	-1.863 ***	-1.658 ***
Investment (percent of GDP)	0.117	0.096 *	0.096 *	0.094 **	0.094	0.061	0.053
Education (years)	0.594 ***	0.495 ***	0.417 ***	0.270 *	0.473 ***	0.391 ***	0.237 *
High inflation dummy	-1.249 *	-1.525 *	-1.567 **	-1.396 *	-1.278 *	-1.498 **	-1.503 **
Change in terms of trade (percent)	0.013	0.020	0.020	0.022	0.013	0.019	0.021
Constant	12.43 ***	13.54 ***	19.41 ***	17.97 ***	11.41 ***	17.60 ***	16.04 ***
Observations	489	489	489	489	489	489	489
Number of countries	136	136	136	136	136	136	136
Number of instruments ³	14	15	17	21	15	17	21
Serial correlation test (p-value) ⁴	0.001	0.372	0.369	0.335	0.062	0.039	0.040
Hansen test (p-value)	0.053	0.279	0.250	0.203	0.149	0.235	0.228
χ^2 -test for H0: $\beta_1 = 0$ and $\beta_2 = 0$ ⁵			11.63 ***	19.37 ***		8.71 **	16.5 ***

Notes: 1 ***, **, * significant at 1, 5, and 10 percent, respectively. P-values are estimated with robust standard errors.

² The regressions are estimated using robust two-step system GMM estimator and include country and time fixed effects.

³ The instruments are the right-hand side controls (as shown above), lagged values of the dependent variable, and a dummy for resource intensity.

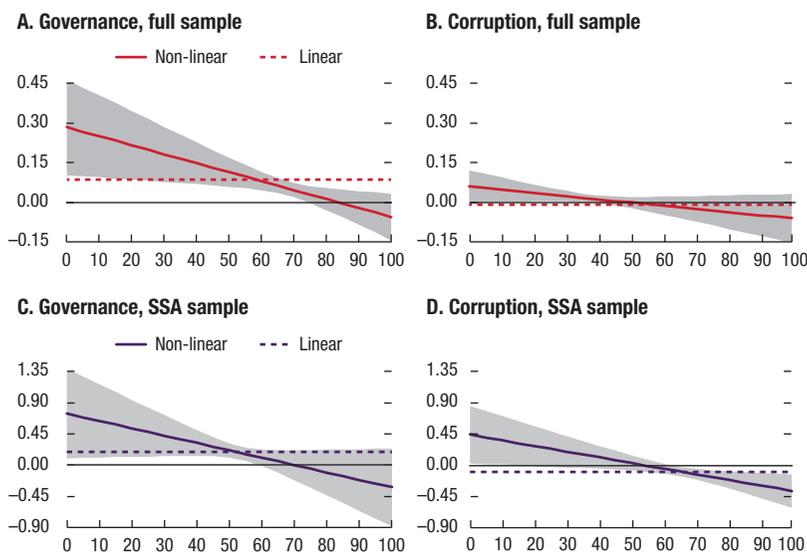
⁴ The serial correlation test is for second-order serial correlation and the Hansen test is for overidentifying restrictions.

⁵ The χ^2 -test shows the test statistics and significance level from testing the null hypothesis that the coefficients on governance are jointly zero.

the estimated coefficients were used to simulate the impact on growth from improving governance and reducing corruption. The finding, in this case, was that sub-Saharan African countries with governance (corruption perceptions) scores below (above) 60—about 75 percent of sub-Saharan Africa country-years in both samples—would benefit the most by addressing governance and corruption problems. As Figure 2.4 shows, the nonlinear models suggest that growth gains could be twice as large as the baseline for those sub-Saharan African countries with very low governance or high corruption scores (for example, at the 5th and 95th percentiles of the respective distributions).

- *Other dimensions of governance can also provide useful information—both about the specific transmission channels through which governance can aid growth and policy options to leverage these transmission channels.* As part of this study, the governance indicators were examined—these individual subcomponents were interpreted as governance channels and were viewed as distinct but complementary transmission mechanisms of governance—

Figure 2.4. Overall Effect of Governance and Corruption Perceptions on Growth



Source: Authors' estimates.

Note: This figure shows the overall marginal effect (in percentage points) of corruption (right-hand side, using CCI) and governance (left-hand side, using ICRG) on GDP per capita growth. In each chart, the horizontal axis measures the normalized governance or corruption indicator, whereas the vertical axis measures the impact on growth. The negatively sloped solid lines are the average estimates for the marginal effect for the nonlinear model, whereas the horizontal dotted lines are the point estimates for the baseline linear model. The shaded areas are +/- two standard deviations around the average estimates.

and their correlation with growth was analyzed. Four key WGI components were considered: voice and accountability, government effectiveness, regulatory quality, and rule of law (see details in Hammadi and others 2019). Table 2.3 shows that the WGI's four selected channels have a strong correlation with growth in sub-Saharan Africa. Using the estimated coefficients, the simulations used in this study indicate that the growth gains from a 10-point improvement in these specific components of governance range from $\frac{3}{4}$ of a percentage point for rule of law to about one percentage point for voice and accountability. These gains are nonadditive, but the overall impact could be higher due to potential complementarities across the different channels. Narrower variants of ICRG and WGI were also constructed by excluding corruption perceptions and a few other components to mitigate endogeneity and multicollinearity problems (for example, political stability, which to some extent is already captured by the measure of inflation used in this study). In a nutshell, these narrower components can be interpreted as proxies for the quality of political institutions and government regulations and policies. The empirical properties of the estimated models are somewhat similar to the baseline. Although the estimated correlations are less subject to concerns about endogeneity, their magnitudes are slightly smaller than in the baseline (see Hammadi and others 2019). In summary, unbundling governance channels may be important to better understand their empirical links with growth, and design tailored policy interventions, which can still yield significant growth dividends at the macroeconomic level.

Taken together, the evidence gathered in this chapter suggests that the correlation between governance/corruption and growth in sub-Saharan Africa could be stronger than in other regions. While not entirely conclusive, the nonlinear models suggest that very low levels of governance or high corruption perceptions are more detrimental to growth than modest levels. In addition, there could be region-specific factors—for example, very weak or ineffective institutions and capacity, latent rent-seeking in resource-rich sectors, or perhaps the fact that corruption has become entrenched in everyday expectations—that may partly explain the amplified impact on growth in sub-Saharan Africa.

Overall, this evidence for sub-Saharan Africa suggests that poor governance and corruption are both acute and endemic problems in the region. Weak institutions and resource intensity often coexist with high incidence of corruption in sub-Saharan Africa. The large economic rents generated by resource-rich sectors such as oil—often controlled by state-owned companies subject to political interference—can expose resource-rich countries to higher levels of corruption, especially when institutions are weak (OECD 2014; 2016).

TABLE 2.3

Governance and Growth: Channels ^{1,2}								
Dependent variable:	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Real GDP per capita growth	Voice and Accountability		Government Effectiveness		Regulatory Quality		Rule of Law	
Governance	0.012	0.004	0.036	0.046 ***	0.034	0.036 *	0.006	0.017
Governance x SSA		0.099 ***		0.074 ***		0.085 ***		0.072 ***
Initial income per capita (log)	-1.713 ***	-2.095 ***	-2.079 ***	-2.707 ***	-1.973 ***	-2.489 ***	-1.705 ***	-2.296 ***
Investment (percent of GDP)	0.147 **	0.119 **	0.155 ***	0.148 ***	0.159 **	0.145 ***	0.145 **	0.129 **
Education (years)	0.504 ***	0.495 ***	0.464 ***	0.338 *	0.464 ***	0.380 **	0.534 ***	0.434 **
High inflation dummy	-2.062 **	-2.130 **	-1.914 **	-1.835 **	-1.854 *	-1.796 **	-2.062 **	-2.014 **
Change in terms of trade (percent)	0.073 **	0.070 **	0.081 **	0.086 **	0.079 **	0.082 **	0.074 **	0.080 **
Constant	11.98 ***	17.15 ***	14.16 ***	20.74 ***	12.99 ***	18.84 ***	12.19 ***	18.44 ***
Observations	470	470	470	470	470	470	470	470
Number of countries	119	119	119	119	119	119	119	119
Number of instruments ³	15	17	15	17	15	17	15	17
Serial correlation test (p-value) ⁴	0.430	0.570	0.420	0.510	0.370	0.370	0.430	0.470
Hansen test (p-value)	0.170	0.200	0.260	0.280	0.210	0.210	0.160	0.200
χ^2 -test for $H_0: \beta_1 = 0$ and $\beta_2 = 0^5$		15.75 ***		23.91 ***		17.41 ***		15.15 ***

Notes: ! ***, **, * significant at 1, 5, and 10 percent, respectively. P-values are estimated with robust standard errors.

² The regressions are estimated using robust two-step system GMM estimator and include country and time fixed effects.

³ The instruments are the right-hand side controls (as shown above), lagged values of the dependent variable, and a dummy for resource intensity.

⁴ The serial correlation test is for second-order serial correlation and the Hansen test is for overidentifying restrictions.

⁵ The χ^2 -test shows the test statistics and significance level from testing the null hypothesis that the coefficients on governance are jointly zero.

POLICY IMPLICATIONS

The findings outlined in this chapter emphasize the importance of buttressing the fight against corruption and striving to improve governance. The nonlinearities in the relationship between corruption and growth suggest there is no one-size-fits-all approach (for example, Klitgaard 1988; Mungiu-Pippidi and Johnston 2017). Improving governance is not without its challenges, as the beneficiaries of the proceeds of corruption will often fight back. It is thus a complex, and likely drawn-out, battle reflecting the interaction between the various players—government, institutions, civil society, media, and the private sector. Development partners and multinationals also have an important role on the supply side. Strong political commitment is thus a *sine qua non* for success.

From an economic perspective, there are some basic principles that apply across countries and can strengthen governance. These include improving regulatory quality and government effectiveness and strengthening fiscal institutions. Indeed, the successful experiences of countries like Botswana, Chile, Estonia, and Georgia suggest that multiple factors may have contributed to their success, including: political will; measures to reduce corruption opportunities (for example, lowering red tape and trade barriers); measures to increase constraints on corrupt behavior (for example, independent judicial system and pressure from civil society); and improved fiscal institutions (greater fiscal transparency and controls).

While institutional reforms take time, in most cases enforcing compliance with existing laws and regulations can be the first step in the right direction. Empowering and capacitating anticorruption institutions will improve their prosecution capability and bridge the gap between public opinion and the courts of law. Corruption prosecution cases often fail, as governments may lack the financial resources or the legal capacity to successfully investigate and present convincing evidence of wrongdoing to the courts. Further improving the rule of law and building checks and balances, particularly by improving the governance structure of state-owned enterprises, will also help. This includes implementing measures related to customer due diligence, beneficial ownership, asset declarations, and politically exposed persons, measures that can support an effective framework for AML/CFT. As shown in Chapter 15, digitalization is also opening new possibilities by facilitating taxation, improving spending efficiency, and making procurement more transparent, inclusive, and efficient.

CONCLUSION

In this chapter, a strong correlation was found between governance/corruption perceptions and growth in sub-Saharan Africa, with similar results for other regions (for example, LAC, MENAAP) that are also perceived to experience

more acute governance and corruption problems. The results show that the governance dividend for the average sub-Saharan Africa country would be two to three times larger than the rest of the world. For instance, bringing sub-Saharan Africa's governance to the world average could increase GDP per capita by an estimated 1 to 2 percentage points per year. This is the case because growth dividends may be larger for countries that are perceived to have severe governance/corruption problems, but less so if such problems are perceived as moderate or small. In other words, the payoffs associated with reforms to improve governance are likely to be nonlinear, with a bigger impact when there are major weaknesses and less substantial payoffs after countries have implemented substantial reforms. The baseline results are robust to several tests that attempt to mitigate potential endogeneity problems in the relationship between governance/corruption and growth. The findings remain largely robust to various specifications and sample choices.

As sub-Saharan African countries consider their policy mix to reignite post-pandemic recovery and growth, potentially significant economic gains can be achieved by improving governance and reducing corruption. Strengthening governance and fighting corruption are not easy tasks—and the process is often time-consuming and requires considerable political effort—but they are worth pursuing given the potentially large payoffs.

ANNEX 2.1. DATA AND BASELINE RESULTS

Summary of Data and Data Sources

The controls in vector X in Box 2.1, equation (1), are measured as follows: (Annex Table 2.1.1):

- *Initial GDP per capita*: Real GDP per capita Purchasing Power Parity (in log) in the year immediately before each five-year period, to control for income convergence.
- *Gross capital formation*: Total investment, public and private (percent of GDP), to capture the contribution of capital accumulation to growth. To mitigate endogeneity problems, investment is measured in the first year of each five-year period.
- *Level of education*: Per capita years of secondary and tertiary schooling for the population aged 15 and above, to capture the contribution of human capital.
- *Dummy variable for high inflation*: This takes value 1 if inflation is larger than 15 percent—at the top quartile of the sample distribution—and zero otherwise. It proxies for the quality of macroeconomic policies and macroeconomic volatility.
- *Terms of trade*: Percentage change in terms of trade, to reflect external shocks.

In the baseline regressions, two aggregate indicators of governance and two indicators of corruption perceptions are used (Annex Table 2.1.1):

- *ICRG*: This indicator covers several aspects of governance, including government stability, internal and external conflicts, corruption, law and order, ethnic tensions, democratic accountability, and bureaucracy quality. It covers a large time span (data are available since 1984) but only covers two-thirds of sub-Saharan Africa countries.
- *WGI*: For the purposes of the regressions in this chapter, this is constructed as the simple sum of the six WGI from Kaufmann and Kraay (Kaufmann, Kraay, and Mastruzzi 2010): voice and accountability, political stability and absence of violence and terrorism, government effectiveness, regulatory quality, rule of law, and control of corruption. It covers all sub-Saharan Africa countries and data are available since 1996.
- *CCI*: This indicator of corruption perceptions is one component of WGI and data are also available since 1996.
- *CPI*: This indicator covers data available since 1995, starting with a relatively small country coverage that was gradually expanded to cover all sub-Saharan Africa countries.

Despite differences in methodology and sample, these indicators are highly correlated. While subjective and subject to various caveats (see “Measurement, Stylized Facts, and Channels for a Governance Dividend”), Hamilton and Hammer (2018) argue that the corruption perceptions measured by CCI and CPI are sufficiently comprehensive to capture all elements of corruption and hence are a good starting point of empirical analyses.

Baseline Results for Sub-Saharan Africa

All coefficients on the core controls have the expected sign and almost all are statistically significant (see Table 2.1). The coefficient on the interaction term for sub-Saharan Africa (β_2) has the positive expected sign and is also statistically significant. The specifications pass the tests for absence of serial correlation and validity of instruments. The null hypothesis that the coefficient β_1 and β_2 are jointly zero is also rejected.

These correlations should not be interpreted as causal effects. But mechanically, a 10-point improvement in governance—equivalent to one standard deviation in the sub-Saharan Africa sample and enough to move a sub-Saharan Africa country from the bottom quartile to the median of the sub-Saharan Africa distribution or bring the average sub-Saharan Africa country to the world average—would be associated with higher growth by between 1¼ percentage point (WGI) and 2 percentage points (ICRG). This impact is about thrice and twice larger than that for the overall sample, respectively. As mentioned earlier, some of the covariates like education and inflation also capture some of the indirect effects of governance on growth. Therefore, the total impact of governance on growth—including the indirect effects through these variables—is likely larger than $\beta_1 + \beta_2$.

Controlling for endogeneity problems, a strong correlation is still found between governance and growth in sub-Saharan Africa. The model also survives several robustness tests, including the use of alternative estimation methods (for example, difference GMM, OLS), inclusion of additional controls, and choice of the averaging window (see Hammadi and others 2019).

ANNEX TABLE 2.1.1.

Summary of Variables and Data Sources				
Variable	Data Description	Data Sources	Sample Period	Expected Sign
<i>Dependent Variable</i>				
Growth ¹	GDP per Capita Growth Rate (Percent)	Penn World Tables 9.0, WEO	1980–15	
<i>Right-Hand-Side Variables</i>				
GDP per Capita	Measured at Purchasing Power Parity (PPP), log	Penn World Tables 9.0, WEO	1980–14	(–)
Investment	Gross capital formation, percent of GDP	Penn World Tables 9.0	1980–14	(+)
Education ²	Secondary and tertiary education, years	Barro-Lee database	1980–15	(+)
Inflation ³	1 if inflation > 15 percent, 0 otherwise	WEO	1980–15	(–)
Terms of Trade	Annual percent change	WEO, WDI	1980–15	(+)
ICRG	Governance indicator, 0–100	ICRG	1984–15	(+)
WGI	Governance indicator, 0–100	Kaufmann and Kraay	1996–15	(+)
CCI	Corruption perceptions, 0–100	Kaufmann and Kraay	1996–15	(–)
CPI	Corruption perceptions, 0–100	Transparency International	1995–15	(–)

¹ Observations with average annual changes of ± 20 percent or more over any five-year period are excluded.

² Observations for the five-year period 2011–15 were obtained by extrapolating Barro-Lee data.

³ The dummy variable takes value 1 if average annual inflation exceeds 15 percent over a given five-year period, and zero otherwise.

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Three Strong Governance Performers in Sub-Saharan Africa: Achievements and Way Forward

Dominique Simard and Arina Viseth

ABSTRACT

Botswana, Rwanda, and Seychelles have established a relatively sound foundation for governance through strong political will, commitment, and societal consensus. Botswana developed a good policy framework to help prudently manage its wealth from mining resources. Rwanda rebuilt itself from a devastating conflict by adopting more advanced institutional models. Seychelles, a small island state, responded decisively to its 2008 debt crisis by embarking on a comprehensive program of economic and institutional reforms. Today these countries are among the sub-Saharan African countries that lead in sound governance, which may now help them address the impact of COVID-19 more effectively. This chapter examines their approach to good governance and finds common characteristics in these three countries' governance frameworks: the reported transparency of their economic policies, sound protection of economic rights, and criminalization of corruption. While key pillars of governance seem to have been successfully established in these countries, further reforms—including strengthening macrofinancial policy frameworks and improving information about their performance in delivering government services—would be needed to ensure accountability and sustained implementation.

MOTIVATION AND CONTEXT

Reducing corruption has fostered good economic performance in Africa. Empirical studies on Africa tend to support evidence of the beneficial impact of good governance on economic performance (see Chapter 2): improving governance and reducing corruption in sub-Saharan Africa could increase the region's GDP per capita growth by about 1–2 percentage points (Hammadi and others 2019), since control of corruption and political stability, among other elements, are associated with higher economic growth in Africa (Ondoa 2019). African firms in industries that are more prone to corruption are also more likely to stop exporting (Faruq 2017). However, the relationship between corruption and

growth could be nonmonotonic with the impact of corruption on growth depending on the quality of institutions (Aidt, Dutta, and Sena 2008). In a more conservative sense, corruption—the abuse of public office for private gain—distorts the activities of the state and undercuts efforts to achieve sustainable and inclusive economic growth (IMF 2019a).

Indeed, a handful of countries have emerged among top governance performers in sub-Saharan Africa, while also achieving relatively strong economic growth. Botswana, Rwanda, and Seychelles are among such performers. In particular, all three countries are not only relatively strong performers in sub-Saharan Africa, but in some cases, they even perform better than some advanced countries.¹ Moreover, these three countries share common characteristics, with all three countries experiencing a relatively strong economic performance, comparable to or with higher growth than the median emerging sub-Saharan African countries from 2009 to 2019.² Yet these three countries also differ from each other, and their structural differences, in fact, indicate that good governance can be achieved in a variety of circumstances: Botswana is landlocked and resource rich, Seychelles is a small island at a higher level of development, while the case of Rwanda shows that it is possible to improve governance over time in countries emerging from conflict and fragility with limited resources. Those structural features highlight the importance of institutional factors in explaining strong governance performance.

This chapter aims at identifying the common institutional characteristics of three of the stronger sub-Saharan African governance performers and providing insights on the key institutional foundations for governance upgrades. It assesses shared and individual characteristics of Botswana, Rwanda, and Seychelles by reviewing these countries' progress against the key elements of the IMF governance framework.³ The framework provides an assessment of the nature and severity of governance vulnerabilities in the institutional functions that are most relevant to economic activity; namely: (1) fiscal governance, (2) financial sector oversight, (3) central bank governance and operations, (4) quality of market regulations, (5) rule of law, and (6) anti-money laundering and combating the financing of terrorism (AML/CFT).

¹ For example, in Transparency International (2020)'s Corruption Perception Index, Seychelles scores better than Spain, Botswana scores better than Poland, and Rwanda scores better than Italy. Based on the Corruption Perception Index alone, Botswana, Rwanda, and Seychelles could then be identified as three of the four best performers in sub-Saharan Africa. (The other one is Cabo Verde.)

² Regarding Seychelles, the average was calculated for 2010–19 (after the country's 2008 debt crisis) and compared to the median growth for sub-Saharan African countries, excluding Nigeria and South Africa during that period.

³ See IMF (2018) for a comprehensive presentation.

Fiscal Governance⁴

The three countries score relatively well in the fiscal governance dimension, which comprises the institutional frameworks and practices of the public sector. This includes practices in revenue administration to strengthen the state's ability to collect taxes, and public financial management, which is crucial to ensure greater efficiency and transparency in public spending.

Revenue Administration

Transparent rules, proper risk management, sound audits, and digitalization are key elements of good governance practices in revenue administration. Transparent rules and sound revenue administration practices foster more revenue collection, helping countries better achieve their development goals. When the rules of paying taxes are clearly defined, disseminated, and understood, tax obligations are viewed as relatively fair, which improves compliance and facilitates revenue collection (IMF 2019a, p. 43). Meanwhile, proper risk management practices help raise resources at a lower cost for the revenue administration by focusing its capacities on higher areas of risk for revenue collection instead of allocating the same resources to all categories of taxpayers. It therefore induces taxpayer compliance, with a more efficient allocation of resources. Moreover, the public's confidence in the revenue administration and government increases as digitalization of the revenue administration reduces opportunities for corruption (Chapters 14 and 15) and actions to reduce tax arrears, including through a sound audit program, intensify.

Transparent rules for taxpayers and strong practices in revenue risk management characterize Botswana, Rwanda, and Seychelles. Based on the PEFA methodology, Rwanda and Seychelles outperformed the median emerging market country in terms of having transparent rules for tax obligations and liabilities, while Botswana was slightly below that benchmark (Figure 3.1).⁵ Botswana's information covered all major taxes. Rwanda had compiled a set of clear and comprehensive tax laws and regulations and had a functional administrative tax

⁴ The relative quality of fiscal governance in Botswana, Rwanda, and Seychelles is based on the Public Expenditure and Financial Accountability Framework (PEFA) methodology. PEFA indices reflect ordinal scores (reflecting a comparison with good international practices) of three or four dimensions of subcomponents (31 in total) of seven different pillars: budget reliability, transparency of public finances, management of assets and liabilities, policy-based fiscal strategy and budgeting, predictability and control in budget execution, accounting and reporting, external scrutiny, and audit. This methodology does not assess government service delivery performance as such, but rather helps to identify the bottlenecks in service delivery due to deficiencies in the public financial management (PFM) framework and implementation.

⁵ The PEFA assessment based its evaluation on taxpayers having easy access to comprehensive, user-friendly, and up-to-date information on tax liabilities and administrative procedures for all major taxes, along with redress processes and procedures. The assessment also gauged whether the revenue administration supplemented this with an active taxpayer education campaign.

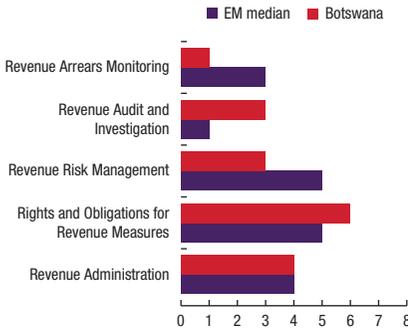
Figure 3.1. PEFA Scores in Revenue Administration

(2016 framework; score: 0 = low to 7 = high)

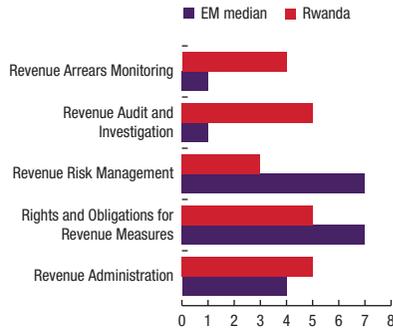
Botswana is a relatively strong performer in revenue risk management and monitoring tax arrears.

Rwanda performed relatively well in transparency of tax obligations and revenue risk management.

1. Botswana (2020)

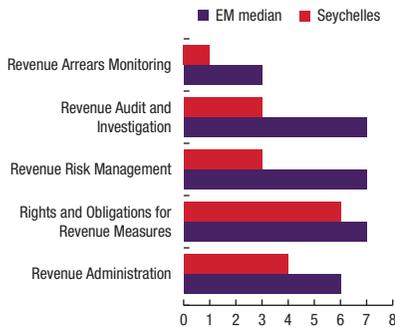


2. Rwanda (2017)



Seychelles outperformed the median emerging market country in revenue administration governance.

3. Seychelles (2017)



Source: Public Expenditure Framework Assessment (PEFA).

appeals system. Seychelles used multiple channels to facilitate taxpayers' access to up-to-date information on revenue obligations and rights. Regarding revenue risk management, all these countries scored above the median emerging market country (PEFA 2017a; 2017b; 2020).⁶ Botswana had set up a relatively new unit focusing on tax risk management. Rwanda used a computerized risk-based taxpayer-profiling module to identify and select taxpayers for audit and fraud investigations. Seychelles used a structured and systematic approach to risk management with specific attention to large and medium taxpayers.

⁶ PEFA assessments based on the 2016 framework for Botswana (assessed in 2020), Rwanda, and Seychelles (both assessed in 2017), were scored on revenue risk management.

Revenue audit and investigation remains a somewhat challenging area for some of these relatively strong sub-Saharan African governance performers. Based on the PEFA, both Botswana (in 2020) and Rwanda (in 2017) scored below the median emerging market country in that area, while Seychelles (2017) performed better. However, Rwanda has recently leveraged third-party information and enhanced IT systems to improve audit procedures and undertake closer scrutiny of large taxpayers (IMF 2019b). Even though Seychelles outperformed the median emerging market country in that area in 2017, it is further building its tax audit capacity (IMF 2019c). Auditing practices need to evolve in parallel with increasingly complex taxpayer accounts, making this area a candidate for continuous improvement. Strong audit and investigation practices foster better compliance from taxpayers and more effective revenue mobilization.

The three countries fared relatively well in at least one other area critical for good governance in revenue administration (IMF 2018). Progress is ongoing in digitalization of the revenue administration, notably in Rwanda and Seychelles. Processing of tax arrears outperformed the median emerging market country for Botswana and Seychelles, while Rwanda is implementing a work program featuring more efficient practices, such as detecting noncompliance using macroeconomic data and implementing a risk differentiation framework to focus on priority areas, for reducing the outstanding stock of tax arrears (Rwanda Revenue Authority 2016).

Public Financial Management

Institutional arrangements and practices to enhance public spending efficiency and foster transparency are critical for good governance in public financial management (IMF 2018). Strong procurement standards minimize opportunities for corruption and ensure a more efficient allocation of budgetary resources. More information for policymakers on a broader set of fiscal activities, including operations of state-owned enterprises (SOEs), is essential to help formulate better fiscal policies. An effective internal control environment is a major component of good PFM governance since it creates appropriate incentives and limits discretion by public servants (IMF 2019a). Strengthening information for the public on government service delivery performance boosts civil servants' accountability. Without information, the public is unable to assess government performance against set standards, which reduces public pressure for corrective actions in the event of poor performance. Finally, public pressure also depends on access to externally audited government accounts by the legislature.

Good access to audit reports by the legislature seems to be a common characteristic of these three countries. Based on PEFA scores, Botswana, Rwanda, and Seychelles either outperform or are aligned with the median emerging market country for legislative scrutiny of audit reports. The capacity by elected officials to access audit reports on government activities offers a level of transparency on these activities that is a necessary condition for good fiscal governance. Moreover, transparency on budgetary execution is reportedly relatively strong in Rwanda

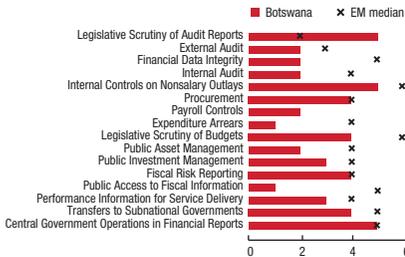
and Seychelles, as they perform well on indicators for the legislative scrutiny of the budget, financial data integrity, and public access to fiscal information. In Botswana, this follows a long tradition of limiting powers of traditional leaders and holding local consultative assemblies.⁷ Rwanda requires in its constitution that the office of the auditor-general issue a report on the annual state budget (Transparency International UK 2011). Seychelles enacted its audit legislation in 2010 to provide independent operation of its office of the auditor-general according to international best standards, including making the auditor-general’s office fully accountable to the National Assembly (OAG, n.d.).

The three countries continue progress in reforming public procurement and oversight of SOEs. Regarding public procurement, Rwanda outperforms while Botswana is aligned with the median emerging market country (Figure 3.2). Seychelles underperformed relative to that benchmark. Nonetheless, as of 2021 Seychelles is planning to receive technical assistance in public investment

Figure 3.2. PEFA Scores in Public Financial Management
(2016 framework; score: 0 = low to 7 = high)

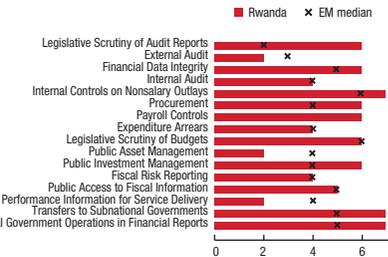
Botswana performed relatively well in procurement, risk reporting, and the transparency of central government operations.

1. Botswana (2020)



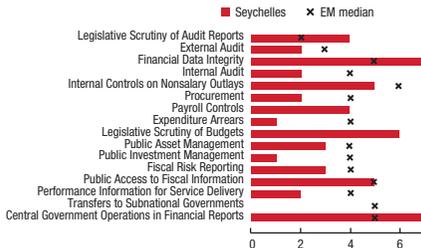
Rwanda performed relatively well in access to comprehensive fiscal information, internal audits, expenditure controls, and public investment management.

2. Rwanda (2017)



Seychelles performed relatively well in access to comprehensive fiscal information and payroll controls.

3. Seychelles (2017)



Source: Public Expenditure Framework Assessment (PEFA).

⁷ Democracy Web: Comparative Studies in Freedom, “Accountability and Transparency: Country Studies—Botswana, <https://democracyweb.org/accountability-botswana>.

management, including to strengthen its capacities in procurement. Moreover, efforts in improving fiscal transparency continue, including reforms to upgrade the oversight of SOEs. Botswana, Rwanda, and Seychelles are making strides in many dimensions to catch up to the median emerging market country in the area of public asset management.⁸ Botswana is considering adopting and implementing a regulatory framework for parastatals, including to empower the country's public enterprises evaluation and privatization agency (IMF 2020a). As of January 2021 Rwanda is preparing a draft SOE ownership policy that mandates planning, budgeting, and reporting and also establishing sanctions and enforcement criteria for noncompliance. Seychelles has amended the Code of Governance for SOEs according to OECD guidelines. It has also adopted amendments to the Public Enterprise Monitoring Committee Act to strengthen that entity's enforcement powers for noncompliance by SOEs, including regarding due diligence in the appointment of directors.

The three countries perform differently on internal control environment indicators, with particular vulnerabilities on implementing audit processes and relatively low effectiveness of expenditure commitments for Botswana and Seychelles. Rwanda is relatively well positioned compared to the emerging market median for financial data integrity (which encompasses financial data integrity processes), internal audit, payroll control, and internal control on nonsalary outlays. However, Botswana needs to catch up to the emerging market median along all these dimensions. Its score on financial data integrity is particularly dragged down by relatively low scores on accounts reconciliation, while its financial data integrity processes are relatively better rated. Implementation of its internal audit processes seems to be a particular vulnerability, while its coverage of internal audit earns a top score. Internal controls over payroll and nonwage outlays are also reported to be relatively weak (PEFA 2020). The performance of Seychelles is more mixed, with relatively strong scores in integrity of financial data and at par with the emerging market median for payroll control. Nonetheless, Seychelles is reported to be relatively weak on implementation of audit processes, which drags down its relatively good score on internal audit (PEFA 2017b). Botswana's effectiveness of commitments on nonsalary outlays is reported to be relatively weak (PEFA 2020).

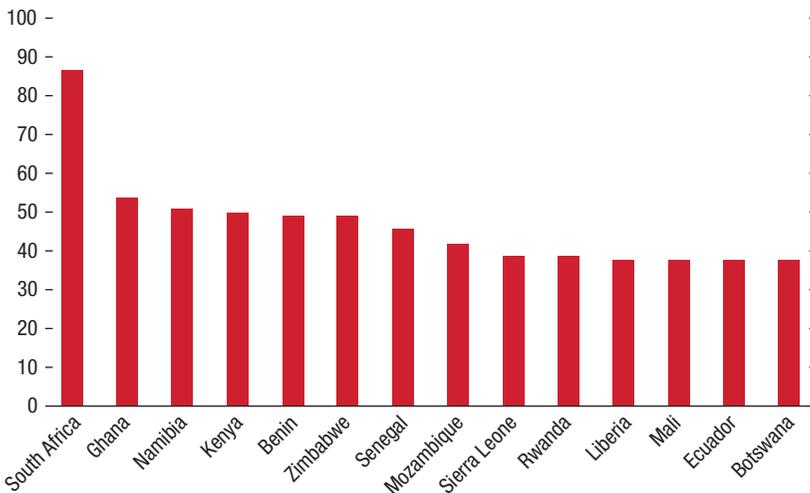
There is also scope for these three countries to improve information on the government's service delivery performance. The PEFA indicator assesses the quality of annual performance information at different stages of the budget cycle: in the budget's documentation, the year-end report, and audit reports. Based on PEFA scores, Botswana, Rwanda, and Seychelles underperform relative to the median emerging market country with respect to information on whether resources reach service delivery units as planned to help achieve annual and medium-term performance targets. Coverage of that information helps promote

⁸ PEFA defines public asset management as compliance by government entities with maintenance of records in financial and nonfinancial assets and transparency of government asset disposal.

greater operational efficiency of the government. Nonetheless, Rwanda has established a distinctive system for individual accountability. Since 2006 every public servant has been required to sign an annual performance contract based on annual individually tailored and team objectives, which collectively aim at controlling the pace and quality of program execution, and the contracts are published. Nonfulfillment of contracts is consequential, including the possibility of dismissal. Improving information on the delivery of public services may allow Rwanda to showcase the impact of its reforms on public servants' accountability for the quality of delivery of public services.

However, Botswana and Rwanda performed somewhat less well overall on the *Open Budget Survey* (OBS) (International Budget Partnership 2020) than several other sub-Saharan African countries (Figure 3.3). Based on these countries' comparative scores on the OBS's very detailed questionnaire, there was scope for Botswana and Rwanda to further improve the information presented in the budget document. This would include more details on revenue and expenditure, the impact of new policy proposals, historical outturns, extending the fiscal perimeter to extrabudgetary funds, transfers to SOEs and other levels of government, and tax expenditures and earmarked tax revenues. Similarly, Botswana and Rwanda could present more comprehensive information, in their pre-budget statements, on macroeconomic forecasts underpinning budget projections, government policies guiding estimates of expenditure and revenue, estimates on government borrowing and debt, and estimates of government expenditure for a multiyear period two years after the implementation of the budget. These countries could also present further

Figure 3.3. Open Budget Survey (2019) Overall Score



Source: International Budget Partnership (2020).

Note: A higher score means a better performance on the OBS questionnaire. Seychelles is not included in the survey.

information on net new borrowing, total debt outstanding at the end of the year, and projected interest spending in the enacted budget document. Moreover, the executive could strengthen its engagement with the public during the budget process, particularly regarding the dissemination of the citizens' budget, further communication with the public on the mode of engagement, and better use of public participation during the budget formulation process. Finally, further progress is needed in the development of the supreme audit institution, particularly regarding the examination of its audit report by the legislature, the frequency of the testimony by the supreme audit's leadership to the legislature, and the independent review of audit processes of the supreme audit institution.

Since the OBS assessment, Rwanda has adopted measures that strengthened fiscal transparency, including setting up a fiscal risk committee, publishing a comprehensive fiscal risk statement, and compiling a fiscal risk registry. It has also produced quarterly execution reports on the budget execution of the central government using GFSM 2014 during fiscal year 2019/20 (IMF 2021a).

FINANCIAL SECTOR OVERSIGHT AND REGULATION OF COMPETITION

The financial systems in Botswana, Rwanda, and Seychelles are reported to be generally well advanced in implementing international standards.⁹ All three countries previously undertook reforms in this area and are continuing efforts to further buttress their financial stability frameworks, finalizing the implementation of Basel II, starting Basel III, and implementing properly BCBS Core Principles for Effective Banking Supervision (Basel Committee on Banking Supervision 2012). Good governance in financial sector oversight is key to macroeconomic stability, and Botswana, Rwanda, and Seychelles have a solid foundation in that area. Country experience shows that weak regulation and supervision of the financial sector can lead to financial instability, with significant macroeconomic implications (IMF 2018). Financial systems in Botswana and Rwanda reportedly enjoy well-regulated competition and a relatively high compliance with prudential rules (Figure 3.4).¹⁰ While Botswana scores high on efficiency of banking and financial

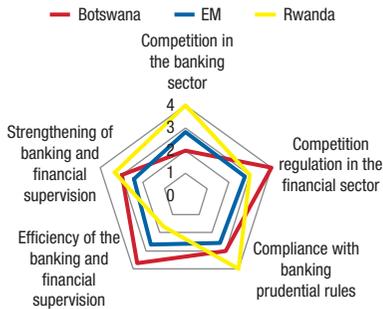
⁹ The assessment of the quality of financial sector oversight in Botswana, Rwanda, and Seychelles is based on the Institutional Profiles Database (IPD), which is a measure of countries' institutional characteristics through composite indicators built from perception data. The data is produced by surveying in each country the economic mission offices of the French Ministry for the Economy, Industry and Employment and the offices of the French Agency for Development. For instance, each indicator is graded from 0 (low) to 4 (high) depending on the perceived degree of quality. For example, the indicator on competition regulation in the financial sector is graded from 0 to 4 depending on the perception of the degree of effectiveness of financial regulation.

¹⁰ While the IMF governance framework pertaining to the oversight of the financial sector does not include areas such as competition in the banking sector or competition regulation in the financial sector, the framework does include an assessment of market regulation. Issues of market regulation pertaining to the banking and financial sectors are included in this section.

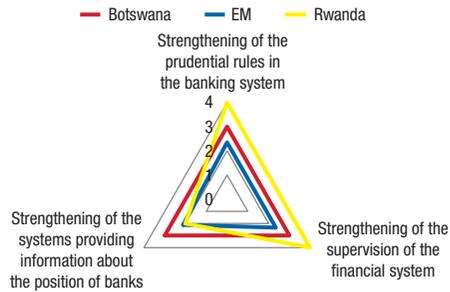
Figure 3.4. Financial Sector Oversight

(Score: 0 = low, 4 = high)

1. Banking and Financial Regulation



2. Strengthening of Banking and Financial Supervision



Source: World Bank, Institutional Profiles Database 2016; 2012 (when 2016 not available).

Note: Seychelles data not available.

supervision, Rwanda scores relatively low on efficiency of banking and financial supervision but does well in banking sector competition. The generally good performance seems to reflect previous efforts undertaken by the authorities to improve financial sector oversight. Between 2013 and 2016 Botswana and Rwanda took significant steps in strengthening (1) the prudential rules in the banking system, (2) the supervision of the financial system, and (3) the system providing information about the position of banks.

Botswana, Rwanda, and Seychelles show continuous efforts to enhance the design of the financial stability framework and remain proactive in the wake of the pandemic. Botswana made progress in assigning a clear macroprudential mandate to the Bank of Botswana (BoB) and in filling data gaps. The Financial Stability Committee has been established and is meeting on a regular basis. The BoB started collecting and monitoring data on households' indebtedness and the real estate market. In the first half of 2020 Rwanda implemented regulations governing mortgage refinancing companies, which involved changes in the shareholding, amalgamation, and transfer of portfolio of insurers and reinsurers. Rwanda also took steps to closely monitor credit risk from COVID-19-related loan restructuring by issuing guidance to banks and microfinance institutions (MFIs) on their proper classification and provisioning. Technical assistance aiming at improving the country's stress-testing framework is ongoing. Seychelles approved the policy framework for crisis management, bank resolution, and safety nets in 2018, which provided for the resolution authority to have adequate powers and tools to ensure capacity to address financial stability issues. Seychelles also continues to make progress toward adopting the Basel II framework and developing the oversight framework of the national payment system. Recently, the authorities took measures to address the risk of the

potential loss of correspondent banking relationships (CBRs) and to buttress financial stability.¹¹

Further reforms on the design of regulatory and supervisory framework are underway to buttress financial stability. Botswana is considering monitoring the liquidity situation in the financial system, strengthening the liquidity framework and the risk-based supervision framework of nonbank financial institutions, and finalizing the banking act to enhance the crisis resolution framework. To enhance efforts to safeguard financial sector stability, Rwanda intends to release the capital conservation and domestic systematically important banks (DSIBs) buffer and require capital restoration plans from banks on a case-by-case basis. Further reforms would, however, be needed to strengthen risk-based supervision, stress testing, financial safety net and crisis preparedness and management, as well as financial infrastructure. Seychelles continues its efforts to strengthen the financial stability framework. The authorities have formulated a policy framework paper on the Financial Sector Stability Act, which will assign macroprudential powers to the relevant institutions, allowing them to take corrective actions to tackle risks from a potential buildup of consumer credit.¹²

CENTRAL BANK GOVERNANCE AND OPERATIONS

Good performance in central bank governance and operations is macrocritical since it fosters appropriate use of public resources (see Chapter 13) in order to avoid potential adverse macroeconomic consequences. The assessment below covers the adequacy of (1) the mandate, decision-making structure, and autonomy of the central bank; (2) the accountability and transparency framework; and (3) the internal control environment.¹³

The three countries considered are reported to have relatively independent and transparent central banks. There is ongoing progress in strengthening their central banks' mandates, frameworks for accountability and transparency, and the effectiveness of their internal controls. However, more reforms are needed to ensure the adequacy of mandates and modern monetary policy frameworks.

Central bank independence and transparency appear to be strong in the three countries considered. Based on the 2016 and 2012 World Bank's IPD central bank independence indices (Figure 3.5), both the degree of independence of the central banks and degree of transparency of economic policy are relatively high in Rwanda and Botswana, above the EM median. While there is no IPD data available for Seychelles, anecdotal evidence, supported by the authorities' request for

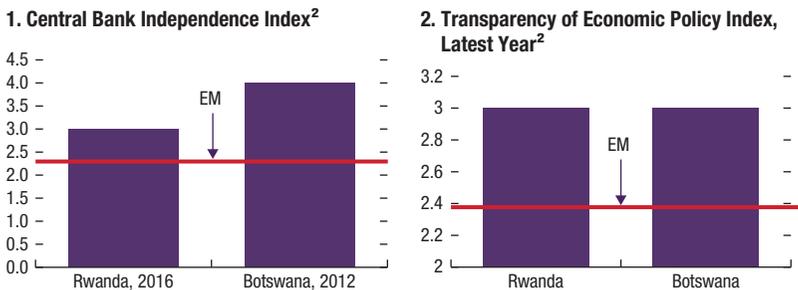
¹¹ IMF (2019d).

¹² As of April 2021 the resulting amendment remains to be submitted to the Cabinet.

¹³ It is based on the World Bank's IPD survey data related to the perception of central bank independence and to the perception of accountability and transparency framework. The indices rank from 0 (no independence/transparency) to 4 (strong independence/transparency).

Figure 3.5. Central Bank Independence and Transparency of Economic Policy Index Financial Sector Oversight¹

(Score: 0 = low to 4 = high)



Source: Institutional Profiles Database.

Note: ¹The Transparency of Economic Policy Index reflects a broad assessment of transparency as it encompasses all public administration, including the central bank.

²Seychelles data is not available.

a voluntary safeguard assessment completed in 2018, suggest a strong level of independence and transparency of the Central Bank of Seychelles (CBS). In particular, the CBS has ensured that its legal framework remains on par with international standards, including through a review of the Financial Institutions Act initiated in 2019, which allows the implementation of risk-based AML/CFT supervision consistent with FATF standards.

In Botswana, Rwanda, and Seychelles, measures to improve central bank governance and operations focused on the adequacy of the central bank mandate and the accountability and transparency framework, and on the effectiveness of the internal control environment:

- In Botswana, both the Bank of Botswana Act and the Banking Act were revised to strengthen central bank governance and support modernization, including for the development of a crisis resolution framework.
- Similarly, the 2016 safeguard assessment for Rwanda resulted in the central bank taking proactive steps to (1) strengthen the National Bank of Rwanda's (BNR) safeguard framework, with amendment in 2017 of the BNR Act, which includes enhanced provisions on personal autonomy of board members and strengthening external audit arrangements; (2) improve the transparency of the IFRS financial statements; and (3) reinforce the composition of the Audit and Risk Committee and enhancement of the internal audit and risk management functions. The National Bank of Rwanda also published macroprojections for the monetary policy committee's (MPC) decision-making in quarterly inflation reports, following best practices established by other central banks.
- The 2018 safeguard assessment in Seychelles resulted in the central bank taking proactive steps to (1) strengthen its reserves management operations

and risk management functions and further progress in developing a comprehensive AML/CFT framework for its own banking operations, and (2) further improve the effectiveness of the internal audit activity. In September 2020 the draft amendments to the CBS Act, including provisions to enhance the governance arrangements, were presented to the National Assembly.

Further measures on the adequacy of the central bank mandate and modernization of the monetary policy framework should complement existing efforts. Further measures to strengthen both the CBS staff's capacity for inflation forecasting and liquidity management and its communication policy would help Seychelles to make the transition toward an interest-rate-policy-based framework. The Bank of Rwanda is also transitioning to a new interest-rate-based operational framework, which will require making further reforms to the monetary policy committee's decision-making process and strengthening communication tools to better anchor inflation expectations. To accommodate changes linked to the increased use of digitalization and financial technologies by banks and nonbank institutions, the Bank of Botswana is planning work on new laws, regulations, strategies, and operations.

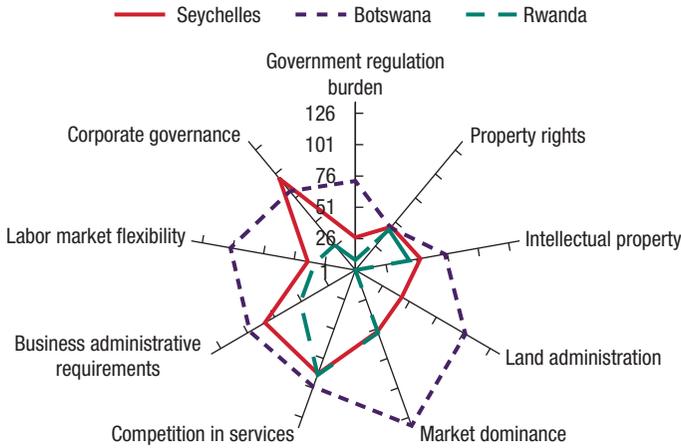
QUALITY OF MARKET REGULATIONS

Market regulation is a key function of the state, with macroeconomic implications. Good-quality market regulation promotes private investment opportunities and minimizes the scope for fraud, abuse, and rent extraction. A strong and resilient regulatory and institutional framework enables a virtuous balance between encouraging private sector involvement and promoting the public good through targeted interventions that address market failures and misaligned incentives and that foster competition.

The assessment below examines the extent to which the regulatory environment could hinder private businesses. It is based on the World Economic Forum Global Competitiveness Indicators, which combine data from the World Bank Doing Business Indicators and scoring from the Executive Opinion Survey, which polls a country's business executives on various aspects of its regulatory environment and other aspects of a country's business environment.

Botswana, Rwanda, and Seychelles are reported to enforce their regulations according to relatively high governance standards. They seem to have relatively clear and accessible regulations, minimizing opportunities for discretionary treatment and corruption. Following corruption scandals during the 1990s, Botswana has proactively sought to reinforce its legal and institutional frameworks (Transparency International 2014). Rwanda also renewed its commitment to fighting corruption during its postconflict recovery, culminating in the enactment of a new law to fight corruption in September 2018 (Bizimana 2019). Seychelles adopted its Anti-Corruption Act in 2016 (anti-corruption Commission Seychelles).

Figure 3.6. Botswana, Rwanda, and Seychelles: Regulations and Global Competitiveness Index



Source: World Economic Forum (WEF), The Global Competitiveness Report 2019, http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf

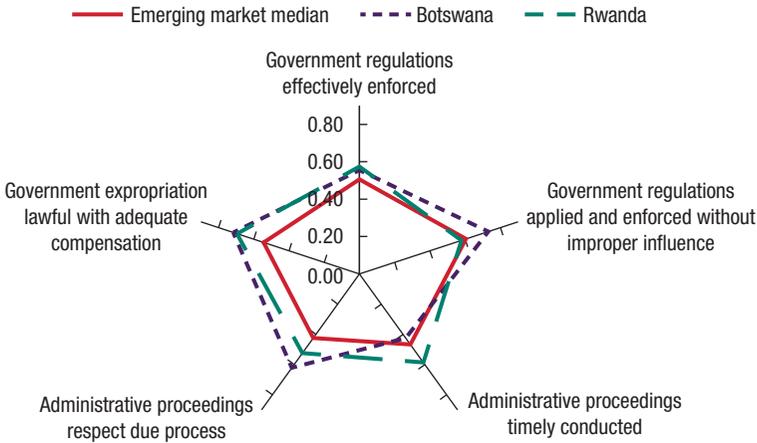
Note: International rank out of 141 countries in 2019 (lower is better) based on scores of different aspects of regulations pertaining to the business environment.

This is the case even though the regulations themselves, as they apply to the business environment, are reported by the World Economic Forum to be somewhat different across these countries (Figure 3.6).

The three countries rank similarly in regulations for property rights and competition in services but more disparately in other business regulations. Botswana, Rwanda, and Seychelles ranked similarly for the protection of property rights in 2019. Botswana, Rwanda, and Seychelles occupy a relatively similar world rank for regulations governing competition in services. In other regulatory areas, however, there are wider dispersions among the countries' positions. Notably, Rwanda's regulations for land administration are reported to be among the best in the world, serving as a model for an area critical for the investment climate due to a fully digital land registration system requiring minimal procedures that can be completed quickly (IFC 2019). Rwanda also is reported to perform well in terms of labor market flexibility, particularly regarding the strength of its workers' rights policies and the flexibility of its wage determination. Moreover, regulations in Rwanda and Seychelles appear to be relatively more conducive to market competition with relatively lighter business regulation requirements.

Enforcement of business regulations in Botswana and Rwanda are reported to follow relatively good governance practices, based on the World Justice Project Rule of Law Index. The index is constructed from survey data, both from polls of the general population in a given country and qualified respondent questionnaires sent to experts around the world. The answers are codified as numeric values, which produces raw country scores that are then normalized (Figure 3.7).

Figure 3.7. Botswana and Rwanda: Rule of Law for the Regulatory Environment



Source: World Justice Project, Rule of Law Index 2020 Scores, <https://worldjusticeproject.org/our-work/research-and-data/wjp-rule-law-index-2020>

Note: Higher scores reflect practices closer to best international practices.

Botswana and Rwanda are reported to apply and enforce government regulations without improper influence at least as well as the median emerging market country (World Justice Project 2020).¹⁴ Government regulations seem to be effectively enforced (in the sense of full compliance enforcement), government expropriation appears lawful with adequate compensation, and administrative proceedings seem to respect due process. The area that would benefit most from development for Botswana is reducing the time to conduct administrative proceedings. Similarly, it seems that Rwanda could further develop its ability to apply and enforce government regulations without improper influence.

Overall regulations in Seychelles could be fine-tuned, including in key sectors such as market concentration, the property market, and tourism (World Bank 2017). While according to the index Seychelles has relatively good regulations to prevent market dominance, certain sectors, such as tourism, banking sector, and information and communication technology, have only a few incumbents that face fewer incentives to innovate. Moreover, while Seychelles ranks relatively well for its administration of land, its property market could be made more transparent by publishing price data. Further financial sector–related laws are needed, as the low level of competition among actors in the banking sector continues to be reflected by the large spreads between interest on deposits and loans. Finally, tourism suffers from a lack of regulation and common standards, with potentially large negative externalities for the overall sector.

¹⁴ The World Justice Project's Rule of Law Index does not include information for Seychelles.

RULE OF LAW

To promote investment, strengthen credit availability, and facilitate debt restructuring, property and contractual rights need to be well protected and enforced. The most important determinant of a strong protection of economic rights is the quality of the judiciary, regarding both its technical capacity and its independence from private influence and public interference. The predictability and timeliness of enforcement of these rights is also critical (IMF 2018).

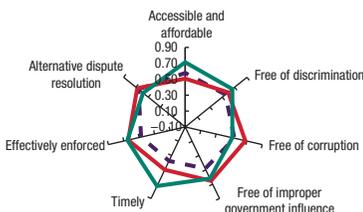
Economic rights are reported to be relatively well protected by Botswana, Rwanda, and Seychelles, supported by a relatively sound judiciary system, but insolvency regulatory frameworks seem widely different across these countries.¹⁵ Overall, based on the Worldwide Governance Indicators, Botswana seems to have a relatively stronger rule of law than do Rwanda and Seychelles (Figure 3.8.2). Based on the World Justice Project's Rule of Law Index,¹⁶ judiciary systems in Botswana and Rwanda seem to compare mostly favorably to that of the median emerging market country, particularly regarding the relative independence of the justice system from the government (Figure 3.8.1). Botswana also is reported to outperform the benchmark for its relatively corruption-free judiciary system. All civil justice systems are reported to be effectively enforced, which enhances the predictability of the protection of property and contractual rights. Moreover, Rwanda and Botswana seem to have a relatively timely judicial system that prevents unreasonable delays. Although a government's ability to restructure debt is an important aspect of the protection of economic rights, this

Figure 3.8. Rule of Law

Botswana and Rwanda appear to have a relatively corruption-free and independent judicial system.

1. Civil Justice (2020; higher scores reflect better performance)

■ Emerging market median ■ Botswana ■ Rwanda



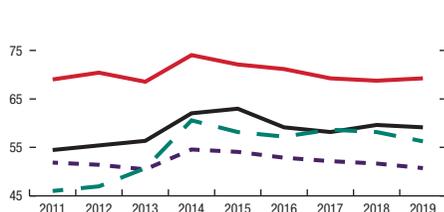
Source: World Justice Project, Rule of Law Index 2020.

Note: Does not cover Seychelles.

Botswana, Rwanda, and Seychelles seem to have outperformed and progressed more than the median emerging market country on their rule of law ranking since 2011.

2. Rule of Law Ranking (Score: 0 = low to 100 = high)

■ Botswana ■ EM median ■ Seychelles ■ Rwanda



Source: World Governance Indicators.

¹⁵ World Bank (n.d.) Worldwide Governance Indicators, <http://info.worldbank.org/governance/wgi/>.

¹⁶ The World Justice Project Rule of Law Index does not cover Seychelles.

is an area of wide disparity among these three countries. According to the World Economic Forum (2019), Rwanda has the best regulatory framework in the world, vastly outranking Seychelles, with Botswana far behind.

AML/CFT

The adequacy of the framework for AML/CFT is another key element of state function with macroeconomic implications. Money laundering and related predicated crimes can undermine the stability of a country's financial system or its broader economy. Weakness in this area can also facilitate corruption, including at the transnational level, by allowing perpetrators to conceal the proceeds of corrupt acts. The assessment below looks at the adequacy of the legal framework, the overall institutional capacity, and effective implementation. Gaps in implementing the framework may foster money laundering and undermine the stability of the financial system. They can also facilitate corruption by providing opportunities for perpetrators to conceal the proceeds of corrupt acts.

The three countries considered progressed in establishing national AML/CFT frameworks, but face implementation challenges in supervision and mitigation. The countries advanced in establishing the framework, cooperating internationally to fight criminals and seize their assets, applying preventive measures, and using financial intelligence. However, they face implementation challenges in most of the objectives a framework for AML/CFT is expected to achieve. Botswana and Seychelles have generally not been effective at reaching most of the 11 key goals that an AML/CFT system should achieve (Figure 3.9). The two countries were moderately effective in three key areas related to (1) international cooperation aiming at facilitating actions against criminals and their assets, (2) application of AML/CFT preventive measures, and (3) the use of financial intelligence and relevant information by competent authorities for money laundering and terrorist financing investigations. Based on the latest Eastern and Southern Africa Anti-Money Laundering Group (ESAAMGL) mutual report for Rwanda (ESAAMGL 2014), the country made considerable progress in establishing a national AML/CFT framework in recent years, but also faces implementation challenges regarding lack of awareness of the prevention and detection of money laundering and terrorism financing, implementation of the legal framework, supervision of reporting entities within the financial sector, and mitigation of the potential domestic and cross-border risks. More recently, however, Rwanda adopted the Law on the Prevention and Punishment of Money Laundering and Terrorism Financing.

Botswana, Rwanda, and Seychelles are compliant with most of the technical requirements of the FATF recommendations in some areas, but still face shortcomings in others. Botswana and Seychelles are rated partially compliant with most of the technical criteria regarding (1) transparency and beneficial ownership of legal persons and arrangements and (2) the powers and responsibility of competent authorities and other institutional measures. On the latter, the two

Figure 3.9. AML/CFT Measures: Effectiveness and Compliance with FATF Technical Requirements

		Botswana	Seychelles	
Effectiveness of Measures	Goals AML/CFT System should Achieve	Money laundering and terrorist financing risks are understood and, where appropriate, actions coordinated domestically to combat money laundering and the financing of terrorism and proliferation.	LE	LE
		International cooperation delivers appropriate information, financial intelligence, and evidence, and facilitates action against criminals and their assets.	ME	LE
		Supervisors appropriately supervise, monitor, and regulate financial institutions and DNFBPs for compliance with AML/CFT requirements commensurate with their risks.	LE	LE
		Financial institutions and DNFBPs adequately apply AML/CFT preventive measures commensurate with their risks, and report suspicious transactions.	LE	ME
		Legal persons and arrangements are prevented from misuse for money laundering or terrorist financing, and information on their beneficial ownership is available to competent authorities without impediments.	LE	LE
		Financial intelligence and all other relevant information are appropriately used by competent authorities for investigations of money laundering and terrorist financing.	ME	LE
		Money laundering offenses and activities are investigated and offenders are prosecuted and subject to effective, proportionate, and dissuasive sanctions.	LE	LE
		Proceeds and instrumentalities of crime are confiscated.	LE	LE
		Terrorist financing offenses and activities are investigated, and persons who finance terrorism are prosecuted and subject to effective, proportionate, and dissuasive sanctions.	LE	LE
		Terrorists, terrorist organizations and terrorist financiers are prevented from raising, moving, and using funds, and from abusing the NPO sector.	LE	LE
Persons and entities involved in the proliferation of weapons of mass destruction are prevented from raising, moving, and using funds, consistent with the relevant UNSCRs.	LE	LE		

			Botswana	Seychelles
Compliance with Technical Requirements of FATF Recommendations	<i>AML/CFT Policies and Coordination</i>	Assessing risks and applying a risk-based approach	LC	PC
		National cooperation and coordination	PC	PC
	<i>Money Laundering and Confiscation</i>	Money laundering offense	C	LC
		Confiscation and provisional measures	LC	PC
	<i>Terrorist Financing and Financing of Proliferation</i>	Terrorist financing offense	C	PC
		Targeted financial sanctions related to terrorism and terrorist financing	PC	PC
		Targeted financial sanctions related to proliferation	PC	NC
		Non profit organizations	NC	NC
	<i>Preventive Measures</i>	Financial institution secrecy laws	PC	C
		Customer due diligence	PC	LC
		Record keeping	LC	C
		Politically exposed persons	LC	LC
		Correspondent banking	PC	C
		Money or value transfer services	NC	C
		New technologies	PC	NC
		Wire transfers	PC	PC
		Reliance on third parties	N/A	LC
		Internal controls and foreign branches and subsidiaries	PC	C
		Higher-risk countries	NC	PC
		Reporting of suspicious transactions	C	C
		Tipping off and confidentiality	LC	C
		DNFBPs: customer due diligence	NC	LC
	DNFBPs: other measures	LC	LC	
<i>Transparency and Beneficial Ownership of Legal Persons and Arrangements</i>	Transparency and beneficial ownership of legal persons	PC	PC	
	Transparency and beneficial ownership of legal arrangements	PC	PC	

(continued)

Figure 3.9. AML/CFT Measures: Effectiveness and Compliance with FATF Technical Requirements (*continued*)

		Botswana	Seychelles	
	<i>Powers and Responsibilities of Competent Authorities and Other Institutional Measures</i>	Regulation and supervision of financial institutions	PC	PC
		Powers of supervisors	C	LC
		Regulation and supervision of DNFBPs	PC	PC
		Financial intelligence units	LC	PC
		Responsibilities of law enforcement and investigative authorities	LC	C
		Powers of law enforcement and investigative authorities	LC	C
		Cash couriers	LC	LC
		Statistics	PC	PC
		Guidance and feedback	PC	PC
		Sanctions	PC	PC
	<i>International Cooperation</i>	International instruments	C	C
		Mutual legal assistance	LC	PC
		Mutual legal assistance: freezing and confiscation	C	NC
		Extradition	LC	PC
		Other forms of international cooperation	LC	LC

LE	Low level of effectiveness—the immediate outcome is not achieved or achieved to a negligible extent. Fundamental improvements needed.
ME	Moderate level of effectiveness—the immediate outcome is achieved to some extent. Major improvements needed.

C	Compliant.
LC	Largely compliant.
PC	Partially compliant.
NC	Non compliant.

Source: ESAAMLG mutual evaluation reports; and IMF LEG; 2017, 2018, 2019.

Note: Data for Rwanda are not available.

countries are partially compliant with requirements on regulation and supervision of financial institutions, as well as requirements on statistics. Similarly, based on the latest ESAAMLG mutual evaluation report for Rwanda, the country's AML/CFT law regarding the beneficial owner would need more details to be effective, while competent authorities lack powers and adequate supervisory authority, as well as detailed statistics on the effectiveness of the AML/CFT regime. Both Botswana and Rwanda are partially compliant with most recommendations regarding preventive measures. While Seychelles is compliant with most of the preventive measures, the country still has major shortcomings in AML/CFT policy coordination, money laundering and confiscation, and terrorism financing.

Recommended actions pertain to implementation and compliance requirements, including enhancing capacity, applying a risk-based approach, and improving transparency and beneficial ownership. Seychelles is encouraged to enhance the capacity of the relevant AML/CFT institutions, implementing a risk-based approach to AML/CFT supervision, and pursuing efforts to improve transparency of both domestic and international business companies while establishing a beneficial ownership register for the offshore sector. Recommendations for Rwanda include improving the collection and verification of beneficial ownership, notably through a provision on beneficial ownership information from bidders as part of the tender for the public procurement process and through information available on the government's e-procurement website. Botswana will need to implement a sound and effective risk-based approach to supervision for offsite surveillance, and on-site activities for the BoB and Non-bank Financial Institutions Regulatory Authority (NBFIRA) should continue.

GOVERNMENTAL MEASURES TO PREVENT CORRUPT ACTS

Deterring transactions involving a public official abusing his or her office is best achieved through strong legal and institutional frameworks. The first element of a good framework is to have laws criminalizing corruption. These laws also need to be applied rigorously, with particular attention paid to the governance of the anticorruption entities. The laws also need to restrain concealment of the proceeds of corruption of officials.

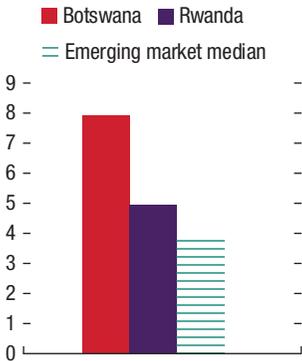
Sound legislation criminalizing corruption contributed to relatively high scores for the anticorruption policies of Botswana, Rwanda, and Seychelles (Figure 3.10). Based on the Bertelsmann Transformation Index, Botswana and Rwanda's anticorruption policies score above the median emerging market country (BTI 2020).¹⁷ This index reflects the scoring by country experts of a country's different dimensions of governance according to a standardized codebook. The scores and assessments are published online and reviewed by a second country

¹⁷ The index does not include Seychelles.

Figure 3.10. Preventing Corrupt Acts

Botswana's anticorruption policies compare favorably to that of most countries in the world, while Rwanda's outperform the median emerging market country.

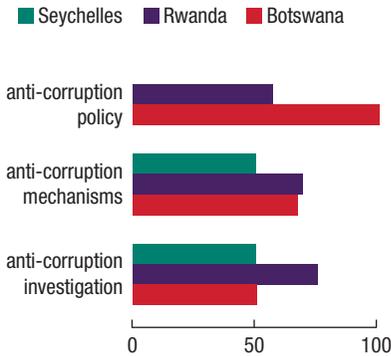
1. Anticorruption Policies (2020; score: 0 = low to 9 = high)



Source: Bertelsmann Transformation Index (2020) (does not cover Seychelles).

Botswana, Rwanda, and Seychelles are among the leading African countries for governance. Botswana's anticorruption policy outperforms its application.

2. Anticorruption Practices (2019; score: 0 = low to 100 = high)



Source: Ibrahim Index of African Governance (2020) (does not rank anti-corruption policy for Seychelles).

expert. Consistency is ensured by subjecting each of a country's scores to regional and interregional calibration processes. Botswana, Rwanda, and Seychelles have enshrined the criminalization of corruption in their laws (Africa Integrity Indicators 2020). Botswana is particularly well noted for its Directorate on Corruption and Economic Crime (DCEC), established in 1994 to combat economic crime through investigation, corruption prevention, and public education. The directorate is part of the office of the president and reports directly to the president.

Botswana also adopted the Whistle Blowing Act in 2016. Furthermore, the government established a special court to expedite corruption cases.

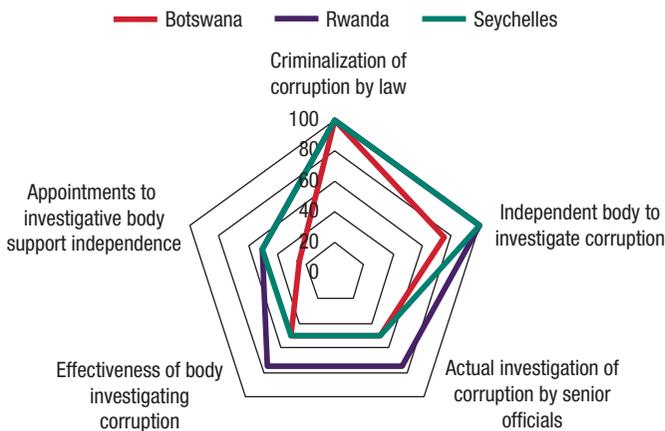
However, the application of these laws is relatively challenging, according to the Ibrahim Index of African Governance (2020). This index is a composite indicator based on experts' surveys of different aspects forming subcategories of the index. Botswana, which outranks Rwanda in terms of its anticorruption policy, earns lower scores on the policy's application and anticorruption investigations. Botswana's DCEC's perceived lack of independence from the government may hamper its effectiveness, including in addressing high-level corruption. Moreover, Botswana has yet to enact laws on the declaration of assets and liabilities¹⁸ and on

¹⁸ Announced in 2018.

political party financing. In Rwanda and Seychelles,¹⁹ the bodies investigating cases of public sector corruption are independent by law, which has earned them higher recognition on that aspect of corruption control (Africa Integrity Indicators 2020). The Africa Integrity Indicators are constructed with scores by in-country researchers using an evidenced-based methodology. Each indicator has a score, an explanatory comment, and sources. Data is gathered through a variety of sources, including legal and scholarly reviews, interviews with experts, and reviews of media stories. Rwanda is rated as being relatively more effective at investigating corruption, due to its well-functioning mechanisms, including online, by which the Office of the Ombudsman can receive citizens' complaints. In contrast, the online mechanism in Botswana is reported to be outdated and not anonymous. Seychelles' effectiveness at investigating corruption improved after amending its Anti-Corruption Act in July 2019, but its Public Officers' Ethics Commission does not have investigative powers (Figure 3.11).

There is still significant scope for improving the process of appointing staff to these countries' anticorruption bodies. According to the Africa Integrity Indicators' methodology, countries would earn a perfect score on "Appointments to investigative body" if appointments were merit based, free of conflict of interests, and changes in the appointment could only be effected through due process by an oversight body. Currently, in Botswana and Rwanda, all appointments are decided by the president, but must be approved by the Senate in Rwanda, while Seychelles approved the head of the ombudsman's office through a merit-based selection process for the first time in 2017 (Africa Integrity Indicators 2020).

Figure 3.11. Control of Corruption



Source: Africa Integrity Indicators, 2020.

Note: Higher scores reflect practices closer to best international practices.

Based on the latest year where scores are available, from 2018 to 2020.

¹⁹ Seychelles' anticorruption legislation was passed in March 2016.

A sound legislative and regulatory framework governing the extractive sector is an important pillar of a strong anticorruption strategy. Throughout the world, the sector contributes the most to the bribery of government officials, with the highest value of the bribes paid in any sector (OCED 2014). More specifically, the sector is prone to abusive cross-border and domestic profit shifting that not only erodes the tax base but is instrumental in causing corruption by facilitating the remuneration of illicit stakeholders and intermediaries. Moreover, the taxation of extractive industries should be brought under the tax administration instead of sectoral ministries or agencies. A recommended practice is to develop units in the revenue administration that specialize in extractive industries. Finally, public disclosure of information on tax payments, including any specific tax or customs incentives and privileges, licenses, contracts, and production data, can help reduce opportunities for corruption in the extractive sector. While Seychelles' oil and gas sector remains at the exploration stage, it has been participating in the Extractive Industries Transparency Initiative (EITI) since August 2014. It adopted the Beneficial Ownership Act in March 2020, which requires it to publicly disclose beneficial ownership in the extractive sector. In September 2020 the EITI board agreed that Seychelles had made meaningful progress in implementing the EITI standard (EITI 2020).

While not participating in the EITI, Botswana, an important exporter of minerals, established in 1994 the Pula Fund, a long-term investment portfolio, to preserve part of the income from diamond exports for future generations. Foreign exchange reserves exceeding what is expected to be needed in the medium term are transferred to the Pula Fund and invested according to established investment guidelines. The Pula Fund is a sovereign wealth fund (SWF) governed under the generally accepted principles and practices for SWF's, also known as the Santiago Principles (Bank of Botswana, n.d.).

CONCLUSION

Botswana, Rwanda, and Seychelles are three relatively strong governance performers that share transparency as a common feature of governance. All three countries have been proactive in adopting policy frameworks that support good governance. Botswana did so to prudently manage its wealth from mining resources, while Rwanda and Seychelles needed to rebuild their institutions after a devastating conflict and a debilitating debt crisis, respectively. These countries have relatively transparent economic policy and management—with more work needed, however, on expanding budgetary information and engaging the public in budgetary discussions, financial supervision, and protection of economic rights. Botswana, Rwanda, and Seychelles have relatively transparent rules for tax obligations and liabilities, their legislatures have somewhat good access to audit reports, and they practice good risk management of their revenue administration. Moreover, these countries have well-supervised financial systems and relatively high compliance with prudential rules, their central banks enjoy a high level of independence and have transparent monetary policy, and they have strong

regulations for property rights and competition in services. All three countries have enshrined the criminalization of corruption in their respective laws.

Accountability and buttressing policy frameworks remain common areas for improvement in these countries. Botswana, Rwanda, and Seychelles would benefit from providing public services more efficiently, including by strengthening accountability through improving the information on the performance of the delivery of services by the government. Strengthening tax revenue audits and investigations would further improve fiscal governance. Other beneficial second-generation reforms, already underway, are to design financial regulatory and supervisory frameworks to support orderly crisis resolutions. Moreover, monetary policy frameworks will benefit from their ongoing modernization.

A common feature of these countries is that their business regulations are applied according to good governance practices and protected by a relatively independent judiciary system and a sound rule of law. Rwanda's regulations for land administration and insolvency respectively earn top rankings, and its other regulations are relatively business friendly, while Botswana and Seychelles have different strengths. Botswana, Rwanda, and Seychelles have proper laws criminalizing corruption, but their application and enforcement remains challenging, as is implementation of the AML/CFT framework. While these countries have sound legislation criminalizing corruption, the application of this legislation is complicated by the relative lack of political independence of some of the institutions mandated to fight corruption, including through ad hoc hiring procedures for staffing these institutions. Similarly, the countries' AML/CFT frameworks are compliant with most technical requirements, but application would be strengthened by accelerating implementation of all requirements, enhancing capacity, applying a risk-based approach, and improving transparency and declaration of beneficial ownership.

Moreover, to bridge the gap with emerging markets, Botswana, Rwanda, and Seychelles need to accelerate reforms centered on accountability and implementation. While these countries have successfully established the pillars of good governance, they need to follow up with second-generation reforms that ensure that implementation is of as high quality as the intended objectives of the laws and regulations. Proper accountability is the first step.

Finally, a good governance framework requires that governance evaluations are recurrent, well disseminated to the general public, and supported by authorities who are committed to explaining their findings, including in areas where progress has been limited or reversed.

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Reaping the Benefits from Better Governance in Nigeria

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ABSTRACT

The macroeconomic benefits resulting from better governance in Nigeria could be significant and include higher per capita GDP growth, higher revenue, and improved public investment efficiency. Given Nigeria's fiscal and external dependence on oil revenue, reducing leakages in the petroleum sector is especially critical. Against this background, this chapter provides an overview of recent governance reforms and challenges in the oil sector. It outlines policy recommendations for better governance and corruption prevention, detection, and resolution, including through mobilizing tools to combat money laundering and the financing of terrorism.

INTRODUCTION

Chapters 1 and 2 highlighted how corruption introduces inefficiencies through its negative impact on government operations. Most tax revenues relate negatively to corruption, which undermines compliance (Baum and others 2017). Taxpayers can escape tax payments through bribes or other unofficial compensation, and companies do not join the formal economy when tax exemptions are granted as the result of a bribe (Dreher and Herzfeld 2005; IMF 2016). In countries with weak institutions, governments may use capital spending as a vehicle for rent-seeking, thus decreasing public investment efficiency (Albino-War and others 2014; Gelb and Grassman 2010; Grigoli and Mills 2014). Lower revenue mobilization and spending efficiency, in turn, shrink fiscal space and can thus lead to fiscal dominance, so that corruption correlates with higher inflation (Ben, Sami, and Sassi 2016).

Indeed, applying Nigeria-specific data to past studies shows significant macroeconomic gains from reducing corruption and boosting governance in the country. Using cross-country estimates, IMF (2017) suggests that, for Nigeria, reducing corruption to the level observed in benchmark countries (for example, Malaysia, Mongolia, Morocco, or South Africa), could boost growth by $\frac{1}{2}$ to $1\frac{1}{2}$ percentage points annually. Results from IMF (2016) imply that Nigeria's tax revenue-to-GDP

ratio could be higher by 0.4–1.4 percentage points if corruption was to be lowered to benchmark levels. Panel regressions for sub-Saharan African countries (Barhoumi and others 2018) highlight the point that lowering Nigeria's level of corruption to that of South Africa, as measured by the Worldwide Governance Indicators' control of corruption score¹, could increase the amount of infrastructure obtained from each publicly invested dollar by 12 percent, while the quality of infrastructure could also improve.

Realizing the significant gains from improved governance outcomes, the Nigerian government has started signaling its commitment to fight corruption in the context of its Economic Recovery and Growth Plan (ERGP) for 2018–20, in the following key ways:

- The government approved the National Anti-Corruption Strategy (NACS) for 2017–20. The strategy identifies national priorities, including enhancing asset recovery and management, improving adjudication of corruption cases by the court system, strengthening the investigation and prosecution of corruption, and enhancing coordination and collaboration among competent authorities. It also makes recommendations for the anticorruption agencies and sets out an implementation plan.
- The government is introducing efforts to implement requirements to disclose the beneficial owners of companies involved in the extractive sector, and is publishing a monthly financial and operational report of the Nigeria National Petroleum Corporation (NNPC).
- The government's ERGP includes a range of additional anticorruption measures, including a whistleblower program and an online portal that allows for the submission of tips and a reward for information that leads to the voluntary return of stolen or concealed public funds or assets.²
- The National Bureau of Statistics is conducting surveys on corruption in conjunction with the United Nations Office on Drugs and Crime, laying out the incidence of bribery across different institutions, and has conducted at least two surveys so far (UNODC 2017; 2019), providing granular evidence on the topic.
- In view of weaknesses in federal government enterprises, the central government decided to strengthen its oversight of the federal government enterprises sector. In early 2021, performance contracts were designed to ensure that revenue targets are realistic and adhered to. The review of the federal government enterprises portfolio to ensure the proper classification is ongoing. Separation of SOEs from departmental agencies, along with calls for publishing regular quarterly financial statements, have also been ongoing as of the time of this publication.

¹ Worldwide Governance Indicators are available here: <https://info.worldbank.org/governance/wgi/>.

² See <http://whistle.finance.gov.ng/Pages/default.aspx>.

Governance in Nigeria's oil sector deserves special attention, given the criticality of oil for Nigeria's macroeconomy. Oil remains Nigeria's dominant source of financial inflows. It accounts for about two-fifths of total government revenue and more than 90 percent of export earnings. Reducing leakages in the sector is therefore key to fiscal sustainability and external stability. Given the prominent role of the oil industry within the Nigerian economy, the analysis offered in this chapter will thus place special emphasis on governance within the oil sector. After a short discussion of general challenges in the SOE sector in 2019, the chapter highlights concrete steps to improve the governance of the oil sector, focusing on its importance for government operations (fiscal transparency and sustainability). It also highlights the unique potential, in and beyond the oil sector, of tools for AML/CFT.

GOVERNANCE CONSIDERATIONS IN THE STATE-OWNED ENTERPRISE SECTOR

The current ownership arrangements for federal government enterprises follow a dual, decentralized model, with the Ministry of Finance and the relevant line ministry each discharging similar oversight and ownership responsibilities. In each case, the state, through the relevant line ministry, is the provider, the regulator, and the supervisor of the product or service performance delivered by the federal government enterprise, resulting in an inherent potential conflict with the Ministry of Finance. The absence of transparent arrangements increases the chances that enterprise assets will be misused for narrowly political or personal purposes.

Quantifying the fiscal risks stemming from the SOE portfolio is challenging for several reasons. The definition of a federal government enterprise is not consistent across several legislative acts. There is no standard reporting policy and no aggregated annual report on the financial performance of the overall federal government enterprises sector. A lack of standardized accounting policies complicates quantifying the operating surplus of each federal government enterprise. Obtaining a true picture of the federal government enterprises' performance or financial situation, which would enable the authorities to react on time and to be selective in their intervention, is therefore difficult.

In strengthening the oversight of federal government enterprises, one key priority—in line with international practices—is to gradually centralize existing fiscal oversight arrangements and streamline ownership arrangements. Efforts to improve financial and fiscal discipline—as planned by the authorities—should be integrated with a broader public financial management reform agenda. A cohesive ownership vision would redesign and streamline the division of regulatory, oversight, policy, and ownership roles and responsibilities. Best-practice examples suggest a central role for the Ministry of Finance in monitoring SOE performance.

GOVERNANCE OF THE PETROLEUM SECTOR

The dual-model institutional setup is also present in the petroleum industry. The institutional fragmentation and overlap of government entities in roles of oversight, ownership, and policy highlight the need to strengthen operational efficiencies, management, and accountability. This has a direct impact on the operations of NNPC, which remains the largest source of income for the federal government.

Several agencies are tasked with overseeing the petroleum industry in Nigeria. At the ministerial level, the Ministry of Petroleum Resources (MPR) is responsible for overseeing the overall sector and for policymaking, while the Ministry of Finance retains a marginal role in the management and oversight of the sector, and of NNPC in particular. The minister of Petroleum Resources has a combined role, serving as both the overseer of the ministry and the chairman of the NNPC. At the agencies level, the regulator for extractives is the Department of Petroleum Resources (DPR), which exercises regulatory powers as well as licensing and monitoring powers for oil, gas, and downstream petroleum products. DPR does not have its own constituting act but instead is legally founded in the act that established NNPC, legislation that also calls for the corporation to house an inspectorate DPR within its organizational structure. Finally, the auditor-general does not have a direct mandate to audit NNPC, and there is no central oversight role for the Ministry of Finance in the current setup. Oversight roles and executive responsibilities thus run the risk of interfering in NNPC's decision making processes and create conflicts of interest. To be more efficient, NNPC is attempting to become a de facto corporate group by creating autonomous business units, and it is aiming to move from a compliance-based to a risk-based approach to its control and audit functions.

Fiscal Discipline of NNPC

Limited fiscal oversight and a fragmented institutional setup impede revenue collection. NNPC engages in fiscal arrangements in the oil sector on behalf of the federal government of Nigeria. These arrangements mainly consist of joint ventures and production sharing contracts.³ According to the Nigerian Extractive Industries Transparency Initiative (NEITI), the country's chapter of EITI,⁴ revenues are often lost or undercollected due to arbitrary decision-making in the awarding of oil blocks, unpaid signature bonuses and royalties, or crude oil theft. For example, NEITI estimates that in 2015 NNPC owed \$9.8 billion to the

³ NNPC participates in joint venture (JV) arrangements with international and domestic oil companies for upstream operations in which the Nigerian government is a majority-share equity investor. This usually entitles the corporation to receive a production share equal to its ownership stake (petroleum revenue). In return, the corporation pays cash liabilities that are its share of the operating and capital expenses associated with its JV activities (cash call payments).

⁴ NEITI was incorporated as a government agency in 2007. It has played a crucial role in legislating the principles of EITI and in improving financial disclosure standards in the Nigerian oil industry.

federal government, mainly due to deductions from gross oil revenues and opacity in the new joint venture cash call arrangements. There is also a conflict between the constitution and the NNPC Act concerning revenue withholdings, generating uncertainties regarding company transfers. The constitution requires that all NNPC revenue proceeds be paid to the federation account, but the NNPC Act states that the NNPC shall maintain a fund from which it can defray expenses, with no need for recourse to appropriation by the National Assembly. The Fiscal Responsibility Act 2007 mandates that the NNPC remit one-fifth of its operating surplus to the consolidated revenue fund of the federal government, but it neither defines “operating surplus” nor provides a limit to deductions.⁵ Reports from NEITI and the auditor-general have consistently highlighted concerns of transparency and accountability as deductions have increased over the years. Government stakeholders (the Ministry of Finance and the accountant general) should be granted full oversight responsibilities over cash flows. Making revenues more transparent requires significant revisions to the legal framework, including establishing a clear mandate to fund NNPC operations (defining the operating surplus, the possibility to make deductions, and limits to defray operating costs) and reconciling provisions of the NNPC Act concerning revenue withholdings in light of constitutional requirements.

The new funding mechanism for cash calls has helped reduce arrears accumulation, but publication of contracts is necessary to reduce fiscal risks. Before 2017 gross proceeds were transferred immediately to the federation account, and monthly cash calls were paid to Joint Venture partners through a budget appropriation process. This setup allowed the federal government to better oversee revenue distribution. However, discrepancies between NNPC-approved amounts and federal government budget allocations, coupled with budgetary process delays, have contributed to the accumulation of significant arrears. In 2017 the corporation had begun to retain revenue from its operations to meet all its expenses, including cash call obligations. After paying its cash call obligations, the corporation then remitted net revenues to the federation account. This new mechanism helped to decrease accumulations of cash call arrears, but it raised concerns about the transparency of the corporation’s cash call deductions as stated in the annual reports of the Office of the Auditor-General.

Petroleum contracts are kept fully confidential, although they have a significant impact on public finances.⁶ The publication of these contracts with attention to the confidentiality of commercially sensitive data is necessary to reduce fiscal risks.

Budget allocation and the actual expenditures of NNPC differ significantly, and the corporation’s participation in the appropriation process seems so far to be limited. As part of the appropriation bill process, NNPC is required to submit its revenue and expenditure estimates to the Budget Office, which submits them to

⁵ Oil revenue accounts for more than half of government revenues (IMF 2019).

⁶ These include sales contracts, service contracts, PSCs, and JVs.

the National Assembly for approval. However, amounts submitted by the corporation often do not match federal government budget allocations. The Ministry of Finance is in charge of revenue forecasting and scenario modeling, but it is constrained by the limited expertise of its staff and by restricted access to data. The corporation's budget is not published, nor is it identified in the federal government budget. There is no information on the operational surplus of the corporation, and nonappropriated spending was increasing at the time this chapter was written, mostly due to the corporation's deductions from oil revenues. These issues, coupled with the lack of verifiable financial data, suggest that significant changes are needed in terms of information sharing, disclosure of fiscal risks, and full integration of NNPC's revenues and expenditures into the budget process.

Transparency of NNPC

The legal framework for fiscal transparency has been significantly enhanced with the enactment of the Fiscal Responsibility Act 2007 and the EITI Act. The Fiscal Responsibility Act requires that fiscal and financial affairs be conducted in a transparent manner and that SOEs (including NNPC) provide full and timely disclosure and wide publication of all transactions and decisions involving public revenues and expenditures and the implications for the enterprises' finances. Nigeria is one of the few countries to have legislated the EITI, via the 2007 EITI Act. The act gives NEITI a mandate to develop a framework for transparency and accountability in the reporting and disclosure of all extractive industry companies' revenue due to or paid to the federal government. It also enables NEITI to conduct audits of Nigeria's oil and gas industry. In February 2019 the board of EITI agreed that Nigeria had made "satisfactory" progress in implementing the EITI standards (EITI 2019).

However, improving data reconciliation and auditing is essential for proper monitoring of NNPC's financial situation. The corporation is self-reporting—its figures cannot be verified or challenged by other government bodies. There is also room for enhancing the level of disclosure, for example, by clarifying what the corporation ultimately considers as net revenue. NEITI noted that its auditors have not independently verified the information and data from NNPC's monthly reports, and there are data discrepancies between the company, the auditor-general, the CBN, and the accountant general. The Fiscal Responsibility Act 2007 requires NNPC to prepare and publish audited accounts. While as of 2019 there had been no published audit report, the company has published audited financial statements for 2018 and 2019 on its website more recently.⁷

Strengthening transparency is crucial if Nigeria is to receive maximum benefits from the oil and gas sector. The IMF's Fiscal Transparency Code requires that resource corporations report on project-level fiscal payments to and from the government, reconciled with government receipts in line with international

⁷See <https://www.nnpcgroup.com/NNPC-Business/Business-Information/Pages/Monthly-Performance-Data.aspx>.

standards, with no major unexplained reconciliation errors. In line with good practices, it is important for the NNPC to disclose all revenue transfers and remittances to the federation account by providing complete and timely information that ensures the accountability of its receipts and expenditures. The corporation could also consider enhancing and integrating its transparency practices by reporting on environmental, social, and governance considerations. The Sustainability Disclosure Guidelines established by the Nigeria Stock Exchange could provide useful guidance in this regard. The guidelines are intended primarily to provide the value proposition for sustainability in the Nigerian context. They articulate a step-by-step approach to integrating sustainability into organizations, indicators that should be considered when providing annual disclosures, as well as timelines for such disclosures.

Oversight of NNPC

The role of the auditor-general can be strengthened. The constitution does not give the auditor-general a direct mandate to audit NNPC. It establishes the appointment of the auditor-general to audit public accounts and offices of the federation but explicitly excludes the accounts of government statutory corporations from the mandate.⁸ However, it grants the auditor-general power (undefined) to conduct periodic checks aimed at verifying that spending is in accordance with the Ministry of Finance's instructions and at investigating expenditure patterns of the government, including payments by NNPC to the federation account. The Office of the Auditor-General is resource constrained and requires greater financial and operational independence, and this impacts the timeliness of the information provided to the National Assembly. The relationship between the Office of the Auditor-General and the oversight committees of the National Assembly should be enhanced to ensure that, to the extent possible, current financial, fiscal, and governance challenges related to SOEs are being analyzed and discussed. In addition, these steps could be combined with examinations of audit reports by parliamentary committees, allowing public hearings during the review process, and submission of a report to Parliament on the issues arising from the audit reports.

The fiscal oversight role of the Ministry of Finance should be enhanced. The Finance (Control and Management) Act gives the minister of finance powers to supervise and control the expenditure and finances of the federation and all matters related to the financial affairs of the federation that are not by law assigned to any other minister. However, the ministry's fiscal oversight function over NNPC should be strengthened. The Petroleum Unit, which was established in

⁸ The constitutional framework does not adequately protect the independence of the auditor-general and the office of the auditor-general. While the constitution states that the auditor-general shall not be subject to the direction or control of any other authority or person in the exercise of his functions, he or she may be removed from office by the president on grounds of an inability to discharge the functions of his office or for misconduct. Also, there are no provisions regarding the power to access information or effective follow-up mechanisms for audit recommendations.

the Ministry of Finance with a mandate to provide sector revenue forecasting and support to the Federal Inland Revenue Service's audit functions, needs to be enhanced, both through additional training on the sector and greater resources. The oversight unit should be responsible for oversight of, among other things, planning and budgeting arrangements, reporting requirements, dividend policy, and financial assistance from the government, including guarantees and quasi-fiscal activities.

An effective sanctions and enforcement regime would also help. This might include giving to the auditor-general and the Ministry of Finance the legal powers to impose sanctions on individuals and institutions for the nonremittance of revenues to the federation account, failure to disclose information required by the law, and noncompliance with requirements related to process, expenditure, and mismanagement of public assets.

The Petroleum Industry Governance Bill Act

Recognizing these challenges, the government has pushed for the approval of the Petroleum Industry Bill (PIB)—a key element of its ERGP—to address institutional weaknesses (Box 4.1). The PIB aims at redesigning the overall institutional architecture of the oil industry in a bill consisting of four acts. The first act—the Petroleum Industry Governance Bill—aims at (1) clarifying separation of ownership, policymaking, and regulatory responsibilities among the agencies; (2) establishing a commercially oriented focus for petroleum entities; (3) promoting transparency of and accountability for the petroleum resources; and (4) creating a conducive business environment.

COMBATING CORRUPTION IN THE SOE SECTOR AND BEYOND

Several reforms discussed in the following sections would have a direct impact on promoting and ensuring good governance in the oil sector. Greater visibility into the beneficial ownership of legal entities and arrangements, along with the strengthened implementation of measures to enhance scrutiny of the finances of politically exposed persons (PEPs)—whether via transaction monitoring or asset declaration—would advance the authorities' efforts to uncover acts of corruption, including those involving SOEs and the NNPC. The key is to track the associated proceeds and prevent those proceeds from being laundered and spent.

Transparency of Beneficial Ownership

Ensuring the transparency of ultimate (or beneficial) ownership is critical to prevent, detect, and investigate corruption, including via the abuse of corporate vehicles. Corrupt officials may form or use legal persons (for example, companies) to obscure their part in a bribery or kickback scheme; strike advantageous deals with themselves, their family, or their associates; or launder the associated proceeds.

Box 4.1. Selected Challenges in the Petroleum Industry Governance Bill¹

Implementation of the Petroleum Industry Governance Bill would represent a clear break from past practices by restructuring institutional arrangements and calling for greater transparency. Its effectiveness will be strengthened by ensuring that the following challenges are addressed:

Coordination: The Petroleum Industry Governance Bill gives responsibility for rents and royalties to the Nigerian Petroleum Regulatory Commission, for profit-sharing contracts (PSCs) to the Nigeria Petroleum Assets Management Company (NAPAMC), and of other contracts held by NNPC to the National Petroleum Company (NPC). Coordinating and streamlining the work conducted by these different parts of the new fiscal regime is critical. It may require adequate information flows among these institutions, assistance in audit processes, and sharing expertise.

Monitoring and oversight: Additional safeguards are required to subject new institutions to effective government oversight, while permitting them to continue to operate independently of political interference. The Petroleum Industry Governance Bill's objective is to improve the clarity of the roles and responsibilities of sector agencies, with the NPC and Petroleum Asset Management Company to be subject to the Companies and Allied Matters Act (CAMA) and the Securities and Exchange Commission's Codes of Corporate Governance. However, there is no single oversight unit that can monitor these entities.

The role of the Ministry of Finance: The ministry's role in monitoring key financial information in relation to NPC and the Petroleum Asset Management Company, and in assessing fiscal risks arising from their activities, is not provided under the Petroleum Industry Governance Bill. This is particularly important given that NPC would be entitled to retain revenue from its operations to cover its expenses, debt liabilities, and cash call obligations in the Joint Ventures. The Petroleum Industry Governance Bill also excludes NPC from the provisions of the Fiscal Responsibility Act 2007 and the Public Procurement Act 2007, creating additional fiscal risks as NPC is excluded from budgetary planning, borrowing limitations, conditions for guarantees by the FG, public procurement provisions, and fiscal transparency requirements.

Formalization of appointment, remuneration, and evaluation policies: The Petroleum Industry Governance Bill remains silent on transparency and formalization of the process for appointment, evaluation, and remuneration of the members of the commission and of the board of directors of NNPC and NAPAMC.

¹ Petroleum Industry Governance Bill, 2018.

Regular and large expenses to procure equipment or obtain services and expertise from local and foreign contractors expose the SOE sector to heightened risks.

The passage of amendments to the CAMA (Repeal and Re-enactment) Bill of 2018 represented a critical step forward. In view of the relevant Financial Action Task Force (FATF) recommendations—and Nigeria's commitments made under the EITI and at the London Anti-Corruption Summit of 2016—the government crafted amendments to the CAMA that would mandate the disclosure of beneficial interests in a company's shares and task the Corporate Affairs Commission to compile and maintain the resultant information in the public domain. The

Amendment (“Repeal and Re-enactment”) Bill was passed by the Senate on May 18, 2018, and by the House of Representatives on January 17, 2019; it was signed into law by the president in August 2020.

The lack of reliable beneficial ownership information is a significant impediment to detecting and investigating corruption cases that involve legal persons. Among the tools that are less potent in the absence of such information are the Nigerian Financial Intelligence Unit’s (NFIU) analysis of suspicious transaction reports (STR) involving corporate entities and law enforcement’s efforts to conduct financial investigations (“follow the money”) in certain corruption cases.

Politically Exposed Persons

In line with the FATF recommendations, Article 18 of the 2013 CBN regulations established relevant requirements for financial institutions (FI), but in practice, FIs struggle to identify those of their clients who are (or are associated with) PEPs. These requirements include, for example, obtaining senior management approval before establishing (or continuing) business relationships with PEPs and conducting enhanced ongoing monitoring of those business relationships. The Chartered Institute of Bankers of Nigeria (CIBN), Nigeria’s banking association, is taking the welcome step of working with consultants to develop a proprietary account and transaction monitoring tool.

Asset Declaration by Public Officers

All public officers must declare their assets, but the completed forms are not available to the public. The Code of Conduct Bureau (CCB) is responsible for receiving and analyzing completed asset declaration forms, but must currently do so on a confidential basis, limiting the potential for civil society organizations and members of the general public to identify, and bring the CCB’s attention to, inconsistencies in asset declarations. In practice, only a small fraction of the required declarations are ever submitted, and the current forms do not capture certain highly relevant information, such as sources of income, beneficially owned assets, or personal property above a certain value. The framework is not being implemented effectively and enforcement has been very weak, partly due to the CCB’s need for additional resources and capacity building.

AML/CFT Supervision

The CBN supervises FIs and exchange bureaus for compliance with their obligations related to AML/CFT, which include the identification of their clients who are PEPs, the mitigation of the risks associated with those clients, and the submission of STRs, as and when appropriate. The CBN’s AML/CFT (Administrative Sanctions) Regulations of 2018 addressed an important gap in its supervisory framework, but limited resources remain a challenge. The regulations provide the CBN with an adequate legal basis on which to impose administrative sanctions and penalties for noncompliance with obligations related to AML/CFT, and

include a detailed schedule laying out the specific sanctions and penalties to be imposed in response to identified violations. The CBN reports that it has begun to issue sanctions in accordance with the new regulations, but that the schedule will likely have to be updated on an ongoing basis to ensure that the applicable penalties remain sufficiently dissuasive in the context of normal inflation.

The pending commencement of a pilot program for risk-based supervision represents a substantial step toward increasing effectiveness. The risk-based approach entails the classification of supervised entities by money laundering and terrorist financing (ML/TF) risk and the subsequent adaptation of the frequency, scope, and intensity of inspections in accordance with that classification. As such, it should enable the CBN to focus its limited resources more sharply. The CBN already incorporates components related to AML/CFT into its annual prudential inspections, but the limited number of inspectors dedicated to AML/CFT precludes targeted inspections focused on this subject of those banks, or of a sufficient sample of exchange bureaus.

Effectiveness of the Nigerian Financial Intelligence Unit

A critical component of every country's AML/CFT framework is its FIU. It receives, analyzes, and disseminates STRs related to ML, TF, and the related, underlying (or "predicate") offenses, such as fraud, bribery, the diversion of public funds, and other forms of corruption. The private sector is on the front lines of the fight against corruption, with FIs functioning as the primary conduit for attempts to transfer, store, or launder ill-gotten gains.

The passage of the NFIU Act in 2018 was a milestone. The act assured the NFIU's operational independence in line with the FATF recommendations, and so enabled its reconnection to the secure information-sharing platform linking more than 160 FIUs all around the world. The act empowered the NFIU to conduct inspections of FIs and designated nonfinancial businesses and professions (DNFBP), putting it in a position to help ensure that they would submit—and maintain the confidentiality of—STRs in *all* cases of suspected corruption. The Economic and Financial Crimes Commission (EFCC) and the closely related Independent Corrupt Practices and Other Related Offenses Commission (ICPC) are confident that the NFIU can be relied upon to provide timely and accurate information, whether held by the NFIU itself or by a foreign partner—and that working with the NFIU to obtain information is generally more efficient than pursuing the same via mutual legal assistance channels. Still, to the extent that this collaboration is based at least partly on good faith or interpersonal connections, it will be important to formalize it to make it more sustainable over the long term.

Vigorous Prosecution and Timely Conclusion of Corruption-Related Cases

The timely and effective administration of criminal justice, particularly in high-profile cases, is key to deterring corruption. Strengthening the detection and investigation of corruption will be in vain as long as the criminal justice system

fosters the perception of impunity by failing to convict and sanction offenders in a timely manner, if ever.

The 2018 budget increase for the EFCC was nevertheless a welcome step, as it allowed the commission to hire 1,200 additional staff that year while also opening three new “zonal offices.” By contrast, the ICPC had conducted its last recruitment in 2012. Both agencies, which have partially overlapping mandates, indicate that they conduct parallel financial investigations in corruption and other cases involving the generation of illicit proceeds and that many of their prosecutions stretch on for years. Those rare corruption cases that manage to advance without undue (procedural) disruption tend to advance slowly, including because judges record the proceedings in longhand and motions are filed manually.

Moving toward a more efficient court system in Nigeria will, among other things, require vigorously enforcing the Administration of Criminal Justice Act (2015) and making far greater use of information technology.

CONCLUSION

This chapter highlighted the large macroeconomic gains to be made from addressing governance and corruption challenges in Nigeria, in particular in the oil sector. The Nigerian authorities must accelerate their anticorruption efforts to maintain momentum against both entrenched challenges and evolving threats. The high-level commitment of the government and the devotion of many public servants working in the SOE sector, as well as in the country’s institutions dedicated to countering corruption and combating money laundering and the financing of terrorism are the foundation for reform. To make a durable dent in the incentive structures that underpin corruption in Nigeria, however, the government will need to accelerate and intensify its reforms in this area—as stated in its ERGP. The Nigerian authorities’ efforts to enhance transparency in the oil sector should include full disclosure of NNPC’s JV arrangements and establishing clear institutional responsibilities for revenue assessment, collection, and reporting. This chapter has examined issues in two key components of the anticorruption effort—SOE governance, especially in the petroleum sector, and AML/CFT.

Achieving critical improvements to governance will require a combination of legislative action, institutional reform, and additional resources:

- *Legislative action:* The authorities should prioritize the implementation of the Petroleum Industry Governance Bill and the CAMA (Repeal and Re-enactment) Bill and enacting legislation for an overall ownership policy for SOEs. They should focus as well on improving fiscal and financial discipline, with a broader effort to reform public finance management; enhancing the transparency of public revenue flows; and establishing coordination among collecting institutions.

- *Institutional reform*: The Ministry of Finance should regain a central role in the oversight of fiscal risks, while the auditor-general should have a legal basis to operate effectively; the CBN will need to fully implement the risk-based approach with respect to its supervision of efforts to combat money laundering and the financing of terrorism; and the judiciary will need to embrace both legal requirements and best practices related to its management of individual cases and the system-wide caseload.
- *Additional resources*: Prioritizing the allocation of any new or newly available resources to the Oversight and Oil and Gas Departments within the Ministry of Finance, the auditor-general's staffing and operational and training budgets, the CCB, the ICPC, and the judiciary will be critical.

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CEMAC: A Regional Approach to Enhancing Governance

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ABSTRACT

Investing in good governance and reducing corruption is a largely budgetary-neutral reform that can empower the private sector and expand opportunities for all. This reform is critical in the Economic and Monetary Community of Central Africa (CEMAC) and thus part of the overall objective to address the root cause of the crisis it has faced following the decline in commodity prices in 2014: a largely undiversified economy overdependent on oil, and a still untapped internal regional market. This chapter analyzes some CEMAC-specific regional dimensions of a possible strategy to enhance governance in support of specific reforms in this area at the country level. The chapter acknowledges that CEMAC faces capacity constraints in many dimensions of its macroeconomic management, so that implementing any recommendations will require a gradual and sustained approach to yield results.

BACKGROUND

The CEMAC was severely affected by a sharp decline in commodity prices in 2014, notably the reduction in oil prices. Facing a continued and rapid decline in regional reserves, member countries decided at the end of 2016 to embark on a coordinated and sizeable fiscal adjustment, supported by the IMF and other partners and backed by adequate policies at the regional level in the monetary and financial sectors. The short-term objective was to restore external and domestic stability. In the medium term, addressing the root cause of the crisis will require reducing excessive dependency on oil and laying the foundation for a broader economic base. Addressing governance constraints—especially in the management of public resources—has been and will continue to be a key consideration.

This chapter focuses on the regional dimensions of reforms that can support better governance, recognizing that the thrust of actions in this area is largely in the remit of national authorities. However, the very design of an economic and monetary union results in a set of policy and reform dimensions that have distinct

regional features. Improvements thus require a coordinating or even steering role by regional institutions in order to establish a coherent framework and maximize reform synergies at the country level. The chapter focuses on three key areas where governance has a specific regional dimension: (1) regional standards to support public financial management (PFM); (2) international standards to strengthen anti-money laundering and combating the financing of terrorism (AML/CFT); and (3) the framework for management and accountability of oil resources. The chapter relies mainly on IMF-led assessments, complemented by some third-party indicators—and supplemented, where relevant, with the use of indicators of corruption (for example, Transparency International's Corruption Perception Index).

The choice of governance themes addressed in this chapter reflects key features of CEMAC's economic structure. Exports by extractive sectors represent a dominant part of the regional economic basis and the main source of foreign exchange. Consequently, good management in this sector, where the state is present directly (through its state-owned enterprises) and indirectly (through related tax collection), is key to ensuring good governance. In addition, given the role of the public sector as a dominant source of economic activity in CEMAC, the transparent management of public funds is another key dimension of governance. CEMAC banks also play a crucial role in avoiding safe havens for the proceeds of corruption, thereby directly contributing to the government's ability to allocate financial resources to productive ends.

The following two features of the current regulatory landscape, particularly as they relate to the management of public resources, are also directly related to CEMAC's own priorities for regional governance:

- The CEMAC regulatory framework for PFM provides strong standards for transparency and accountability in the management of public resources. Moreover, a strong regime for AML/CFT is a crucial tool in addressing corruption. Because the proceeds of corruption are often concealed to avoid detection or confiscation, an effective framework for AML/CFT can contribute to deterring, preventing, detecting, investigating, and prosecuting corruption.
- The oil sector is central to the CEMAC, given the strong presence of the state, often through SOEs that involve profit-sharing agreements signed with private entities. Such agreements, in turn, should be consistent with the regulatory framework set at the regional level in the area of foreign exchange. As such, the good management of these resources is essential to ensuring external stability to the monetary arrangement. Work in this area is a shared responsibility of member countries, primarily via the CEMAC Commission (which facilitates the proper implementation of adequate tax codes and the tracking of funds covered by state budgets), and the BEAC (which supports member countries in fully understanding the link between export commodity prices and volumes and accumulation of foreign exchange).

THE CEMAC FRAMEWORK FOR PUBLIC FINANCIAL MANAGEMENT

Background

A strong and transparent framework for the management of public resources is the first line of defense against poor governance and potential corruption. The CEMAC has designed and adopted at the regional level the relevant regulations to build this framework and improve efficiency in managing public resources. The challenge is to ensure proper and full implementation of these principles at the national level. This is best done by ensuring regular assessments, reporting on implementation status, and supporting member countries in their efforts in this area.

The CEMAC's PFM framework provides a sound basis for managing public resources in a transparent and efficient manner and addressing PFM vulnerabilities to corruption. The architecture underpinning the regional framework in the area of PFM is rooted in six CEMAC directives. Taken together, these directives form a coherent framework within which to direct the roles and responsibilities, the processes, the reporting, and the internal and external controls and audits related to the collection of taxes and management of public resources. They also provide clear guidance on consultation with civil society, publication of data, and, importantly, the interaction between executive and legislative bodies in budget preparation, execution, and reporting. Principles included in these directives reflect international standards and best practices for promoting fiscal transparency and effective management of public funds (Table 5.1).

As CEMAC standards are defined with the legal instrument of a directive, their provisions need to be transposed into national laws to become applicable in member states. This transposition requires that member countries submit their draft law to the CEMAC Commission for the latter's assessment of conformity. Recommendations of the CEMAC Commission are then embedded in the finalized law, which can then be approved by national authorities. This process is meant to ensure coherence between the regional framework and the national level. There are a set of administrative actions that then follow the approval of legislation at the national level to ensure that processes and procedures, as well as specific obligations in the area of data reports and audits, are well defined and guide work practices in the public administration.

The transposition of these PFM directives into national legislation has been uneven, which limits the potential for harmonization and adherence to key standards in this area (see Figure 5.1). In particular, CEMAC central directives on governance and transparency (06/2011) and on the budget law (01/2011) have been transposed into national legislation by all CEMAC countries, except by Equatorial Guinea. Implementation on all other directives is also partial, as Equatorial Guinea has not transposed these into national legislation.

At the same time, transposition into national legislation does not guarantee that the regional—framework of these PFM directives to enhance governance and

TABLE 5.1

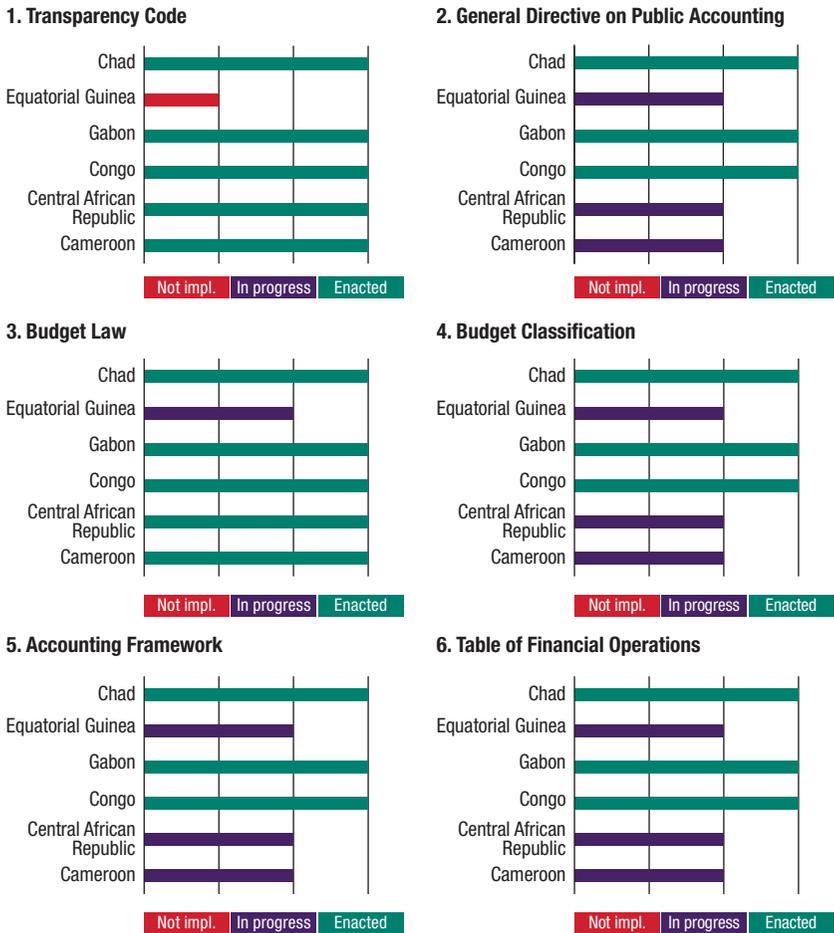
CEMAC: Key Directives on Public Financial Management			
CEMAC PFM Directive Number	Adoption Date	Scope	Issues Covered
06/2011	11-12-2001	Code of good governance and transparency in the management of public resources	Key principles to ensure transparency, good governance, and participation of civil society in the areas of fiscal policy, and budget formulation and execution
01/2011	19-12-2001	The framework for budget law preparation and implementation	General rules on the nature, coverage, presentation, preparation, and adoption of the budget law
02/2011		General rules in the area of public accounting	Operational and procedural framework underpinning budget execution and controls
03/2011		Structure of the State's accounts and of its balance sheet	General rules defining the object of the state's public accounting plan, and the rules of its production so as to track status and evolution of the state's assets and liabilities
04/2011		The nomenclature and presentation of budget operation	Key principles related to the presentation of operations of the general budget, annexed budgets, and special accounts of the treasury
05/2011		Statistics presentation of the financial operation of the state	Defines principles (concepts and methodologies) for the production of statistics on budget executions (follows GFSM international statistical standards)

prevent corruption is effectively implemented. When a national law or regulation is enacted to transpose a CEMAC directive, there are several administrative steps that need to follow, as well as sometimes deep modification of procedures, IT systems, and work practices, for the new legislation to be effective.

A key role is played by the foundational CEMAC regulation on transparency and good governance (directive 06/2011). This regulation serves as the general framework for all the other directives, and lays the groundwork in terms of (1) attribution and responsibilities of each public institution, (2) the economic context in which fiscal policy decisions are embedded, (3) the elaboration and presentation of the budget law, (4) the activities related to revenue collection and expenditure, (5) the information to be provided to the public, and (6) a participative process, with involvement by civil society, in defining key policy decisions. By design, this regulation provides a strong basis in terms of governance. It also establishes clear-cut responsibilities and strong requirements for transparency to support an environment that limits the potential for corruption.

However, the actual implementation of this key directive remains problematic. First, regional coverage is partial, as Equatorial Guinea, a top oil producer in the region, has not transposed this central directive. In addition, some crucial principles of this directive are not actually implemented in countries that have adopted it. Fiscal reporting on natural resources management is a case in point. While the

Figure 5.1. CEMAC: Status of Transposition of Directives on Public Financial Management (December 2020)



Source: CEMAC Commission and (IMF) Fiscal Affairs Department.

Note: Degree of transposition of the six PFM Directives into national legislation is reflected.

“Not implemented indicates” that no initiative was taken so far by the authority to provide the CEMAC Commission with a draft national law to transpose a given CEMAC Directive. In progress means that a draft law was prepared by the national authorities and sent to the CEMAC Commission, but the comments of the latter have not been incorporated as yet in a revised national law. Enacted indicate that the national law to transpose a given CEMAC directives has been approved. This last step, in itself, does not guarantee effective implementation of a Directives unless the concerned public administrations adapt their procedural approach, internal IT systems, and mode of cooperation with other public entities in accordance with the spirit of the CEMAC Directive.

directive requires the publication of financial operations concluded by the public sector, contracts with the oil sector are not made available to the public in a full and transparent manner. Public procurement is another example. The directive stresses that regulations on public procurement must comply with international standards. Based on these standards, open competition should be used as the preferred or default method of procurement and a complaints review mechanism should be in place. This is not systematically observed in practice and creates vulnerabilities to corruption in public investment management.

The limited implementation of the CEMAC directive on the budget law also increases the risks of exposure to corruption in several PFM areas. First, transactions to and from SOEs, including SOEs that are part of profit-sharing agreements in the extractive sector, are not systematically covered by central governments' fiscal reporting. This weakens the scope of internal and external controls in this key area. It also adds to the difficulty of tracking the flow of foreign exchange back to the CEMAC which relates to the activity of SOEs, a monitoring capacity that is a key pillar for supporting external stability. Second, tax exemptions and tax expenditures are rarely detailed and assessed in the budget documentation, or they are maintained for several years but without a clear legal basis or economic justification. This may create governance problems and even provide an opportunity for favoritism. Third, the consolidation and the full operationalization of the treasury single account (TSA) still need to be completed. The TSA is not used extensively by most governments, in particular with regard to the domiciliation of the state's share in the extractive industry, as well as for some external financing. In such cases, holdings related to the central government are even kept in foreign accounts. While the directive prohibits the deposit of public funds in commercial banks, maintaining fragmented banking arrangements outside of the TSA reduces the ministry of finance's or treasury department's oversight of all government cash flows and weakens budget control and monitoring. This practice directly creates the potential for weak governance.

Finally, the implementation of the CEMAC Directive on Public Accounting also needs to be completed to strengthen expenditure controls and reduce fiscal risks. Challenges in this area are of two types. First, in practice, expenditure controls are neither effective nor streamlined in most CEMAC countries, and exceptions to the regular expenditure procedures defined by the directive have multiplied. This creates incentives for expenses that are executed outside the normal spending chain, delinking budget execution from the resource envelope available and approved in the budget law. In turn, this contributes to the emergence of a large stock of arrears that plague the region, in particular when the resource envelope is reduced by a decline in world commodity prices. Second, *ex post*, it also severely weakens the legislative input to budget orientation and fiscal policy. Assessments of governance in the management of public funds based on an analysis of the status of implementation of CEMAC directives closely match assessments based on the Public Expenditure and Financial Accountability framework

(PEFA) and highlight several governance problems. Work is conducted occasionally, including by the IMF, to assess public financial management performance, as part of the PEFA framework.¹ It identifies 94 characteristics (dimensions) across 31 key components of public financial management (indicators) in 7 broad areas of activity (pillars). Based on a selection of specific indicators more closely related to measures of governance in the management of public resources, the CEMAC countries for which the information is available (Cameroon, Central African Republic, Gabon, Republic of Congo) are in most cases below the average for sub-Saharan countries, and these two groups—the four CEMAC countries for which information is available, and all of sub-Saharan Africa—are below the average for the rest of the world. Such assessment is consistent whether one looks at the more recent or the pre-2013 PEFA indicators.

The Way Forward

The CEMAC Commission is working on several fronts to address weaknesses in PFM. First, its core mandate to oversee the full and effective implementation of CEMAC directives translates into ongoing interaction with member countries to facilitate full transposition into national legislation and assess how work practices comply with the directives. A specific area is the gradual implementation of budget according to program classification (for example, Gabon and Cameroon, and, partially, Republic of Congo and Chad), an approach that benefits from guidance from the CEMAC Commission. Second, the CEMAC regional surveillance framework provides a basis for relating outcomes in budget execution to the degree of implementation of CEMAC directives.

However, strengthening PFM remains imperative in order to enhance governance and reduce the potential for corruption in the CEMAC. Progress in this area requires steps on different fronts:

- *Strengthen the capacity of the CEMAC Commission to monitor and ensure the proper implementation of the CEMAC directives.* The CEMAC Commission faces a daunting task, with very limited resources, in covering a wide array of issues ranging from internal market regulation, to international treaties, to harmonized budget preparation and execution. It is critical to assign dedicated resources to a CEMAC Commission unit tasked with assessing PFM progress on a regular basis. Ideally, such a unit would issue periodic reports on the status of implementation, describing gaps and actions in countries. Strong collaboration with donors will be key to achieving this. Such an approach has been implemented successfully in the WAEMU. In principle, it is advisable that the entity in charge of overseeing the treaty establishing an economic union (“commission” in the case of the European Union, CEMAC, and the WAEMU) be provided with clear jurisdiction to

¹ For background information on the survey methodology, concepts, and definitions please refer to the PEFA website, at <https://pefa.org/>.

determine whether national law is compliant with community directives. Moreover, ideally this verification process would be formalized through an annual peer-review process.

- *Ensure the transmission of petroleum contracts to a centralized unit within the CEMAC Commission.* Such contracts are often kept confidential to regional institutions. The specific tax agreements embedded in these contracts are known to be often in derogation of the CEMAC framework, thereby reducing the tax base. Moreover, the exact terms of the benefit to the state from participating in profit-sharing agreements (via SoEs) or concessions are not known, as they originate in complex formulas described in confidential contracts dependent on oil volume, prices, and the investment cycle. As a welcome step to strengthen governance in this area, the CEMAC Commission will ask national authorities to share such contracts and use this information to enhance understanding of the revenue accruing from them.²
- *Require CEMAC member countries to finalize their convergence reports.* These reports would describe the convergence path over three years with regard to those convergence criteria not met. In this respect, they are a potentially useful instrument for relating full implementation of CEMAC directives (for example, in the area of tax regime) to the expected flow of resources, thereby enhancing accountability and scrutiny on the adoption of sustainable fiscal policy. To date, these reports have not been completed.
- *Coordinate with BEAC to develop and operationalize treasury single accounts (TSAs) in CEMAC member countries.* Both BEAC and national treasuries need to interact and to develop shared practices and procedures to maintain the TSA in an operational manner. Developing TSAs requires adapting institutional arrangements between BEAC and treasuries to clearly define responsibilities, policies (including on the rates of interest paid on the TSA balance), and requirements for information exchange. Upgrades of IT systems and procedures used by the BEAC are also a prerequisite to ensure active and timely cash management.
- *Enhance transparency, an essential step.* There is a lack of transparency in terms of disclosure of contracts in the extractive sectors and proper recording in budget documents of transactions at the subnational level and with regard to state-owned enterprises. Budget documents are often incomplete, for instance with regard to providing information on tax exemptions, their economic rationale, and their estimated costs. Enhancing transparency could initially start with a regular report, disseminated to the public, on the various budget documents and background reports that are expected, according to CEMAC regulations, to be made available to the public.

² In general, better institutional arrangements for SOEs would also benefit the oil sector, where large SOEs operate, including better reporting and controls and better corporate governance.

THE CEMAC FRAMEWORK FOR ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM

Background

The regime for AML/CFT can be a powerful tool for supporting efforts to deter, prevent, detect, investigate, and prosecute acts of corruption. The Financial Action Task Force (FATF), the international standard-setter for AML/CFT, calls for the mobilization of the framework for AML to help detect and trace the laundering of proceeds of corruption and assist in the investigation and prosecution of bribery.³ Specific elements of the framework for AML/CFT are particularly relevant: implementation of enhanced due diligence requirements for (high-risk) domestic politically exposed persons, including the identification of PEPs who are the beneficial owners of legal entities, and reporting to the authorities by financial institutions of transactions when such institutions suspect or have reason to suspect that the subject funds are the proceeds of criminal activity, including corruption.

The regionalization of the framework for AML/CFT within the CEMAC is a welcome effort to create economies of scale and ensure a level playing field within the community. A regulation regarding AML/CFT was adopted in 2003, subsequently revised in 2010, and replaced in 2016. The current CEMAC regulation is of direct and immediate application to all the member countries. Other steps have also been taken at the regional institutional level with the establishment of the Task Force on Money Laundering in Central Africa (*Groupe d'Action contre le Blanchiment d'Argent en Afrique Centrale*)—a specialized organ of the CEMAC whose purpose is to assist its members in the fight against money laundering and terrorist financing (ML/TF). The GABAC was recognized as a FATF-style regional body in 2015—and a supervisory function for AML/CFT was created within the Central African Banking Commission (COBAC). Notwithstanding the regionalization effort, some important functions—such as law enforcement and the receipt, analysis, and dissemination of financial intelligence—remain at the national level.

While the regional framework for AML/CFT was strengthened with the adoption of the 2016 CEMAC regulation, there is significant scope to improve compliance with the FATF standards and increase effectiveness. Assessment of the CEMAC member countries' compliance with the 2003 FATF recommendations found strategic weaknesses in the 2003 and 2010 CEMAC regulations, with most assessment criteria being evaluated as noncompliant or partially compliant in the related areas.

Overall, CEMAC countries were found to be noncompliant or partially compliant with most of the FATF recommendations (that is, the FATF or “international” standard). The assessment reports highlighted the finding that neither the

³ See FATF (2013).

legal nor the regulatory frameworks were aligned with the international standard. For instance, it found strategic deficiencies with respect to financial institutions' preventive-measures obligations that are relevant to the fight against corruption, namely, provisions related to the identification of customers who are PEPs, the reporting of suspicious transactions, and the transparency of beneficial ownership of legal persons. The assessments also noted that while frameworks for sanctions had been formally established in case of breach of the obligations related to AML/CFT, implementation of those sanctions was difficult to assess. The 2012 FATF standard introduced new requirements, including with respect to anticorruption measures and an emphasis on the effectiveness of regime for the AML/CFT in mitigating identified ML/TF risks. The first round of assessments (that is, "mutual evaluations") of CEMAC countries against the current standard is ongoing and is scheduled to be completed by 2023. These assessments will highlight pending shortcomings of the 2016 CEMAC regulation and deficiencies in the implementation and effectiveness of both the national and regional frameworks.

Banking supervision, a key component of the regime for AML/CFT, is a COBAC responsibility. While the onus of meeting the international standard for AML/CFT technically remains with national authorities, individual CEMAC countries depend, in certain respects, on the actions and efforts of regional bodies. In particular, the COBAC is responsible for ensuring the strength of the regulatory framework and the proper implementation of preventive measures by credit institutions. The COBAC has carried out off-site and on-site examinations of credit institutions and has issued formal warnings and imposed administrative sanctions on institutions and their directors when important breaches have been uncovered. The COBAC is in the process of strengthening its implementation of the risk-based approach to the supervision of activities related to AML/CFT and is increasing its capacity to carry out these activities.

Ensuring that the regime for AML/CFT is effectively implemented through effective risk-based supervision by the COBAC will help support anticorruption efforts across the CEMAC. The COBAC supervisory role is critical in ensuring that credit institutions appropriately implement their obligations relative to AML/CFT in order to prevent and detect the laundering of the proceeds of corruption. This would also support national efforts regarding AML and anti-corruption, notably by ensuring that (national) financial intelligence units receive all appropriate suspicious transaction reports from credit institutions, and that these are fully and correctly completed. Suspicious transaction reports may trigger investigations of acts of corruption and the laundering of their proceeds.

Another key international standard to guide reforms to reduce corruption (hence contributing to AML) is the United Nations Convention against Corruption (or "the Convention"). According to the United Nations, "The . . . Convention is the only legally binding universal anti-corruption instrument. The Convention's far-reaching approach and the mandatory character of many of its provisions make it a unique tool for developing a comprehensive response to a global problem. The Convention covers five principal areas: preventive measures, criminalization and law enforcement, international cooperation, asset

recovery, and technical assistance and information exchange. The Convention covers many different forms of corruption, such as bribery, trading in influence, abuse of functions, and various acts of corruption in the private sector.”⁴ It has 187 states parties, including all of the CEMAC member countries. The states parties submit to a voluntary peer-review process. The first cycle of the review process has been completed for nearly the entire membership. It is not completed for three CEMAC member countries (Chad, Equatorial Guinea, Republic of Congo).

The Way Forward

To support efforts to address money laundering and financing of terrorism in the CEMAC, the following measures should be taken:

- *Continue to strengthen the regional framework for AML/CFT, in particular those measures relevant to the fight against corruption.* The adoption of the 2016 CEMAC regulation was a positive step in bringing the regional framework into closer alignment with the 2012 FATF standards. The CEMAC should address the pending shortcomings to be identified in the current round of assessments related to AML/CFT (that is, “mutual evaluations”) by the GABAC. The COBAC should also swiftly revise its 2005 regulation to implement the 2016 CEMAC regulation.
- *Fully implement the risk-based approach to supervision, which will help focus the limited resources of the COBAC in the areas presenting the greatest risks.* As called for in the FATF standard, jurisdictions should deepen their understanding of the risks and vulnerabilities related to ML/TF and allocate more resources to high-risk areas. Hence, the COBAC should enhance its understanding of the risks faced by the financial sector, develop comprehensive risk profiles of supervised credit institutions to inform inspections, and adapt the overall supervisory strategy accordingly. This should take into account the particular risks related to the laundering of the proceeds of corruption.
- *Strengthen COBAC’s efforts to ensure that high-relevance preventive measures related to AML/CFT for the prevention and detection of the laundering of the proceeds of corruption, are properly implemented by credit institutions.* The 2016 CEMAC regulation establishes requirements for preventive measures related to the identification of customers and specific guidelines related to politically exposed persons and beneficial ownership structures. However, implementation by the private sector is a challenge and national financial intelligence units continue to receive a low number of suspicious transaction reports. To address these shortcomings, the COBAC and domestic financial intelligence units should, among others steps, issue comprehensive guidance to the private sector, conduct training, and carry out more targeted

⁴ See “United Nations Convention against Corruption,” United Nations Office on Drugs and Crime, <https://www.unodc.org/unodc/en/treaties/CAC/>.

supervision efforts (for example, thematic versus full-scope, on-site inspections to address AML/CFT).

- *Ensure that proportionate and dissuasive sanctions are imposed on credit institutions in case of breaches of obligations related to AML/CFT and reinforce its cooperation with national authorities to ensure the effectiveness of the regionalized regime for AML/CFT.* As per the 2016 CEMAC regulation, the COBAC should communicate any administrative or disciplinary sanction imposed on a credit institution to the relevant national financial intelligence unit and prosecutor. Establishing effective channels of communication and mechanisms for exchanging information between the regional and national levels will be key to strengthening the understanding of risks and to following up on institutions whose implementation of measures for AML/CFT has been found to be deficient.

The CEMAC should also encourage its members to comply with the standard UNCAC peer-review process as part of a broader accountability infrastructure. This peer-review process includes the identification of gaps in the national legislative system to implement the standards. Some of these gaps are directly relevant to CEMAC on matters related to AML/CFT, and to procurement.

THE CEMAC FRAMEWORK FOR GOVERNANCE IN THE EXTRACTIVE SECTORS

Background

Oil extraction and export play a major role in the economy of most CEMAC countries. Oil accounts for about 20 percent of GDP and covers roughly 75 percent of the region's exports of goods. Tax and nontax revenues related to oil contribute to more than 40 percent of total revenues. Given the size of this sector and its importance in commanding public resources, good management in the oil sector is key to ensuring good governance in the rest of the economy.

The oil sector is very complex by nature and often stretches the capacity of public administrations to their limits (Box 5.1). The industry is organized basically around two typical arrangements. In a production-sharing agreement (PSA) the state (normally through a state-owned enterprise), and a foreign private company (usually through a resident subsidiary), set up a partnership for the extraction and export of oil, and agree on a profit-sharing scheme. In such a scheme, a certain amount of oil (cost-oil) is used to pay the costs incurred in the exploration and extraction. The next part (profit-oil) is shared between the two parties according to an agreed formula. This agreement takes into consideration the investment cycle and depreciation of the fixed investment as a cost factor. By contrast, in a concession scheme, the operator typically pays a royalty and an income tax for the right to extract and export oil. Sometimes a concession scheme includes sector-specific taxes, such as a resource rent or additional profit taxes. The fiscal terms of concession systems are typically specified in legislation, rather than negotiated on a project-by-project basis.

Box 5.1. Production-Sharing Agreements versus Concession Systems

The main types of fiscal regime for the petroleum upstream sector are (1) contractual production-sharing arrangements and (2) concessional tax-royalty regimes. Some countries combine a production-sharing regime with tax-royalty instruments, making this a hybrid fiscal regime. Moreover, both regimes can also include some form of state equity participation.

The production-sharing fiscal regime is common for petroleum. Under this fiscal regime, the government or a government appointee (such as the national oil company) enters into a contract with one or more companies. The contractor explores for and extracts petroleum discoveries within a production license area in return for a share of the petroleum extracted from the development. Under this fiscal regime, the company only takes ownership of part of the petroleum resources. Another contractual type of fiscal regime is a risk service contract, through which a company is contracted to develop and produce petroleum in return for an agreed remuneration.

The tax-royalty regime combines a royalty that provides early revenue from the start of production with one or more profit-based taxes that capture economic rents. Under this regime, the government issues a license or concession to the investor to explore for and extract natural resources within a specific license area. The licensee takes ownership of any resources that are extracted, with the government collecting revenue based on the assessment of royalty and taxes.

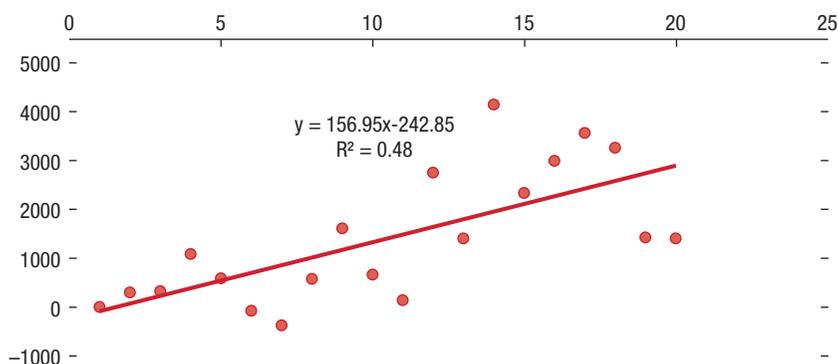
Direct state participation is very common. At one end of the spectrum are countries that have a national oil company, which may enter into joint-venture arrangements with private sector companies. Other forms of state participation include the government having an equity position in a petroleum project with different options available for the government to finance its participation, ranging from free equity, to carried interest, to fully paid equity.

While the various fiscal regime types look different, their economic and fiscal impacts can be very similar. This leads to a general insight about fiscal equivalency. Simply put, the fiscal parameters under either a tax-royalty or a production-sharing fiscal regime can be chosen to provide the same government tax or revenue profile over time.

When countries enter into contractually agreed-upon fiscal terms, it is good practice to set these terms out initially in model contracts (for example, for a production agreement). The model PSA contract should specify which fiscal terms are biddable or subject to negotiation; best practice is to keep the number of fiscal parameters that can vary to a minimum. The general legislative framework for the petroleum sector can either be incorporated into income tax legislation or into stand-alone legislation for more specialized taxes for extractives (that is, via a petroleum code or a mining code). The latter is the model mostly used in the CEMAC.

In both cases—but particularly in the PSA—the quantification of the actual share of the oil accruing to the state requires complex calculations, which depend on the exact amount of oil produced and exported, its selling price, and the imputation of various cost factors. It must be noted that an important share of oil production is sold on futures markets. As a result of the ever-growing complexity of this sector, in practice it takes time and steadfast investments for the state to

Figure 5.2. CEMAC: Oil Export and Capital Outflow (1997–2017; data in billions of CFAF)



Source: IMF staff data and calculations, based on countries' balance-of-payments statistics.

Note: The concept of capital flow is defined as the sum of recorded short-term capital outflows and errors and omissions.

build full capacity to manage and control such contracts and properly calculate (or audit) its share.

An analysis of available data and studies suggests that oil export data in official statistics are sometime prone to miscalculation (see Figure 5.2):

- First, an analysis of CEMAC balance-of-payments data suggests a strong correlation between recorded oil exports and recorded capital outflows. In other words, the higher the total value of recorded oil exports, the higher the estimated capital outflows. This is probably an indication that part of the counterpart to oil exports is not repatriated into the exporting country and is recorded as capital outflow.
- Second, other studies suggest that the oil export sector is plagued by the phenomenon of underinvoicing. This phenomenon relates to the fact that oil exports as recorded by the exporting countries in several cases are lower than the partner data as recorded by the importing countries, as seen in some cases for the total of exports.⁵

⁵ Data from the COMTRADE database, based on Republic of Congo and Cameroon, suggests that the statistical discrepancy between the recorded value of export and mirror data on imports from the trading partners accounts can be very large (up to 60 percent in this example). The larger contributor is lower export volume data compared with partner data (discrepancy at about 43 percent) and to a smaller extent lower (implied) unit prices. If these data are indicative of a wider problem, they would suggest that what is called misinvoicing is in fact underreporting of actual export volumes. Since COMTRADE data are initially collected by customs, this would indicate that issues related to capacity and governance in this complex sector rest primarily with ineffective management at the customs level.

- Third, there is also evidence of very large deposits by CEMAC residents in foreign countries, which are likely not in total compliance with the CEMAC foreign exchange regulation. That regulation requires that holdings by CEMAC residents in foreign banks are kept only for limited amounts and for justifiable reasons, such as to finance anticipated imports or to cover short-term debt service. Data from the BIS suggest that the stock of CEMAC residents' holdings with foreign banks (about \$5 billion as of the end of 2017) are above such notional allowed amount. If this conclusion holds, and given the importance of oil as a primary source of foreign exchange earnings (and based on evidence drawn from the balance-of-payments data), it is possible that part of such holdings is related to proceeds from unrecorded oil exports.
- Fourth, there has been some concern that the increase in oil prices through 2018 did not translate into higher oil tax revenue (and NFA accumulation). In fact, at their extraordinary meeting in November 2018, CEMAC's heads of state called for stepping up efforts to repatriate export proceeds, in particular by the state-owned enterprises part of PSA, to help strengthen this link.

The complexity of this sector and the vital importance that its governance plays in the CEMAC economic and monetary union calls for strong capacity to assess and monitor the link between oil prices and volumes and oil revenues. It is possible to use spreadsheet modeling techniques to forecast the tax revenue and foreign exchange implications of alternative economic scenarios. Such models require information on the fiscal terms contained in a PSA, as well as projections of the costs of production and the quantity of production from the time of inception of a given petroleum project. This type of analysis is feasible for a limited number of oil fields, where such detailed data may be available. The outcome of a project-by-project analysis of the major petroleum projects in a country cannot be readily extrapolated to the national petroleum sector as a whole, but such an analysis may give useful indications of the order of magnitude of the effects of various economic shocks and could help to identify potential problems in revenue collection and amounts of foreign exchange.

The oil-exporting countries can refer to the Extractive Industries Transparency Initiative, an international standard widely used to enhance and report on governance in this area.⁶ The EITI sets ambitious standards for strong governance and full accountability in extractive industries. There is no formal relationship between the CEMAC Commission (or other regional institutions) and the EITI as membership is held by countries only. However, there is a strong synergy between the (voluntary) EITI requirements and the CEMAC guidelines for PFM (which set specific requirements for CEMAC countries).

In fact, four of the CEMAC countries have a form of engagement with the EITI. Full membership is effective for Cameroon, Chad, and Republic of Congo. Central African Republic was a member but was suspended. Equatorial Guinea

⁶ For more on EITI, see <https://eiti.org>.

and Gabon have committed to submit their EITI applications as part of their engagement under IMF and IMF staff-monitored programs, respectively. Among the corrective actions asked of Cameroon and Republic of Congo as part of the regular validation process to address serious deficiencies are those related to contract transparency, license registration, state participation, and (transparency and reporting on) SOEs transactions.

However, possible membership in the EITI needs to be part of a wider effort to enhance governance in the oil sector. By design, the EITI does not guarantee that the commercial part of a given oil project (the initial physical transaction) is covered in a timely manner. It deals mainly (and above all) with the use of recognized resources. In fact, there have been instances of inefficient governance and of corruption related to the oil trade, even in countries formally part of the EITI (for example, Republic of Congo). Opaque practices can even result from barter transactions (private companies working for oil) or commercial financing (leading to the prior commitment of oil exporters to repay their debt through credits provided by large foreign financial institutions). This complicates the challenge of reconciliation, as part of some transactions may be in the form of barter.

As a result, CEMAC member states must be proactive in ensuring good governance in such a complex sector; the CEMAC legislation provides solid ground on which to build progress (Box 5.1):

- The first task is to ensure that customs are and remain at the center of the declaration of export transactions and that this information is shared with the tax institutions (at the national level) and those charged with the governance of the monetary union (BEAC). The framework of the CEMAC in the field of customs legislation is clear: nothing can leave the region without prior declaration to customs and without their authorization. In other words, the customs authorities of CEMAC member states authorize the transit into and exit out of the community of goods and authorize these operations only after compulsory import and export formalities have been met. There is no exception, based on the law, to the fact that all resident economic agents exporting goods are subject to the obligations mentioned above. To oppose the exercise of customs functions is an offense (Article 62 of the Customs Code or “CC”). Article 2 of the CC provides that customs laws and regulations must be applied without regard to the quality of the persons; goods imported or exported by the state are not subject to any immunity or derogations. As a result, there is no suspension of customs obligations in any way when the economic entity exporting consists of a partnership between a private entity (for example, an oil company, through its resident arm) and a SOE.
- The customs legislation also establishes the specific obligation to provide any additional information that the customs authorities may need to verify the plausibility of the customs declaration.
- The customs law and the foreign exchange law also oblige CEMAC residents (including oil companies) always to include the invoice in the customs

declaration (as part of this declaration) and to provide information on the expected timing and domiciliation of the oil exports. This is also necessary to comply with specific obligations related to the foreign exchange law.

In fact, CEMAC customs have a weak capacity to cope with this complex sector and have often not proactively applied these regulations (Box 5.1). As a result, customs declarations may be incorrect or incomplete in many cases. The strict monitoring capacity of oil transactions is limited. It is often assumed that, given the presence of the state in several benefit-sharing agreements, customs should not impose an additional burden.

The Way Forward

The CEMAC Commission should work to ensure full implementation of the regional legal framework in this area, including through enhancing its own capacity. Given the lack of concrete implementation in many areas, member states should submit an annual report to the CEMAC Commission on the status of the implementation of the guidelines to support the sound functioning of the customs union.

Control of oil and gas exports should be elevated as a core customs mission (even though customs revenue is not directly collected), and this should be reflected in specific performance indicators and incentives

Membership in the EITI can help enhance reporting requirements and the provision of data that should be published to fully implement the CEMAC directives (in particular on governance). It is important to note that CEMAC guidelines and EITI standards both require full disclosure of and transparency regarding contracts and activity related to the extractive sector and its share in the state.

Fully implementing the foreign-exchange law will also be important. The issue of repatriation highlights an important difficulty that regional authorities need to consider in greater detail: the rule of law when individual members do not respect the regional legal framework. In particular, improvements could cover the banks' responsibilities in this area and the nature of (mostly ex-post) customs verifications and sanctions for noncompliance. This would need to cover oil traders, and perhaps extend to banks involved in settling the transactions.

Strengthening capacity for real time monitoring of the link between oil exports and evolution of net foreign assets will be helpful. Given the complexity of extractive sectors, but also the importance of good governance to ensure its contribution to the budget, specific capacity to monitor this sector should be built. In particular, it will be important to establish capacity at the regional level (ideally via the BEAC) to assess the link between oil prices and volumes and expected tax revenues. This will be essential in determining whether the tax revenues that enter (and therefore the gross NFA inflows) are justified by the level of prices and output or if other policies are needed to strengthen external stability (including monetary policy at the CEMAC level or fiscal policies at the country level). Discussions with regional institutions suggested that one step in this direction would be revisiting the adequacy of the documentation model to be provided

by petroleum companies to customs and the reporting system envisaged with the BEAC.

It will also be vital to establish in the customs administrations of the largest oil exporters a dedicated function or unit endowed with specialty knowledge of the oil sector (at the national level). Such a unit would have intelligence and risk-analysis capabilities and would play a central role in directing, supporting, and monitoring overall customs control activities from field operations (for example, fiscal measurement) to post-clearance audits. In particular, it would define the exact information it would ask oil exporters to fill out or provide upon request in order to monitor and respond to emerging governance risks (for instance, when otherwise available information on oil prices and production does not match that of the customs declaration). In other words, the dedicated unit would need to establish a cartography of the risks of mis- or nonreporting, so as to direct controls to these risks. The dedicated unit would benefit from including representatives of the state-owned oil companies, as SOEs may be in an ideal position to obtain critical data for the analysis of oil and gas contracts.

Finally, tracking and reporting the status of implementation of CEMAC directives will also be critical. The CEMAC Commission should also strengthen the implementation of the transparency provision included in the CEMAC directive on transparency and governance (06/2013). In particular, it needs to urge member countries to provide a complete reconciliation of oil production and export data with the oil tax revenues included in the budget documents. Doing this would lay the groundwork for participation in the EITI membership, which should be encouraged.

CONCLUSION

The analysis included in this chapter shows potential areas for enhancing governance in the CEMAC and provides a key engine for sustained and inclusive growth. There are two common themes to the set of possible reforms included here. First, there needs to be a “transparency shock” in the regular production and sharing of basic documentation related to public resource management. This step is an absolute priority, well inscribed in CEMAC’s own institutional setup, in particular the key directive on transparency and governance. Second, and relatedly, there needs to be a continuous focus to turn the CEMAC regional framework, which is overall well designed, into consistent procedures and work practices within public institutions.

As this chapter suggests, there are several specific lines of action through which to achieve these objectives. First, there should be an ongoing effort to implement the CEMAC PFM directives. This requires ensuring more transparency, full disclosure, ongoing reconciliation, and internal and external audit of transactions of the public sector. Second, efforts to enhance the AML/CFT, reflecting the CEMAC’s directive in this area, should deepen. Finally, the full system of checks and balances envisaged by CEMAC legislation for extractive industries needs to

be enforced. This includes the full disclosure and regular reconciliation of contracts and transactions in the oil sector, as well as the rigorous implementation of a stronger network of CEMAC customs, with better governance and more capacity (in particular, in complex sectors such as oil).

The CEMAC regional institutions should play a central role to lead progress in these areas, and support member countries' own efforts in the establishment of a coherent framework that generates synergies between the country and regional levels. The success of the regional strategy that CEMAC member countries and regional institutions are implementing to exit the severe crisis they are facing depends critically on creating the conditions for a diversified economy within a well-functioning regional market and an environment that provides opportunities for all, one in which public resources are geared to the most productive uses. The single most important element in this effort is good governance of public resources and reducing the perception of widespread corruption. The CEMAC regional institutions can play an important role in achieving this objective, in support of member countries' own efforts.

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Macro-Fiscal Gains from Anticorruption Reforms in the Republic of Congo

Giovanni Melina, Hoda Selim, and Concepcion Verdugo-Yepes

ABSTRACT

Notwithstanding the anticorruption efforts the authorities have made since 2017, this chapter argues that oil revenue management and public investment in Congo remain vulnerable to corruption as a result of insufficient transparency and accountability. Corruption in these sectors is potentially a significant factor of weak macro-fiscal outcomes. Nevertheless, macro-fiscal gains from anticorruption reforms are significant. Depending on how ambitious reforms are, the potential additional growth can range between 0.8 and 1.8 percentage points per year in the long term over the next 10 years. Furthermore, debt can decline by 2.25 to 3 percentage points of GDP per year over the same period. Oil sector governance reforms could target improving transparency in oil trading and strengthening oversight and accountability of Congo's national oil company. These reforms would be supported by measures to enhance the framework for anti-money laundering. Measures to reform public investment management and efficiency would include increasing transparency of public investment execution, strengthening external controls, and restructuring the internal audit system.

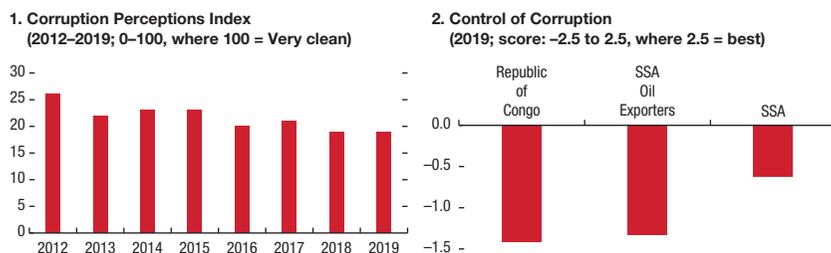
INTRODUCTION

As of 2019 the Republic of Congo was the third-largest oil producer in sub-Saharan Africa. Annual oil production is estimated to have averaged 87 million barrels between 1990 and 2019. Between 2005 and 2019, oil revenues accounted for about 25 percent of GDP. Between 1991 and 2018, oil generated close to \$3 billion in annual rents, or close to \$750 in rents per capita every year.¹

However, oil rents in Congo remain subject to significant volatility, partly from fluctuations in global commodity prices. Indeed, oil fiscal receipts collapsed from

¹ Rent is defined as the difference between the value of crude oil production at world prices and the total costs of production.

Figure 6.1. Corruption Perception Indicators and Macro-Fiscal Outcomes in Congo



Sources: Transparency International; and Worldwide Governance Indicators.

Note: Third-party indicators reported in the figures may be subject to uncertainty. The Corruption Perceptions Index is scored from 0 to 100, where 100 is very clean. SSA, sub-Saharan Africa.

an average of 50 percent of the value of oil production between 2005 and 2014 to less than 30 percent between 2015 and 2019. The ratio of oil revenues to exports also deteriorated from about 50 percent to 25 percent over the same period, well below the average for oil exporters in sub-Saharan Africa, which stands at about 45 percent. This steep decline in oil revenues also partly reflects the impact of the change in the legal framework governing oil-production sharing in 2015.

Notwithstanding commodity price volatility, the large oil windfalls allowed the country to finance a public investment program that brought public capital spending from an already high average of 35 percent of GDP in the 1990s to above 50 percent in 2012–14, far above the ratio in other LIDCs and sub-Saharan Africa. Yet the ratio of the stock of public capital to GDP has not kept pace with the rapid scaling up of investment (Melina, Selim, and Verdugo-Yepes 2019).

The potential of these oil-financed public investments to contribute to poverty reduction and growth was significant but did not fully materialize. In fact, oil revenue management and public investment spending occurred in a context where corruption—as measured by a range of internationally recognized indicators—is perceived to be prevalent relative to other sub-Saharan African countries (Figures 6.1.1 and 6.1.2). Moreover, the large investment spending was not the most efficient (Republic of Congo 2018): as a result, socioeconomic performance was dismal, with low and volatile GDP per capita growth, fast-rising debt, deep-rooted poverty, and persistent inequality (Melina, Selim, and Verdugo-Yepes 2019).

In this context, this chapter has two objectives: first, it explores the transmission channels between corruption vulnerabilities and macro-fiscal outcomes in Congo. The chapter focuses on oil revenue management and public investment because both involve the management of large public funds and frequent interactions between public and private actors.² With limited transparency and

² For a review of the literature on corruption, oil wealth, and public investment, please see Melina, Selim, and Verdugo-Yepes (2019).

Box 6.1. Report on Governance and Corruption: Summary of Main Findings

There are significant challenges in implementing and enforcing the rule of law: Congo's governance system suffers from an implementation deficit, due to a failure to enact implementing regulations, weak institutions, or simple inaction. There is also a significant shortfall in transparency and public data-reporting. Up until 2018 Congo was one of the few countries where the central government did not have an official website. Finally, the enforcement of claims remains a significant challenge, with public trust in the legal system, notably the courts, being particularly weak.

There is ample scope to strengthen governance in PFM and address corruption vulnerabilities: On the revenue side, in relation to natural resources (especially oil), governance challenges result in a significant leakage of revenues before they reach the national budget. Weaknesses in procurement—for example, lack of due diligence in contracting and sanctioning systems, as well as frequent opportunities for circumventing formal processes—result in significant losses. Excessive spending has been a major factor in the significant increase in the debt stock (from 20 percent of GDP in 2010 to 118 percent in 2017). Internal control systems are weak. Both the internal and external audit agencies are insufficiently empowered to perform their functions effectively. Other structural weaknesses include poor control of the public sector wage bill.

Governance challenges also affect market regulation and the business climate: The government recognizes the diverse challenges, including the hurdles and costs to start a business, the weakness of public registers of land and companies, the many-layered tax services, and the potential for abuse of these services.

The weak anti-money laundering framework only inadequately addresses governance vulnerabilities: As a signatory to the United Nations Convention against Corruption (UNCAC), the Republic of Congo has enacted laws intended to address AML weaknesses, but these have significant limitations. Also, agencies created to detect and investigate the laundering of the proceeds of corruption have not been properly staffed or trained, lack coordination, and do not have the necessary powers to carry out their legal mandates.

The anticorruption efforts need significant strengthening to address these governance vulnerabilities: The current weaknesses lie principally in gaps in the statutory framework and in the ineffectiveness of the institutions tasked to implement anticorruption laws, both specially tasked institutions (such as the Commission Nationale de Lutte Contre la Corruption, CNLCFF) and the regular enforcement agencies. The anticorruption agencies are not independent and lack legal enforcement powers.

Source: Republic of Congo (2018): report on governance and corruption.

accountability in those sectors, collusive institutional arrangements between public and private actors could enable corrupt practices that undermine macro-fiscal outcomes. Second, the chapter presents the findings from the DIGNAR model simulations to quantify the impact of anticorruption reforms in Congo on macro-fiscal outcomes.

In 2017 the authorities of the Republic of Congo came to recognize the fight against corruption as a development priority. They prepared and published the *Rapport sur la Gouvernance et la Corruption: République du Congo* [Report on Governance and Corruption: Republic of Congo], in which they acknowledged

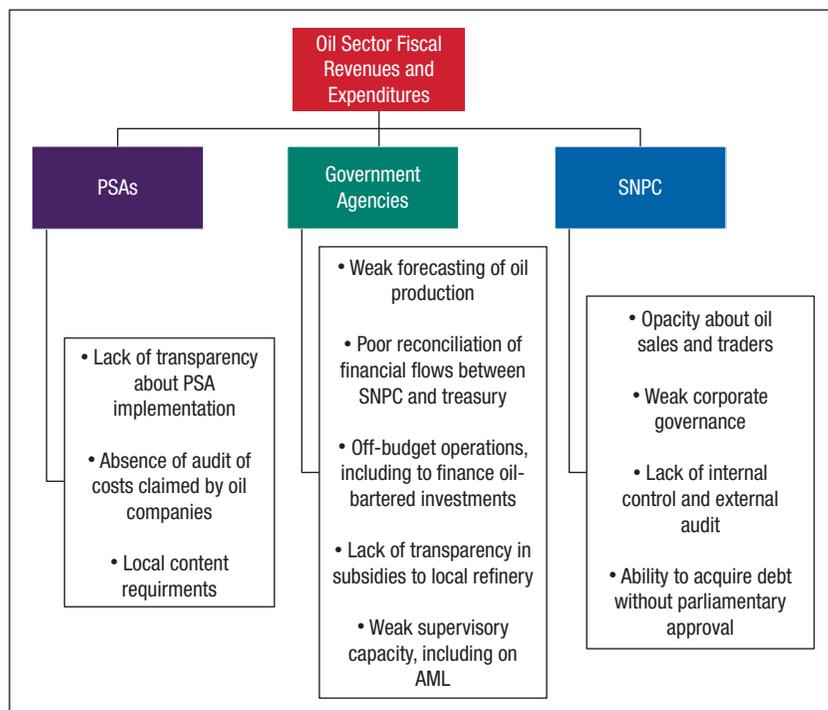
that their efforts to date had not been effective and that they needed a new policy of *breaking with the past* (politique de rupture) (Republic of Congo 2018, p. 4). The report also informed their anticorruption reform agenda, aiming to address vulnerabilities in the rule of law, PFM systems, financial sector oversight, market regulation and the business climate, AML/CFT, and the anticorruption framework (Box 6.1).

The remainder of the chapter is structured as follows: the following two sections explain corruption vulnerabilities in oil revenue management and public investment, respectively. The next section presents the results of simulations of the potential impact of anticorruption reforms on Congo's growth and public debt. The last section concludes and suggests possible reforms to reduce corruption risks.

OIL REVENUE MANAGEMENT

Large oil rents could create incentives to “grand corruption” (which results from the abuse of power by a few high-ranking public officials and leads to the waste of massive amounts of public money that could otherwise benefit the citizens) at

Figure 6.2. Corruption Vulnerabilities in Oil Revenue Management



Source: Authors.

various stages of the oil value chain including exploration, development, and production and trading. If unaddressed, these vulnerabilities could result in the misappropriation of public funds. This section identifies three main sources of corruption risks in oil revenue management in Congo: (1) the production-sharing agreements (PSAs), (2) inadequate budget-reporting and misallocation of oil funds, and (3) the national oil company, the Société Nationale Pétrolière du Congo (SNPC) (Figure 6.2).

Production-Sharing Agreements

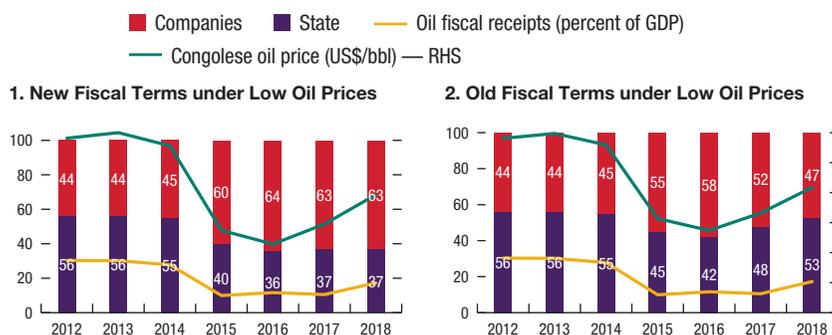
Production-sharing-agreements allow Congo to retain ownership of its oil resources but grant the rights of exploration and production within a specified area, and for a limited period, to a private oil company or consortium (the contractor). The contractor assumes all costs, which are later recovered against a share in oil production. Production-sharing terms between the oil companies and the government determine the oil share that each party would receive from total production and therefore how much revenue would flow to the treasury.

The 2016 Hydrocarbons Code provides a more transparent basis for the awarding of licenses in the petroleum sector, as well as guidance on the main production-sharing fiscal terms—royalties, cost recovery, profit sharing, and taxation. The code also requires the parliament to approve all PSAs and, that they are published in the official gazette.

Yet the opacity of the PSA negotiations between the state and the private companies may create incentives for corruption. The authorities recognize that these complex negotiations may be open to abuse by the companies. The specific terms of PSAs are negotiated on a case-by-case basis between the government and private sector oil companies. Moreover, some contractual terms (such as the amount of the signature bonus) are not disclosed and could thus disguise illegal payments to public officials. Also, exemptions granted to oil companies are not published at the end of each fiscal year and operating costs claimed by them are not audited. If exemptions are too high or these costs are overestimated, then these terms would lower the share of oil accruing to the government.

Furthermore, the authorities offered more generous fiscal terms to oil companies in 2015. The new terms were meant to compensate oil companies for relatively higher costs in a low oil price environment and to attract interest in Congo's maturing oil fields and deepwater fields, which are difficult to access, making exploration and development operations expensive. These revised terms—which affected about half of oil production beginning 2015—increased the ceilings for costs recovered by the companies and lowered the government's share of profits. As a result, they significantly reduced the government's share of oil production from 56 percent in 2012–14 to only 40 percent in 2015 and to about 37 percent in subsequent years, thus depriving the state of substantive fiscal revenue (Figure 6.3.1). Simulations show that if the government had retained the old fiscal terms, the oil price decline would still have reduced the government share from oil production but only to an average of 52 percent of total production (Figure 6.3.2).

Figure 6.3. Fiscal Receipts and Distribution of Oil Production in Congo (2012–17)



Sources: Authorities; and authors' calculations.

Note: Oil production shares were estimated by authors based on PSA terms. The scenario in Figure 6.3.2 reflects a simulation based on oil fiscal terms.

The new terms, which are unfavorable to the state on almost all accounts, principally benefit private sector oil operators in the upstream oil market. Two international oil companies control more than 70 percent of Congo's oil production.

Finally, the introduction of local content requirements under the 2016 Hydrocarbons Code is another potential source of corruption risk. The code requires that national companies (defined as companies based in Congo in which individuals with Congolese nationality hold more than 50 percent of shares) hold a minimum of 10 percent share in new joint ventures. Moreover, oil contractors must employ Congolese personnel and give preference to equipment and services of Congolese origin, if the price of this labor and equipment is no more than 10 percent higher than that of foreign equivalents. In addition, at least 25 percent of the development and operational costs of oil fields must be sourced locally. If these requirements are not met, the companies are not allowed to recover any additional costs incurred. While such requirements can support diversification, they represent a significant risk of rent-seeking if not implemented under a transparent framework. The provisions could be a potential source of corruption if they are used to favor local companies with political connections or to channel and conceal kickback schemes to public officials (Camos and Pradham 2007).

Inadequate Budget-Reporting and Misallocation of Oil Funds

The uncertainty of estimates of oil receipts stemming from commodity price volatility complicates oil revenue management. The forecasting of oil revenues suffers from substantial weaknesses. The General Directorate for Hydrocarbons and the Natural Resources Office of the Cabinet of the Ministry of Finance work closely with the SNPC and selected international oil companies to validate projections of

oil production. However, there is no clear methodology used for oil forecasting, and there are inconsistencies between the estimates of oil production and oil revenues produced by the oil companies at the end of the year and the data collected by the Ministry of Finance. Moreover, reconciling the value of production from oil sales based on PSAs terms with amounts received by the treasury has been problematic.

A reconciliation exercise done with assistance of IMF staff for the period 2014–17 has helped identify substantial amounts of off-budget oil revenue. These amounts relate primarily to oil-backed prefinancing arrangements contracted by the SNPC with oil traders (\$2.3 billion), and special contracts with oil companies that were repaid with the equivalent of at least \$0.5 billion in annual withholdings of government oil. These funds were largely used to finance infrastructure projects, including a power station (EITI 2014). The oil reconciliation exercise also identified additional oil revenue (about \$250 million per year) that bypassed budget processes. These amounts were reportedly used to finance transfers to the oil refinery as well as payments of the government's share in the operating costs of the five oil fields in which it participates.

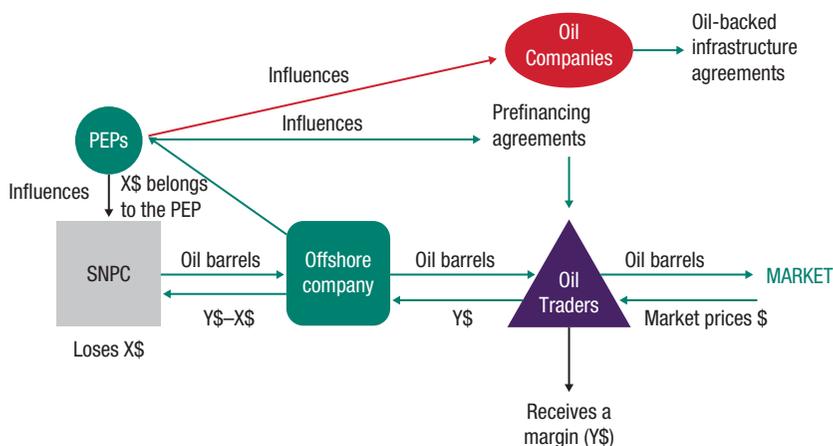
Finally, the lack of enforcement of the repatriation and surrender of foreign exchange provisions associated with the AML framework is a concern. According to CEMAC regulations (Chapter 5), companies must repatriate export proceeds received in foreign currencies and surrender them to the regional central bank within one month of collection. The authorities have indicated that multinational companies tend to evade this requirement.

The Role of the SNPC

Created in 1998, SNPC has been a key player in the oil sector.³ It has the dual mandate of managing its own share of production received through stakes in oil fields from joint ventures with oil companies, and managing the state's oil share on behalf of the government. In its latter capacity, SNPC represents the state's interests in all third-party contractual negotiations, signs PSAs on behalf of the state, and receives the state's in-kind share of oil. Yet the regulations governing the management of the state's oil resources are loosely implemented by the SNPC, a practice that may conceal corruption risks.

SNPC also remits the proceeds of oil sales—net of its fees—to the treasury on a quarterly basis (EITI 2015). Yet accounting for oil revenue flows and related financial transfers between the government and the SNPC remains inadequate. EITI reported being able to reconcile the quarterly oil transfers between oil producers and SNPC based on PSAs—but not the quarterly transfers disclosed by SNPC with those received by the treasury. In part, this may be explained by weak capacity, but in larger part it may be explained by corruption vulnerabilities as a result of weak corporate governance in SNPC.

³ SNPC has five subsidiaries (Société Nationale de Recherche et de Production, Société des Forages Pétroliers, Integrated Logistics Services, Congolaise de Raffinage, NPC-Distribution), covering the entire oil industry value chain.

Figure 6.4. Political Economy of Grand Corruption Vulnerabilities: Oil

Sources: Longchamp and Perrot (2017); and authors.

Figure 6.4 describes the key corruption vulnerabilities surrounding SNPC. Politically exposed persons (PEPs) can influence decisions related to oil-trading transactions conducted by SNPC on behalf of the government, including through prefinancing and oil-backed infrastructure agreements (Longchamp and Perrot 2017).⁴ In the absence of full transparency and sufficient oversight, the proceeds of these transactions may have been channeled abroad to companies with obscure beneficial ownership or that could be related to a PEP or someone in that person's patronage network (Longchamp and Perrot 2017).⁵

These corruption vulnerabilities persist against a backdrop of lack of transparency about SNPC's oil-trading operations. There is a severe lack of published, timely and regular information on (1) regulations for competitive public tenders for the sale of oil; (2) objective criteria for the selection of buyers or prequalification of local suppliers; (3) a list of oil buyers and traders; and (4) the volume of oil sales and their pricing. The opacity of oil-trading transactions also raises concerns about potential mispricing of these transactions, which may allow the buyers to resell oil to traders at an inflated margin. Edgardo and Pradham (2007) report that financial audits uncovered that SNPC was selling the state's share of crude oil production at prices that were 5 to 6 percent below market.

⁴ According to the FATF, a PEP is an individual who is or has been entrusted with a prominent function. Many PEPs hold positions that are open to abuse, including through laundering illicit funds or engaging in other predicate offenses, such as corruption or bribery.

⁵ See the cases of Philia and Vitol in Longchamp and Perrot (2017).

PUBLIC INVESTMENT AND PUBLIC SERVICE DELIVERY⁶

The rapid scaling up of public investment, financed essentially with bilateral debt (mostly from China), has occurred in a poorly managed and nontransparent environment with strong perceptions of corruption and inadequate PFM systems (IMF 2019; Republic of Congo 2018).⁷ This section identifies corruption vulnerabilities in public investment spending in Congo.

Opportunities for corruption could arise at various stages of the investment project cycle, from initiation and planning, to allocation of resources, to implementation and procurement.⁸ In Congo, during the planning phase, corruption risks could have stemmed from two aspects. First, limited available information on the public investment plans suggests that programming and budgeting processes were weak and not well coordinated. Second, there were no clear guidelines (or an underlying regulatory framework for PPPs) to guide the planning and management of projects, and no clear and objective criteria for project selection. As such, projects were not systematically subject to a rigorous technical, economic, and financial appraisal, which may raise concerns about their overall efficiency (Republic of Congo 2018). To the extent that such appraisals were done, they did not undergo independent external review and were not published. Major projects (including those funded by development partners and through PPPs) were not scrutinized by a central ministry or by an independent agency prior to inclusion in the budget.

The lack of transparency during the project allocation phase provides opportunities for influence by PEPs who may financially benefit from the projects. Anecdotal evidence suggests that construction contracts are often allocated to members of the governing coalition, particularly if these contracts involve projects that provide high-value consumption goods to the Congolese elite (Bertelsmann Stiftung 2016). Firm survey data show that around 75 percent of firms were expected to give gifts to secure a government contract. Against a lack of transparency and accountability for budget execution, discretionary extrabudgetary investment spending occurred in the form of oil barter agreements, as explained earlier in this chapter (see “Oil Revenue Management”). Infrastructure projects executed under such agreements have bypassed official budget processes for selection, qualification, and monitoring.

Weak public investment management, along with poor implementation capacity, also suggest that selected projects were not the most efficient, which contributed

⁶ All third-party indicators reported in this section may be subject to uncertainty.

⁷ The analysis builds on the discussion in *Rapport sur la Gouvernance et la Corruption* (Republic of Congo 2018) of inefficiencies in public investment.

⁸ A diagnostic tool, the Public Investment Management Assessment (PIMA), has been developed by the IMF to assess the efficiency of public investment management during each phase of the investment cycle. PIMAs have been carried out in more than 50 countries, not including the Congo. See IMF (2015; 2018a).

to weakening the link between public investment and growth (Republic of Congo 2018).⁹ In particular, weak procurement processes and internal controls may have created widespread opportunities for misuse of public funds.¹⁰

Public procurement is particularly susceptible to corruption if processes are not transparent and the underlying legislative, regulatory, and institutional frameworks are weak. According to the procurement subindicator of the Ibrahim Index of African Governance, procurement procedures in Congo have become much less competitive since 2014, with the country's score dropping from 50 to 25 in 2019.¹¹ In fact, projects are sometimes tendered in a competitive process, but the public does not have access to complete, reliable, and timely procurement information. There are also no available data on public tendering versus direct procurement. Other corruption risks include insufficient controls of the procurement process, the absence of mechanisms to impose sanctions when the regulations are breached, and weak capacity of civil servants responsible for conducting procurement transactions in line ministries. Only a limited number of procurement audits have been conducted in recent years, and they have excluded high-value contracts.

Some progress was made with the introduction of a new procurement law in 2009, the establishment of a review mechanism for monitoring and processing appeals related to complaints, and the operationalization of the existing Public Procurement Regulatory Authority. Even though the law requires that procurement complaints be reviewed by an independent body, it is not known whether such reviews have been carried out or are rigorously enforced.

There is also evidence of corruption risks faced by the private sector when interacting with public administrations. In fact, Congo ranked poorly in 2019 on indices of the Ibrahim Index of African Governance that assessed both the absence of bribery in the public sector (with a score of 36.9)¹² and risks of corrupt practices faced by the private sector when interacting with the public sector (with a score of 20).¹³ Earlier findings from the 2009 Investment Climate Assessment

⁹ Examples of investments deemed inefficient by CSOs and other stakeholders are the Kintélé National Stadium, the Imboulou Dam Project, and the Congo Power Station. For a discussion of inefficient investments, see World Bank (2015).

¹⁰ This paragraph and the next are based on discussions between IMF staff and the authorities in December 2017 and April 2018. Other sources of information include EITI (2014; 2016), Republic of Congo (2018); and World Bank (2015).

¹¹ This subindicator assesses (1) the extent to which bids from competing contractors, suppliers, or vendors are invited through open advertising of the scope, specifications, and terms of the proposed contract and (2) whether the criteria by which the bids are evaluated are available for scrutiny. The assessment score ranges between 0 and 100, where 100 is the best possible score.

¹² This sub-subindicator assesses the extent to which bribery is absent from administrative processes, the extent to which the police and military do not use public office for private gain, and the extent to which public sector employees do not engage in bribery. It ranges between 0 and 100, where 100 is the best possible score.

¹³ This sub-subindicator assesses the risk that individuals or companies will face bribery or other corrupt practices in order to carry out business, from securing major contracts to being allowed to import or export a small product or obtain everyday paperwork. It ranges between 0 and 100, where 100 is the best possible score.

(ICA) survey for Congo confirm that close to 40 percent of firms have experienced at least one bribe request and were expected to give gifts to tax officials. More than 80 percent of firms were expected to give gifts to public officials to “get things done.” In this context, it is not surprising that selected infrastructure projects have not had a significant impact in improving development outcomes. For instance, the poorest 10 percent of the population has no access to electricity, and only half of those in the poorest quintile have access to safe water (World Bank 2017).

DIVIDENDS FROM ANTICORRUPTION REFORMS

This section presents the results of simulations using the DIGNAR model by Melina, Yang, and Zanna (2016) to quantify the impact of anticorruption reforms in Congo on macro-fiscal outcomes, including output, private investment, private consumption, and debt. This model was also used in IMF (2018b).

The model calibration for Congo incorporates the anticorruption reforms to address vulnerabilities described earlier in this chapter (see “Oil Revenue Management” and “Public Investment and Public Service Delivery”). We calibrate different reform scenarios.¹⁴ The baseline scenario captures the effect of an ambitious but realistic reform package that would advance Congo within the distribution of sub-Saharan African countries. The second scenario assumes a partial reversal of reforms, as commitment to governance reforms may falter over time. Finally, a more conservative scenario includes less ambitious reforms.

Under the baseline scenario, the reforms are calibrated such that (1) the reduction of bribes would boost private sector investment within 10 years from 14 to 16 percent of GDP, advancing Congo by a decile in the distribution of sub-Saharan African countries; (2) public investment efficiency would rise from 0.43 to 0.58, which is the median level of sub-Saharan African countries; (3) a more efficient government bureaucracy would increase the nonoil revenue-to-GDP ratio by 2 percentage points;¹⁵ and (4) a correction of the mispricing of Congolese crude oil exports would raise total oil revenues by 7 percent.¹⁶

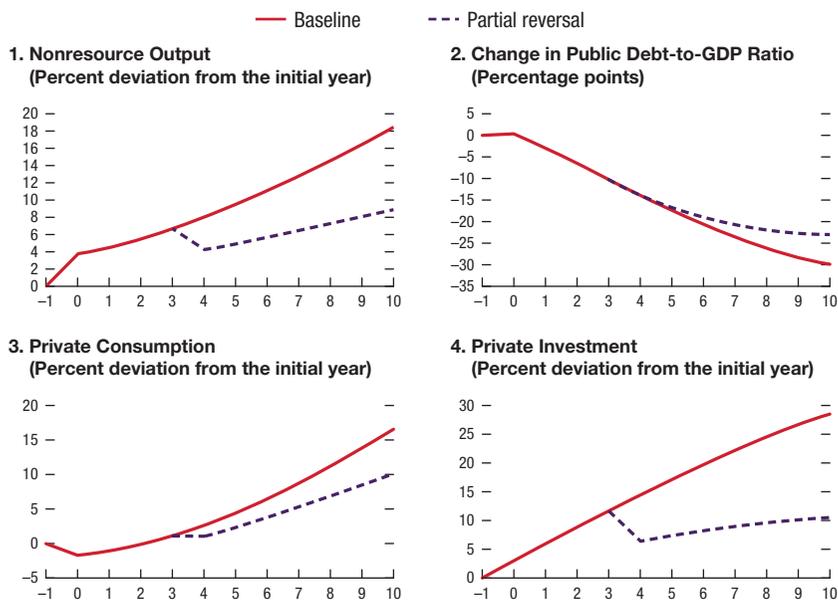
Baseline simulations show that these reforms can increase the level of real nonoil output by 18 percent in 10 years, implying approximately an additional growth of 1.8 percentage point per year on average, with a crowding-in effect on private consumption and investment (Figure 6.5). Reforms would also reduce the

¹⁴ More details on of the model and its calibration to Congo are provided in the annex of Melina, Selim, and Verdugo-Yepes (2019).

¹⁵ This number refers to the IMF Fiscal Affairs Department estimate for an efficiency index ranging between 0 (worst) and 1 (best). This is a somewhat conservative assumption as PFM reforms can improve revenue mobilization by a more significant margin.

¹⁶ This indicative figure is derived from an oil reconciliation exercise undertaken by IMF staff. If Congolese crude oil were sold at Brent prices, the government would be able to accrue an additional 14 percent of oil revenue. If around 7 percent of revenues are due to the lower quality of the Congolese crude, then the remaining 7 percent could capture revenues lost to corruption.

Figure 6.5. Baseline Scenario: Macro-Fiscal Gains from a Comprehensive Anticorruption Reform Package



Sources: DIGNAR model simulations; and authors' calculations.

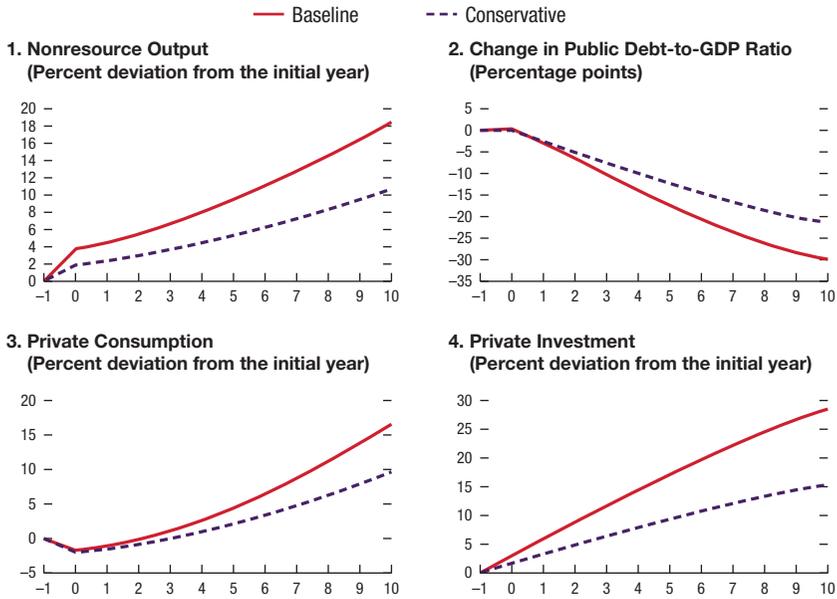
Note: X-axis reflects years. Policy changes occur in year 0. Red line refers to the baseline reform scenario; black dashed line refers to a scenario where there is a partial reversal of reforms in year 4.

ratio of public debt to GDP by about 3 percentage points per year. Moreover, 10 percent of the increase in growth and almost one-third of the reduction in public debt is due to better oil sector governance.

Congo's weak initial conditions, including very low investment efficiency, can explain the large growth dividends. They are also of the same order of magnitude as results for both other developing countries and other cross-country empirical estimates reported in IMF (2018a), and in Chapter 2 of this book. Finally, these reforms are only a subset of possible reforms that Congolese authorities may choose to pursue. It is reasonable to conjecture that coupling governance reforms with broader fiscal reforms is likely to deliver much larger growth dividends.

Two additional simulations highlight more conservative reform scenarios. Results suggest that economic dividends from anticorruption reforms remain significant even under (1) a partial reversal of reforms or (2) the adoption of less ambitious reforms (Figure 6.6). The first alternative scenario assumes that gains are partially reversed after three years. This reversal is captured by the following assumptions: a decline in private investment to 14.5 percent of GDP, a deterioration of public investment efficiency to 0.47, and a decline in the ratio of nonoil revenue-to GDP by 0.5 percentage points and fiscal revenues by 1.75 percent.

Figure 6.6. Conservative Scenario: Macro-Fiscal Gains from a Comprehensive Anticorruption Reform Package



Sources: DIGNAR model simulations; and authors' calculations.

Notes: X-axis reflects years. Policy changes occur in year 0. Red line refers to the baseline reform scenario; black dashed line refers to a more conservative reform scenario.

The calibration shows that anticorruption reforms would yield an average increase in nonoil growth of 0.8 percentage points per year and a decrease in the ratio of public debt to GDP by 2.25 percentage points per year.

In a second alternative and more conservative scenario, the reforms are calibrated to lead to (1) an increase in private sector investment from 14 to 15 percent of GDP; (2) an increase in public investment efficiency to 0.5375; (3) an increase in nonoil revenue mobilization by 2 percentage points of GDP; and (4) oil revenues that are 3 percent higher. This scenario yields an average increase in nonoil growth of about 1 percentage point per year and reduces the ratio of public debt to GDP by 2 percentage points per year (Figure 6.6).

CONCLUSION

This chapter has argued that oil revenue management and public investment in Congo are vulnerable to corruption. Collusion between public officials and private actors has facilitated corrupt practices. The chapter also showed that the potential dividends from anticorruption reforms could be significant, and range per year between 0.8 and 1.8 percentage points of higher growth and between

2.25 to 3 percentage points of lower debt-to-GDP ratio. Improvements in oil sector governance alone account for around 10 percent for the increase in growth and one-third of the reduction in debt.

The authorities have already taken several anticorruption measures. In 2019 they adopted a law introducing asset declaration requirements for senior political figures, and in 2020 they established an anticorruption commission with investigative powers. Going forward, however, it will be necessary to bring the asset declaration regime in line with international good practices (Swanepoel and Verdugo-Yepes 2020).

To upgrade oil sector governance, the government (1) revised the SNPC statutes in 2017 to clarify accountability for functions performed on behalf of the state;¹⁷ (2) published online oil production sharing agreements in 2018; and (3) submitted to Parliament in late 2018 draft amendments to the law requiring the SNPC and its subsidiaries to publish their audited financial statements.

The following oil sector reforms would also reduce corruption risks and increase the government's accountability for the use of oil revenue: (1) auditing the recovery costs claimed by oil companies; (2) publishing, by SNPC, of detailed information on oil sale volumes, prices, sales, and buyers; (3) enhancing the AML framework to deter and detect illicit transactions in oil trading; (4) auditing, by an independent entity, all financial flows between the SNPC and the budget; and (5) increasing transparency regarding the operations of SNPC subsidiaries, including the national refinery company.

To enhance public investment efficiency, the authorities submitted to Parliament a report on past transactions involving the financing of infrastructure projects with oil revenues and the use of oil prepurchase transactions. They further committed in 2018 to (1) publish detailed information on public investment; (2) conduct an investment tracking survey; (3) adopt a law and underlying implementing regulations on the organization and functions of the supreme audit institution of Congo (Cour des Comptes et Discipline Budgétaire); and (4) restructure the internal audit system and establish a mechanism to coordinate the work of the internal and external audit institutions. Another area of reform should include the expedition of plans to finalize a comprehensive medium-term strategy for PFM reforms with a three-year rolling action plan.

Finally, government commitment at all levels to its governance strategy is critical for Congo's citizens to fully reap the anticorruption dividends. Such dividends will also depend on how well the reforms are implemented and how compliant stakeholders are with reporting obligations under the new framework. The issues discussed in this chapter can guide reforms in other CEMAC or other resource-rich sub-Saharan African countries facing similar challenges.

¹⁷ Article 59 of the 2017 Statutes for the Société Nationale Pétrolière du Congo.

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Addressing Corruption in Fragile Country Settings

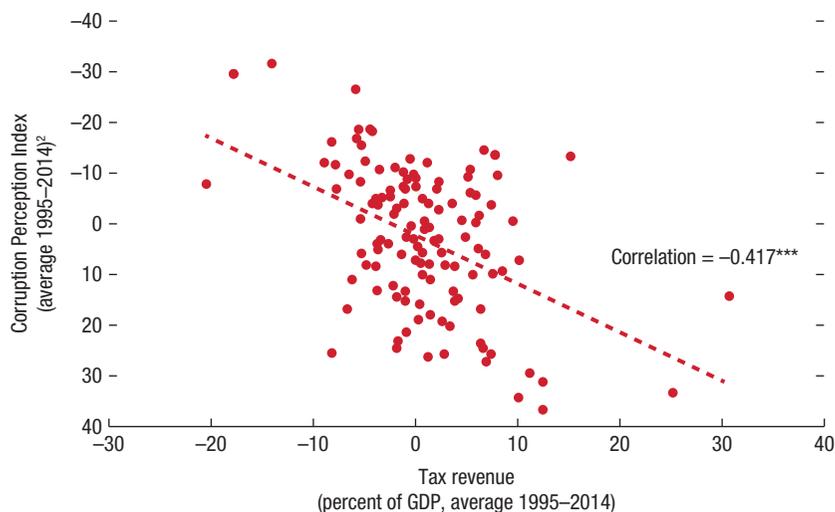
Sebastian Pompe and Joel Turkewitz

ABSTRACT

This chapter explores the role of corruption in the multidimensional sources and symptoms of fragility, focusing on countries in chronic or extreme fragility in sub-Saharan Africa. After a brief overview of definitions and applicable standards, it focuses on how international financial institutions have approached the issue. The chapter takes the example of the IMF, examining the efforts within the institution to balance, on the one hand, assisting fragile countries to improve access to international markets by lifting their macroeconomic frameworks to international standards, with, on the other hand, a country-based approach emphasizing institutional resilience. The chapter explores the increasing prominence of governance and anticorruption measures in the IMF's engagement with members over the past decade, and the growing emphasis on country-tailored approaches.

INTRODUCTION

Understanding of the causes of state fragility and of the relationship between fragility and corruption has deepened over the years. The persistence of fragility has created awareness that fragile countries are not just “harder cases of development,” but a distinct typology in which “weakened governance, corruption and insecurity” translate into a breakdown of the normal development process, and not solely into lower economic growth (Zoellick 2008). Corruption is a “symbiotic” part of the multidimensional frame of reference developed by the World Bank and the OECD (GIZ 2020, p. 9). Its link with fragility is pronounced. The economic impact of corruption in fragile countries is well established (IMF 2017; 2018b), and the association of fragility with poor governance, high levels of corruption, and depressed or negative economic growth, investment, tax revenues (Figure 7.1), and human development outcomes are severe and long-lasting. The link between corruption and fragility has become more concentrated over time, as has the link between fragility and poverty (Hammadi, A., M. Mills, N. Sobrinho, V. Thakoor, and R. Velloso 2019).

Figure 7.1. Corruption and Tax Revenues¹

Sources: Transparency International; and IMF staff estimates.

Note: Samples include commodity importers only. Asterisks from the correlation equation imply significance at 1 percent.

¹ Variables presented are deviations from values predicted by income level.

² Larger numbers indicate lower perceived levels of public sector corruption.

These relationships are particularly valid in sub-Saharan Africa. Half of the weakest scores in the 2020 Transparency International Corruption Perception Index were received by fragile countries in the region. Given the corrosive effect of corruption on state legitimacy and the effectiveness of its institutions, addressing it is increasingly recognized as a necessary precondition to development, poverty reduction, and exiting fragility.

Progress on addressing fragility remains brittle and difficult to sustain, and progress on anticorruption efforts remains nonlinear. OECD (2020a) finds significant slippage in efforts regarding United Nations SDG 16 (which seeks to support peace, justice, and strong institutions, including through anticorruption measures), observing that progress toward meeting the indicator has stagnated or regressed since 2018. Similarly, the 2020 Ibrahim Index of African Governance finds that progress on governance in Africa has slowed in the past five years. For 2020, for the first time in a decade, the report finds that the aggregate score for all countries had declined on a year-to-year basis.

The COVID-19 health and economic crisis will aggravate an already challenging situation. The infrastructure needed to address the immediate challenges, from health care to access to vaccines, is weak in all fragile states. The WHO in November 2020 found that a significant majority of African countries lack the

capacity to respond to the epidemic.¹ The projected increasing inequalities and their corrosive effects on fragile peace settings are expected to be compounded by the reduced abilities of the authorities to respond due to a narrowing of the tax base (OECD 2020b), despite some upbeat reports (Akitoby, B., J. Honda and K. Primus 2020). Critically, weaknesses in health sectors in fragile states are often the outcome of broader governance shortcomings and cannot be addressed in isolation.

This chapter explores potential avenues for reducing corruption in fragile countries in sub-Saharan Africa. It begins by setting out the characteristics and dynamics of fragility in the region. The next section focuses on the corruption dimension of fragility, looking specifically at the domestic roots. In the following section, the chapter considers how international organizations have engaged on anticorruption in fragile contexts. Taking the IMF as an example, the chapter examines how the institution has aimed for an economic growth model in past years while seeking to define a bigger role for institutional resilience going forward. The first approach maximizes access to international markets by emphasizing best-practice institutional models. The second aims at building sustainable and resilient institutions through an engagement that builds on the domestic context. Finally, the chapter offers suggestions to support consequential and outcome-oriented anticorruption efforts in fragile spaces.

FRAGILITY IN SUB-SAHARAN AFRICA

The causes of fragility are multidimensional—with a diverse group of states qualified as fragile (Harsch 2020)—and debates on the definition of fragility are still ongoing (Chayes 2016; Saeed 2020). IMF (2015a) mentions four factors of fragility: (1) a lack of a common vision and inclusiveness; (2) weak governance and ineffective institutions; (3) underdevelopment, lack of education, and lack of employment opportunities; and (4) conflict and political instability. Both the OECD and the World Bank use comparable factors: the OECD focuses on economic, environmental, political, security, and societal aspects, and the World Bank focuses on economic policies for social inclusion and equity and on public sector management and institutions. The OECD *States of Fragility* reports and the World Bank Country Policy and Institutional Assessment (CPIA) Index identify fragility based on the assessment score and on data derived from international peacekeeping operations (Box 7.1).

¹ WHO urges African countries to ramp up readiness for COVID-19 vaccination drive | WHO | Regional Office for Africa <https://www.afro.who.int/news/who-urges-african-countries-ramp-readiness-covid-19-vaccination-drive>

Box 7.1. Categories of Fragility¹

- *Fragile countries*: Countries identified by the World Bank, the IMF, and the OECD as fragile. The World Bank 2020 list of fragile and conflict-affected situations includes 37 countries; the IMF Fragile States list includes 42 countries, and the OECD Fragility Framework covers 57 countries. In the IMF list, 22 out of 42 countries are from the sub-Saharan Africa region.² (See Annex 7.1.)
- *Chronically fragile countries*: Countries that have been fragile for a prolonged period (countries listed in the OECD reports on fragility since 2005). There are 27 of these countries worldwide, of which 18 are in the sub-Saharan Africa region (OECD 2018, 26).³
- *Extremely fragile countries*: Countries that are extremely fragile according to the OECD scoring system. There are 13 of these countries worldwide, of which 8 are in the sub-Saharan Africa region (OECD 2020a, p. 23–24).⁴

¹The World Bank and IMF do not rank fragile countries, and as a result do not use terms that classify forms of fragility, such as “extreme fragility,” which is an OECD concept. Also, while the World Bank and IMF indices show chronic fragility, in the sense that countries are listed consistently as fragile (Figure 7.2), the term is used mostly by the OECD.

²This figure is based on the IMF list, not the regional classification of the organization. The institutional organization does not include in sub-Saharan Africa countries such as Sudan and Somalia (not part of the IMF’s sub-Saharan African country list). See IMF (2019), *Updated List of Fragile and Conflict-Affected States*. The World Bank 2021 list of fragile and conflict-affected situations includes 20 sub-Saharan African countries.

³The OECD is the only international organization in this group that ranks countries. For reasons of consistency, the numbers used here follow the geographic classification for sub-Saharan Africa, not the IMF regional classification.

⁴For reasons of consistency, the numbers used here follow the geographic classification for sub-Saharan Africa, not the IMF regional classification.

This multidimensional definition of fragility results in a diverse group of fragile states² and a rich and ongoing debate on the concept of fragility.³ Regardless of the definition used, state fragility is not invariably related to poverty or conflict, as 63 percent of the population in fragile states lives in middle-income countries (OECD 2020a), and the majority of fragile states have not experienced conflict in the past decade (OECD 2018). However, within this diverse community, subgroups can be distinguished in which the challenges of

² The multidimensional definition used by these agencies is incorporated by very large numbers of indicators (the OECD uses 44 and the World Bank 16), and thus has attendant challenges in weighting, which can affect outcomes. These were recently illustrated by the fact that Cameroon (11 indicators) is classified as more fragile than conflict-ridden Libya (20 indicators) or Iraq (17 indicators) in the OECD 2020 Fragile States Index (Harsch 2020). Also, from a diagnostic perspective, most rankings and reports do not always clearly distinguish between the consequences of fragility or its causes. See, generally, Easterly and Freschi (2010).

³ Thus, some propose to extend the concept to so-called strongmen countries—even if those might not be viewed as fragile according to the CPIA (Chayes 2016; Saeed 2020).

fragility are particularly acute. This notably includes the group of countries that are chronically fragile (fragile for a prolonged period) and extremely fragile (weakest scores in the OECD scoring system since 2016 [OECD, 2016]), and whose condition is characterized by singularly deep-rooted corruption, poverty, and conflict.

State fragility is a particular challenge for sub-Saharan Africa, where it carries common characteristics. The region hosts more than half of fragile countries worldwide, with a disproportionate number of chronically fragile countries. More than two-thirds of the sub-Saharan African countries on the IMF fragile states list for 2019 (IMF 2019) had been on that list for more than a decade—the 17 African countries on the 2020 World Bank list of fragile and conflicted-affected situations had been on these lists for 14 years (Figures 7.2 and 7.3). Similarly, 8 out of 13 countries that face extreme fragility are in sub-Saharan Africa (OECD 2020a). Further, the nexus between extreme or chronic fragility with poverty and conflict in sub-Saharan African countries is clear: all fragile countries in the region are low-income countries, and the majority (11 out of 20) face violence or have recently emerged from it (OECD 2021). The link with corruption in these countries is particularly pronounced.⁴

These countries have struggled to escape the fragility trap. IMF (2015a) flagged progress in a group of countries, which has since been followed by a relapse by some countries in that group, highlighting the fluid and tentative nature of achieving resilience and progress for fragile countries in sub-Saharan Africa.⁵ Expert analysis suggests that an exit from fragility will only take place after sustained improvement over a period of a quarter century and then only for a select group. Cilliers and Sisk (2013), for instance, have determined that of the 26 fragile countries in sub-Saharan Africa at the time, 12 might become more resilient by 2039. These reports generally point to the challenges of chronically and extremely fragile countries to escape the so-called fragility trap. The fragility trap is predicated on the interconnectedness of the drivers of political instability and minimal state capacity, which makes the transition out of fragility a precarious, complicated, and long-term journey.

⁴ Of the 20 lowest-scoring countries in the 2020 Transparency International Corruption Perception Index 2020, half are fragile states from the region.

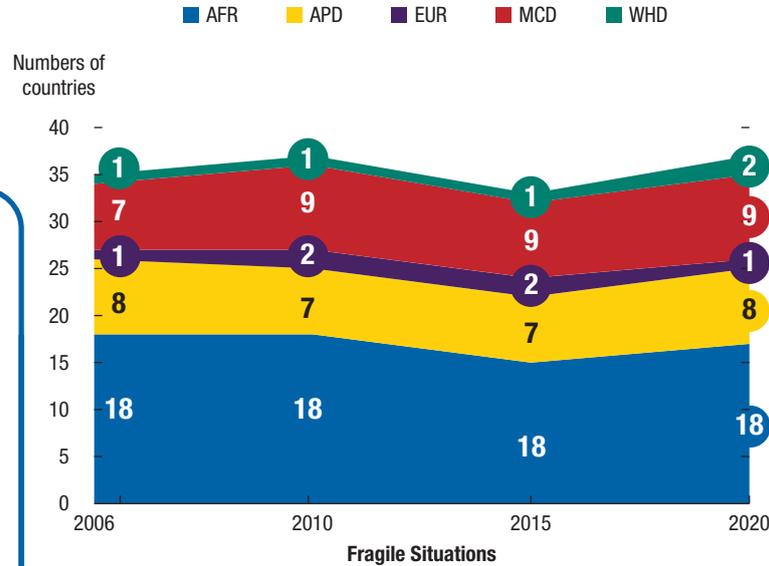
⁵ The IMF (2015a) report flags progress in Cameroon, Ethiopia, Mozambique, Niger, Nigeria, Rwanda, and Uganda, but a number of these countries have since seen regression. Cameroon has been slipping on the Fragile States Index because of a slow-burning insurgency. Niger fell 11 places in the Global Peace Index and slipped on the Fragile States Index (OECD 2020a, p. 34). The *New Humanitarian* (2020), citing J. J. Messner of the Fund for Peace, notes that “Mozambique . . . is ranked 27th on the list, but over the past decade [it has been identified as] the sixth most worsened [country], ‘behind the “more obvious” humanitarian emergencies evident in places like Libya, Syria, Mali, Yemen, and Venezuela” (“The 2020 Fragile 15” 2020).

Figure 7.2. Regional Breakdown of Fragile States in World Bank Lists (2006–20)

AFR Chronic Fragility Countries LICUS 2006 List



- Angola
- Burkina Faso
- Burundi
- Cameroon
- Central African Republic
- Chad
- Comoros
- Congo, Democratic Republic of the
- Congo, Republic of
- Côte d'Ivoire
- Eritrea
- Gambia, The
- Guinea
- Guinea-Bissau
- Liberia
- Mali
- Niger
- Nigeria
- São Tomé and Príncipe
- Sierra Leone
- South Sudan
- Togo
- Zimbabwe



LICUS list

FCS 2020

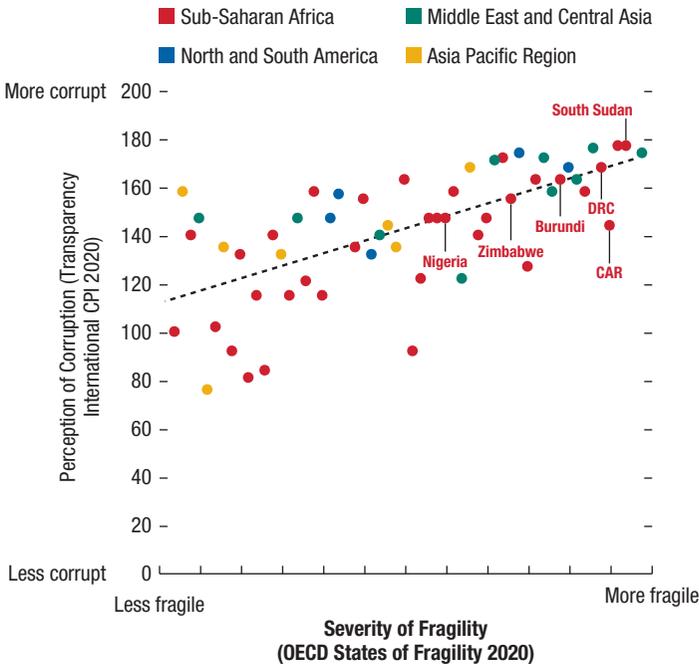
AFR Chronic Fragility Countries FCS 2020



- Burkina Faso
- Burundi
- Cameroon
- Central African Republic
- Chad
- Comoros
- Congo, Democratic Republic of the
- Congo, Republic of
- Eritrea
- Gambia, The
- Guinea-Bissau
- Liberia
- Mali
- Niger
- Nigeria
- South Sudan
- Zimbabwe

Source: World Bank, Classification of Fragile and Conflict-Affected Situations (<https://www.worldbank.org/en/topic/fragilityconflictviolence/brief/harmonized-list-of-fragile-situations>)

Note: AFR: Sub-Saharan Africa; APD: Asia and Pacific; EUR: Europe; MCD: Middle-East and Central Asia; WH: Western Hemisphere.

Figure 7.3. Fragility and Perception of Corruption

Source: Transparency International, Corruption Perception Index 2020 | OECD, States of Fragility 2020

ANTICORRUPTION WITHIN THE DOMESTIC POLITICAL EQUILIBRIUM

Almost all fragile states in sub-Saharan Africa have decades-long histories of anti-corruption activities. Even if these efforts have had limited traction in establishing rule-based governance, they have left an array of laws, international commitments, state and nonstate institutions, a cadre of people both inside and outside of government with anticorruption experience, and a national discourse on corruption in fragile states. The challenge going forward is to make use of these legacies to establish durable anticorruption reforms that contribute to equity, efficiency, and societal well-being.

These local contexts show that anticorruption, for all its complexity and international ambit, is very much part of the domestic discourse in fragile states. Anticorruption efforts have strong support within the communities (and among committed public sector officials), in that corrupt practices foster universally a deep sense of injustice. This push is not just driven by poverty but also by the exclusion from access and facilities as well as by the personal grievances corruption invariably engenders (Lewis 2020). The grievances and tensions resulting

from corruption can have a corrosive effect on government legitimacy and threaten its survival.

States in sub-Saharan Africa, whether fragile or not, publicly proclaim to combat corruption, are signatories of international conventions, and have anticorruption programs and policies because the national discourse calls for it. These anticorruption efforts are part of the political equilibrium within countries in which vested interests seek to balance responses to societal grievances while simultaneously retaining their hold on power and access to rents and privileges. These grievances often are shared by responsible and dedicated public officials, and the tension does not simply exist between the (captured) state and society but typically plays out within state structures.

This helps explain the long roots of anticorruption efforts in sub-Saharan Africa, many of which predate the international conventions. In Nigeria the history of anticorruption-related institutions goes back to the Public Complaints Commission, established in 1975; the Independent Corrupt Practices Commission, established in 2000, continued to support these efforts. These institutions were introduced prior to important standard-setting international developments, such as the Foreign Corrupt Practices Act (FCPA) (enacted in 1977) and the United Nations Convention against Corruption (UNCAC, agreed to in 2004 which calls for an anti-corruption body (or bodies) invested with the necessary independence). Nigeria is no exception. Other sub-Saharan Africa countries have also a long-standing history of anticorruption efforts. Zimbabwe put in place comparable measures in the 1980s. Similarly, Benin's first anticorruption commission dates from 1996 (Decree 579/1996 of December 19, 1996).

Country histories in the region suggest that anticorruption measures often are a response to domestic pressures. Even as efforts to bolster the effectiveness of anticorruption institutions in West Africa often are “not yielding the expected results” (Open Society Initiative 2016, iv), these anticorruption reforms point at a dynamic local setting, where accountability and anticorruption institutions have carved out a public role. Depending on the state and institutions, this role has included taking up and processing cases, producing reports, and generating media headlines. Admittedly, these agencies and institutions generally have been frustrated in bringing cases to a successful conclusion or achieving the oft-repeated promise of eradicating corruption, but there is a continuous interagency dynamic. Commentaries note that even in more challenging circumstances, despite “major dysfunctions,” there has been “undeniable progress in terms of running its [Niger] mechanisms and institutions” (Damiba 2016, p. 109).

Anticorruption and oversight agencies are part of this societal ecosystem. They are often a prominent voice in the domestic discourse, frequently amplified through media headlines (or responding to those). They do not operate in a void but partake with CSOs and other societal actors in a long-running societal dialogue, which can leverage their influence. This conversation often revolves around corruption scandals and allegations of corrupt behavior. Elsewhere, media and public attention focus on the inability of accountability institutions to serve their function, pointing to delays in the publication of government accounts, weak

audit capacity, cursory or excessively formalistic audits, and the tendency for anticorruption investigations and prosecutions to end well short of a satisfactory conclusion.

The challenge has been to identify methods for improving governance that are fit for the difficult and unstable environment of Africa's fragile states. The history of attempted reforms in these spaces should be sufficient to demonstrate that efforts to transform governance through the adoption of imported models distract from the hard and long task of establishing practices, rules, and organizations consistent with the local realities and thus fit for purpose to improve people's lives.

The local roots of the anticorruption agenda are a critical factor in the political equilibrium. The task for reformers and international partners is to mobilize this underlying dynamic for reform and use their mutual knowledge base to enhance institutional resilience. Certainly, within this dynamic setting, international standards, especially those established by UNCAC, represent a key benchmark, both as a legally binding convention for public sector agencies but perhaps more so as a means for articulating aspirational values that local communities recognize and share.

THE POLICY DEBATE IN INTERNATIONAL AGENCIES

Increased International Attention to Corruption

The approach taken by international agencies to anticorruption has been influenced by the international legal framework that governs this domain, notably UNCAC and the African Union Convention on Preventing and Combating Corruption (AUCPAC). This framework sets out legal and institutional approaches to fighting corruption that are understood to be universally applicable (Open Society Initiative 2016):

- The provisions of UNCAC impose on signatory countries (which include all fragile countries) a set of statutory commitments and the requirement to establish dedicated bodies to the prevention of corruption. The convention requires all signatory countries to enact mandatory criminalization of active and passive bribery (Article 15), active bribery of foreign public officials (Article 16), embezzlement (Article 17), laundering of proceeds of crime (Article 23) and obstruction of justice (Article 25), as well as providing for the criminal liability of legal persons (Article 26) and criminalizing participation in a criminal offense (Article 27).
- The AUCPAC makes it mandatory for signatory countries to create anticorruption agencies (Article 5).
- Similarly, specialized agencies are recommended by the FATF to curb money laundering and the financing of terrorism. Noncompliance with FATF standards may result in countries being excluded from international financial markets.

These international treaties and standards unreservedly aim at a legalistic and institution-building approach, and by their nature encourage standards-based approaches with limited consideration of the specific sociopolitical context of fragile countries.

Following the publication of the *World Development Report 2011* (World Bank 2011) and the establishment of UN SDG 16, the IMF has increasingly recognized corruption as an important and integral part of the broader problem of engaging in fragile countries. The IMF approaches the topic from two angles: the first is through institutional discourse on fragile countries, in which IMF papers and reports since 2012 have become more explicit about the relevance of corruption for building institutions in fragile countries. The other is through its discourse on the macrorelevance of corruption more generally, which had a run-up of several years before being affirmed by the IMF Board in 2018 (IMF 2018b).

As a result, the IMF has become more explicit in identifying corruption as a core concern for fragile countries, including by explicit use of the term “corruption.” Some of the IMF’s early documents, such as IMF (2012), which remains the basis for IMF engagement in this area, do not mention corruption but refer to “governance” as a key challenge facing fragile countries. Governance then covers both general institutional challenges as well as possible corruption issues. This tendency to subsume corruption under the broader term of governance continued until about 2017–2018, when the IMF became more emphatic and outspoken regarding the fact that corruption is a specifically important challenge for fragile countries. The report by the Independent Evaluation Office of the IMF (IEO 2018) on fragile countries frequently uses the term “corruption” as an important concept. The report openly acknowledges that the governance weaknesses that characterize fragile countries significantly increase corruption vulnerabilities. The 2018 IEO report thus places corruption at the heart of its assessment of the 2012 policy implementation on fragile countries (IMF 2012), when that policy itself does not use that term. The report also recommends IMF engagement on this issue at an early stage, albeit “with humility and patience” (p 40).

This increased focus of IMF policies and reports on corruption in fragile countries aligns with the discourse on the macrorelevance of corruption in national institutions that has emerged since 2016. IEO (2018) cites the IMF (2017) stocktaking paper on the IMF approach to governance, which calls on the organization to be franker in naming the issue. After the publication of preparatory work undertaken by the IMF (IMF 2016; Lagarde 2016; 2017), the 2017 IMF paper examines the IMF’s own institutional approach to corruption. The paper noted the high degree of correlation between corruption and economic growth, and among other things called on the institution to address the issue in a more direct manner. At the same time, high-level cases of corruption added to the urgency of addressing the issue in the policy dialogue (Box 7.2).

The ensuing 2018 IMF policy on governance affirms the macroeconomic role of corruption and gives IMF staff a mandate to engage on the topic directly, with a specific focus on six core state functions. The “Proposed Framework for Enhanced Fund Engagement” (IMF 2018b) established that the institution

Box 7.2. High-Level Cases of Corruption Informing the Policy Debate

Several major cases have raised concerns about the prevalence of corruption and its macroeconomic impact and about the adequacy of current instruments and frameworks. Examples include the \$45 million “cashgate” scandal in Malawi (2013), the pledging of 30 percent of Guinea’s subsoil mineral reserves in collateral for an unauthorized \$25 million loan to a national mining company (2010), the use of external financing raised by the Mozambique State Tuna Company for purchase of military vessels (2013), and the off-budget purchase of a \$40 million presidential plane and the overbilling of off-budget military supplies for \$140 million in Mali (2012). The severity of these cases and their impact on the economy in all these countries resulted in a significant erosion of public trust in the authorities and undermined confidence among foreign investors. In some countries the IMF suspended its programs and external budget support stopped.

These cases contributed to a broader reflection on how these corruption challenges came about and could best be addressed. They raised questions about the adequacy of the systems in place and the approaches followed to date. While each of these cases was complex and specific in its own way, three features stood out and helped shape the institutional response.

First, the cases were marked by a high degree of sophistication, which core PFM controls had been unable to prevent from occurring or had failed to identify after they occurred. Core PFM controls and reporting arrangements were purposely sidestepped through complex noncash financial transactions (government guarantees, informal loan agreements, or pledging of subsoil assets) involving extrabudgetary entities, state-owned enterprises, special-purpose vehicles, or shell companies in offshore jurisdictions. In other countries, the corruption took place within the core PFM system, with the participation and support of senior officials in a range of institutions (including the prime minister’s office; central bank; budget, treasury, and accountant general’s departments of the ministry of finance; and line ministries).

Second, cases were marked by a failure of existing domestic control systems to identify the corruption or to sanction it. In all the above cases the scandals were unveiled by the press.

Third, the failure of the authorities to investigate or sanction perpetrators even after they were detected added to the concerns. In all the above cases corrective action was only taken under pressure from the international community, including via the suspension of financial support from the IMF and bilateral development partners. In some countries the authorities reimbursed fraudulent loans, but no criminal investigations or other sanctions were initiated against the perpetrators. In others, the extrabudgetary spending was incorporated into the budget, but no punitive action was taken against individuals involved in the cases.

The IMF analysis in articulating a response called for a strengthening of the PFM framework, including an adjustment of the PEFA framework as well as of domestic control systems, including supreme audit institutions.¹ However, the nature of these corruption cases also raised the question of whether such measures by themselves would achieve the necessary effect, since, after all, it had been the officials tasked to administer the PFM system who had conspired to circumvent it. The analysis, therefore, reinforced the view that further steps were needed to prevent such cases in the future. Such steps notably would be directed to changing the incentives underlying the behavioral framework of key actors within the PFM system, including by enhancing the anticorruption

(continued)

framework. These on-the-ground realities were important background considerations to the 2018 IMF policy on governance (IMF 2018b).

Cases were, of course, not limited to sub-Saharan Africa, as there are significant concerns about the facilitating role of advanced economies. For instance, UNCTAD (2020) found that annually an estimated \$88.6 billion, equivalent to 3.7 percent of Africa's GDP (over 2013–2015), leaves the continent as illicit capital flight, in part facilitated by advanced economies. The report found, among other things, that in African countries with high illicit financial flows, governments spend 25 percent less on health and 58 percent less on education than do countries with low illicit financial flows.

¹ The analysis called for bolstering the capacity and impact of supreme audit institutions and enhancing cooperation with the International Organization of Supreme Audit Institutions. This backdrop helps explain the subsequent increased involvement of the IMF with the supreme audit institutions during the COVID-19-related emergency finance and its intensified cooperation with the International Organization of Supreme Audit Institutions.

would rigorously engage in addressing corruption, when it was found to be macrocritical (i.e., affect significantly macroeconomic performance), by focusing on those state functions most relevant for economic activity. These functions, as discussed in Chapter 1, include (1) fiscal governance, (2) central bank governance and operations, (3) financial sector oversight, (4) market regulation, (5) rule of law, and (6) anti-money laundering and combatting the financing of terrorism. These changes point at a firmer and more explicit institutional recognition of the role of corruption in state fragility.

From Best Practices to Country-Specific Engagement

Fragile states have struggled to establish functional accountability institutions despite the assistance of international financial institutions and other development partners. Formulating higher-level objectives, such as having an effective anticorruption legal and organizational framework, is now commonly accepted; however, the main challenge has been to manage the transition from paper organizations and endemic corruption to functional accountability institutions that operate in accordance with the rule of law (World Bank 2011).

International partners increasingly recognize the corrosive effect of corruption on state legitimacy and the essential importance of front-loading support for improving the effectiveness of institutions engaged in development and poverty reduction efforts (Johnson 2016; Rose-Ackerman 2013). The WDR (World Bank 2011), the New Deal Agreement on Fragile Countries (OECD 2011), and the UN SDG 16 all agree on the need to strengthen institutions as a first step toward reducing the internal fragmentation that afflicts fragile countries. Based on reviews of the development experience to date, each of these organizations concludes that institutional stabilization and resilience is at the foundation of the transition out of fragility, in which anticorruption is key, as it touches upon the legitimacy and effectiveness of the state and its agents.

How this institutional stabilization and resilience is to be achieved in fragile states continues to be the key challenge (Commission on State Fragility, Growth, and Development 2018; World Bank 2011). For international financial institutions such as the IMF, an important underlying consideration has been the need to establish complementarity between two distinct approaches. The first approach prioritizes economic growth by maximizing access to international markets, including capital markets. It supports universal legislative and institutional models that these markets recognize. It promotes international standards and best practices, which can result in an approach designed to introduce model laws and institutions into countries. The other approach focuses on building institutions within the local context—sometimes referred to as institutional resilience. This approach taps into and engages with the networks and contextual factors of fragile states and aims at building institutions within those local contexts that are fit for function, which was the overall thrust of the World Development Report 2011 (World Bank 2011).

These different approaches cannot always be easily reconciled, notably in conditions of extreme institutional fragility. The approach that aims at stimulating economic growth by maximizing access to global capital markets, which has been the dominant approach of international financial institutions such as the IMF, often prioritizes efforts to put in place the institutions and procedures that international capital markets recognize and want. This translates into a certain uniformity in the institutions and procedures to be established (underpinned by international standards and best practices). The approach consequently is marked by a high degree of formality and technicality, with country challenges being primarily viewed in technical terms—which then also allows for these challenges to be addressed through technical means. Thus, institutional weakness is defined as the gap between prevailing rules and international standards, often focusing on weaknesses of mandate, independence, capacity, and resources. Reforms designed to respond to those weaknesses emphasize providing the support that will enable organizations to close the gap through corresponding enhancements related to statutory change, capacity building, resource allocation, and so on.

The country-specific approach focuses on the underlying causes of institutional and state fragility. These invariably are country specific. This approach emphasizes the idea that institutions cannot be strengthened without addressing those contextual factors, sometimes called networks or power equilibriums (Commission on State Fragility, Growth and Development 2018; Khan, Andreoni and Roy 2016; Mason 2020). It recognizes that societal fragmentation, as a core feature of fragile states, stands in the way of establishing a civil space that allows for the development of the middle ground that underpins the development of inclusive institutions. Consequently, its approach is principally focused on establishing processes and platforms to promote civil engagement and foster the creation of a collaborative and inclusive framework. It involves a more consensus-building and incremental process within the political economy marking fragile countries.

Both approaches attempt to establish a pathway to creating functional institutions that operate in accordance with formal rules and procedures, but the

dynamics of the transition process differ significantly. The economic-growth approach is premised on the idea that changes in laws and formal processes drive functional changes by tapping into an underlying independent rule-of-law and civil space. The country-specific approach is based on the idea that this civic space and rule of law are largely absent and need to be created first in order for institutions to develop an autonomous space in which to operate.

Obviously, as early IMF publications themselves have pointed out (Shah and Schacter 2004), these are not rigid categories.⁶ Even so, the dominant shift in international thinking on addressing fragile states generally, including on corruption, is a movement away from a simple application of international standards. The new approach features greater attention and inclusion of country-specific features, building on the evidence collected over the past half century that shows that the transplantation of rational-legal institutions onto fragile countries tends to fail (Commission on State Fragility, Growth and Development 2018).

The IMF's experience in this area illustrates the challenges in implementing the different approaches on fragile states and corruption, and the evolution in thinking. Its policies on fragile countries emphasize the importance of contextualizing engagements and programs, yet actual implementation has tended toward the economic-growth model. Thus, the 2012 "Staff Guidance Note on the Fund's Engagement with Countries in Fragile Situations" (IMF 2012) calls on IMF staff to focus on country specificity, explicitly considering the sociopolitical context and carefully tailoring structural reforms to the fragile context. Applying such guidance means tailoring policy advice to the sociopolitical constraints faced by the authorities, aiming at enhancing social cohesion (or, at a minimum, avoiding placing undue stress on the political and social fabric), prioritizing reforms in a context of low capacity and institutional weaknesses, and adjusting implementation expectations (IMF 2015b).

Even so, the 2015 stocktaking report (IMF 2015b) finds that in actual implementation, the IMF has tended toward a technical approach marked by uniformity: "Judged by the number of quantitative targets and structural benchmarks, program design has not changed much in recent years, and is broadly comparable across fragile and non-fragile countries" (IMF 2015b, p. 1). An IMF IEO report issued three years later found the approach unchanged: it concluded that the IMF continues to treat fragile countries "almost like any other country" (IEO 2018, p. 14), and the IEO struggled to find the distinctive country-specific treatment called for in the 2012 guidance.

⁶ Shah and Schacter (2004) point at the differentiated approach that is required depending on the gravity of the challenges. Their article was recently cited with approval by prominent current anti-corruption experts such as Mason (2020). Mason, in the seminal study on donor performance in this sector, *Reassessing Donor Performance in Anti-corruption*, notes that "because corruption is itself a symptom of fundamental governance failure, the higher the incidence of corruption, the less an anticorruption strategy should include tactics that are narrowly targeted at corrupt behaviour and the more it should focus on the broad underlying features of the governance environment" (2020, p. 6). Mason then proceeds to note that this is exactly what development partners failed to do.

An OECD report noted that this was the prevalent approach of nearly all international organizations and development agencies, which offer “a standardized political support package that focuses on the technical and procedural aspects of an idealized democracy” (OECD 2017, p. 2). The challenges flagged in its reports brought the IMF in 2018 to take further concrete steps to strengthen country-specific engagement. These measures included the establishment of a permanent interdepartmental committee tasked with enhancing engagement in fragile countries by introducing country-specific strategies and strengthening capacity development, including its integration with surveillance (IMF 2018a).

This also is reflected in the institutional approach on corruption: IMF program conditionality (as well as surveillance) on preventive and repressive anticorruption in sub-Saharan African countries shows a relatively high degree of uniformity and emphasis on a limited number of institutions (Table 7.1).

The program measures are about laws and institutions. Over a period of nearly two decades (2002–2020), IMF programs for sub-Saharan Africa included 45 measures on corruption for 19 countries, which focus basically on three areas: high-level strategies and surveys (for example, in Mozambique, Sierra Leone, Somalia, and Tanzania); statutory compliance with UNCAC (for example, in Central African Republic, Liberia, Malawi, Mozambique, Republic of Congo, and Tanzania); or setting up (or enhancing) anticorruption institutions. The last includes asset declarations for 17 countries (including Burkina Faso, Gabon, Guinea, Kenya, Liberia, Mali, Mozambique, and Uganda) and anticorruption commissions in eight countries (including Liberia, Guinea, Kenya, Mali, Mozambique, and Republic of Congo). There is little distinction between country typologies, including for fragile countries.

The anticorruption measures do not distinguish between fragile countries and others. Generally, the same or very comparable measures apply to fragile states and nonfragile states. Thus, anticorruption agencies are proposed equally for nonfragile countries (for example, Kenya) and for fragile countries (for example, Chad, Liberia, Mali, and Republic of Congo). Asset declarations are similarly applied to nonfragile countries (for example, Gabon, Kenya and Uganda) and to fragile countries (for example, Central African Republic, Guinea, Liberia, Madagascar, and Mali). Corruption criminalization through compliance with the

TABLE 7.1

IMF Program Measures on Anticorruption in Sub-Saharan Africa (2002–2020)

Adopt a strategy or do a survey	7 countries	Including 1 fragile state
Submit or enact an anticorruption law or amendment	12 countries	Including 5 fragile states
Submit or enact an anticorruption commission law	8 countries	Including 5 fragile states
Submit or enact an asset declaration law	17 countries	Including 5 fragile states

Source: Monitoring of Fund Arrangements (MONA) – 2002–2020.

Note: Measures in the list include prior actions, structural benchmarks, and structural performance criteria (which no longer exist) and are listed individually as reflected in IMF records: thus, a prior action or a structural benchmark on the same topic are listed as two measures.

UNCAC is driven by where statutory gaps are found, rather than country typology. These gaps are prominent among fragile states (for example, Chad and Malawi), but the measure can be found equally among nonfragile countries (for example, Mozambique).

The OECD notes that the general tendency among international organizations and development agencies to offer “a standardized political support package that focuses on the technical and procedural aspects of an idealized democracy” is “unlikely to help” (OECD 2017, i). The Cameron Commission, one of the more high-level commissions to have considered the issue in recent years, notes the broader impact of the standardized and technical approach: “IMF Programmes have adopted essentially the same framework in all countries, whether they belong to the OECD or fragile low-income countries.” (Commission on State Fragility, Growth and Development 2018, p. 37). The report views this approach in fragile states to be “damaging,” (p. 38) noting that overambitious policies tend to undermine the accountability process, broadly speaking. The report calls for a major and public overhaul of the IMF approach.⁷ The challenges flagged in the IEO’s report, as well as the OECD’s and Cameron Commission’s reports, spurred the IMF to take further concrete steps to strengthen its country-specific engagement, of which the current discourse related to FCS is the natural follow-up.⁸

The Way Forward

The new IMF policy framework on corruption, notably the 2018 policy, in conjunction with the findings of the IEO’s report on fragile states (IEO 2018), has opened the door to broadening the IMF’s anticorruption approach, notably for fragile states. A broadened approach could involve a more outcome-driven engagement embedded in, and addressing, the specific country contexts that mark fragile states. A recent DFID assessment notes that the emphasis of international financial institutions on formal frameworks and institutions tends to be on process measures that skirt the key underlying issues and that carry the risk of the institutions being viewed as complicit with the authorities in adopting superficial responses and retaining the status quo (Mason 2020).

⁷ The Cameron Commission refers to the Commission on State Fragility, Growth and Development, chaired by former UK prime minister David Cameron. Its 2018 report is called *Escaping the Fragility Trap*. The commission flags the different nature of the IMF’s involvement in fragile states compared to many of its peer organizations because of its durable engagement, which tends to overambitious policy change. This dynamic is deemed to undermine “social learning” (p. 38). The commission calls for an IMF policy change that is “public; too painful to be interpreted as business-as-usual (i.e. a ‘signal’); linked to clear and monitored milestones; and enforced through annual scrutiny by the IMF Board” (p. 38).

⁸ Following the publication of IEO (2018), the IMF put in place a number of measures that broadly aim to strengthen country-specific engagement. These measures included the establishment of a permanent interdepartmental committee tasked with enhancing engagement in fragile countries by introducing country-specific strategies and strengthening capacity development, including its integration with surveillance. See IMF (2018a).

Implementational adaptation to country conditions, such as through sustained capacity development aimed at building on local networks, would bolster targeted responses and is vital to shaping reforms to fit into the actual organizational and institutional context. World Bank experts refer to “isomorphic mimicry,” which describes a setting in which countries will be willing to adopt so-called best-practice laws and institutions in order to access financial resources, yet these institutions will fail because the laws and institutions are disconnected with the country realities (Pritchett, Woolcock, and Andrews 2012). Isomorphic mimicry carries two risks: (1) an emphasis on the outward forms (institutions and laws), which camouflage a persistent lack of effective function; and (2) premature load-bearing, in which local learning, legitimacy of change, and support of key constituencies are undercut by high and unrealistic expectations for fledgling institutions, notably in fragile countries. This approach, therefore, is not just ineffectual but can end up becoming counterproductive (Khan, Andreoni, and Roy 2016).

The issue with isomorphic mimicry is not that countries are learning from the experience of others, as such, since countries tend to borrow from each other liberally. Instead, the challenge for countries in fragile states is to shift from trying to replicate foreign structures to working to establish essential functions in local conditions, in part by emulating key principles and practices that have been demonstrated to work in the past (Krause 2013). This approach might come closer to securing the elusive stabilizing and legitimizing effect called for by the *World Development Report 2011* (World Bank 2011), UN SDG 16, and IMF policies on fragile states (Johnson 2016).

CONSIDERATIONS ON HOW TO APPROACH CORRUPTION IN FRAGILE STATES

Within the overarching reform objective of building institutional resilience, rather than boosting economic growth, reports and studies broadly agree on the high-level principles of how state fragility should be addressed. These principles come down to four, with implications for how to help implement good-governance and anticorruption reforms:

- Improved understanding of the political economy (including through sustaining an in-country presence and conducting diagnostic and fragility assessments)
- Country ownership (including by strengthening leadership and institutional buy-in, tailoring engagements to capacity, and leveraging domestic knowledge and experience bases)
- Inclusive approach (including by broadening stakeholder participation in policymaking and institutions, by both civil society and private sector actors)
- Coordinated support by development partners.

Deeper Understanding of the Political Economy

The “deeper understanding of the political context” that IMF (2012 p. 13) reports refer to involves identifying and engaging with the “distribution of organizational power” (Khan 2017) in fragile states. This understanding calls for immersion in the existing national discourse by engaging with the key institutional and societal agents that inform it and shape its outcome. The reforms should also build on the knowledge and, notably, problem diagnostics or analyses within these countries. Reform in that sense is not top down and institution-driven, but bottom up through a more diagnostic-based, problem-oriented, and incremental process that builds on initiatives and engagement within countries and focuses on the priorities and objectives identified as a result of this engagement.

With an eye on building state legitimacy and institutional resilience, this bottom-up approach ideally should target anticorruption reform in ways that directly benefit society (Zoellick 2008). A careful balance should be struck between a focus on high-profile cases and widespread endemic corruption, which undermines public services and market access, notably in chronic and extremely fragile states. Focusing on high-profile cases typically will challenge dominant interests, will require the mobilization of large resources with very modest success rates, and will often be distant from the day-to-day lives of citizens. While sometimes such cases must be tackled, doing so can also be disruptive in building legitimacy and resilience, and thus the approach should be carefully calibrated, notably in extremely fragile states. Conversely, an approach that focuses on service delivery will aim to improve the daily lives of citizens and can have a legitimizing effect. As an example, outside of sub-Saharan Africa, in Georgia the anticorruption reforms that targeted the traffic police significantly enhanced the legitimacy of the authorities.

It is also important to strategize anticorruption approaches by assessing their distortive impact on an economy. Khan, Andreoni and Roy (2016) notes that the distortive effect on an economy of targeting high-value corruption transactions depends on the productivity of the underlying investment. If that productivity is not too adversely affected, the impact is limited, as is typical of profit-sharing corruption. On the other hand, modest bribes, such as those related to permits, can have a major distortive effect on the economy. The latter form of corruption is harder to capture in some PFM oversight instruments, such as audits, because the PFM triggers tend to be weak. An example of this is the impact of corruption on access to birth, marriage, and death certificates, where the need to make side payments to secure these documents has a profound impact on the economic opportunities for disadvantaged communities and reduces the impact of social programs. Another example is the granting of permits in the health sector—individual bureaucratic decisions that have a potentially wide-ranging effect on health and related topics.

Ownership and Inclusiveness

An inclusive approach is critical in shoring up state legitimacy and institutional resilience. Inclusiveness in this context covers the need for broader engagement of

competing interests and stakeholders, and the importance of bringing in civil society and market actors. It also translates into providing incentives that will accommodate key stakeholders.

Reforms should be tailored to balance aspirational and formal and legal objectives with the underlying incentives offered to key stakeholders. The objective should be to progressively build legitimacy and resilience, which is different from the elusive goal of establishing an idealized state setting. Ownership, therefore, should be understood as a substantive alignment of interests (Khan, Andreoni and Roy 2016). Inclusiveness also requires a form of institutional architecture that facilitates broadening stakeholder participation in procedures and institutions.

An example is the CEMAC directive on the budgetary process, which envisages the participation of both stakeholders and civil society, the importance of which is hard to overstate. Another example is CEMAC Directive 6/2011, *relative au Code de transparence et de bonne gouvernance dans la gestion des finances publiques*, which calls for the publication of, among other things, revenue from extractives, SOEs, and procurement, and for the participation of civil society and societal partners. This CEMAC directive has been enacted in some CEMAC countries, such as Cameroon, Chad, Gabon, and Republic of Congo, though implementation in some of these countries has been slow (Chapter 5). The EITI standards are similarly important in creating an architecture of transparency, not just internationally but domestically.

It is also important to envisage institutions as multistakeholder platforms, aiming to accommodate the often adversarial interests in fragile states. Institutions, then, are seen to serve as platforms to hash out matters in small forums, seek compromises, and build an institutional agenda and identity in the process.

This points toward more committee-based institutions (rather than single-head command structures) to prevent institutions being captured by a single dominant interest, which undermines institutional resilience and sustainability. This approach requires a trade-off between short-term functionality, on the one hand, and medium-term resilience and sustainability, on the other.

An example is the Indonesia Anti-Corruption Agency (ACA), whose committee structure was purposely aimed to create broad political ownership of the agency. In fact, under this structure, competing stakeholders (such as CSO representatives and senior police officers) became commissioners and their respective constituencies became co-owners of the agency. This ensured that for a long time important competing interests owned a share in the agency, and while criticized, none were radically opposed. The committee structure prevented partisan capture and created institutional space, as the ACA fought out battles on competing interests internally. That structure helped enhance ACA sustainability and resilience, as it continued to exist and operate effectively beyond the five-year period initially envisaged in the face of sometimes significant challenges.

In aiming for an inclusive approach, it is tempting to focus on process measures that are broadly uncontested (such as compliance with UNCAC, which calls for setting up an anticorruption agency), rather than focusing on outcomes

(limiting corruption in procurement). The emphasis on criminalization and anti-corruption agencies can be somewhat removed from the actual problematic faced by citizens in their daily lives.

In most countries the number of corruption cases that can be investigated and prosecuted is limited, and the overall impact of such criminal enforcement of corruption on an economy remains tentative. Khan, Andreoni and Roy (2016) therefore advocate complementary engagements. Their more problem-oriented approach focuses on specific corruption types (for example, corruption in the central bank, the budgetary process, SOEs, fiscal systems, procurement, or extractive industries) and seeks to address them through targeted structural measures.

This approach is reflected in the constructive efforts to address corruption in strategic transactions in Somalia. While corruption remains a critical issue for the country, substantial progress has been made in increasing oversight and monitoring of high-value state contracting under the auspices of the Financial Governance Committee, a transitional structure bringing together representatives from the government of Somalia and officials from the IMF, World Bank, AfDB, and key bilateral donors, mostly in an advisory capacity (World Bank 2019). The work of the committee proved to be instrumental in stopping and forcing the retendering of the largest procurement contract in the country, with substantial savings to the country and enhanced civilian control over expenditures by the military (Davis, Farley, and Handley 2020).

International Agencies

International agencies play a critical role in addressing countries' fragility, notably when chronic or extreme. Several considerations are significant in this regard:

- *The importance of being there:* This refers to the broader concept of building understanding and relationships, which is best achieved through physical presence in the country. This would seem to be a necessary precondition to an institutional policy that calls for “a deeper understanding of the political context” (IMF 2012, p. 13). The absence of some international agencies in some fragile states has been noted and would seem to make achieving the objective of those policies harder (Manuel 2017). Several factors impact on the country presence of IFIs, including their mandates, some of which by their nature will necessitate significantly more local program engagement. IMF engagement in fragile states has been extensive, including through technical assistance (IMF 2018b).
- *The importance of multidimensional rather than single-issue engagement, tailoring, and sequencing:* One of the challenges for international financial institutions and development agencies is the tendency toward single-issue engagement, such as an exclusive focus on the passage of an anticorruption law or the creation of an anticorruption agency. It is important for external partners to support a more joined-up engagement, given the multidimensional challenges of state fragility.

The policy advice should be tailored to the sociopolitical constraints faced by the authorities and should recognize that efforts to strengthen accountability have the potential to place extraordinary stress on the political accommodations and social negotiations that have established peace. This tailoring of structural reforms to the fragile context should be adjusted to reflect capacity. This calls for prioritizing reforms, factoring in capacity constraints, and managing implementation expectations. Similarly, the need for a sequenced approach that recognizes the capacity constraints, and is more prioritized, staggered, and paced, is a recurrent theme in the literature on engagement in fragile states. The development of diagnostic tools and fragility assessments should assist in achieving a good pacing of reforms, though country studies show the challenges international partners experience in addressing that issue.

- *The importance of mixed instruments, including broad-based capacity development, targeting outcomes:* One of the challenges for international financial institutions is how to implement the different instruments at their disposal to help countries exit fragility. These instruments typically are surveillance, financial programs and projects (which come with conditionality), and capacity development. A sustained engagement based on a “deeper understanding of the political context” typically calls for significantly enhanced and sustained engagement within these countries, with surveillance and program support pushing that capacity development program along, rather than the reverse.

The process-oriented nature of most anticorruption measures, such as developing a plan (an anticorruption strategy, for example), passing a law (UNCAC compliance legislation, for example), or setting up an institution (an anticorruption agency, for example), typically do not address the underlying problems. International partners should be more outcome-based, with a stronger focus on the contribution of anticorruption activities to achieving better public sector performance. The corollary is that less emphasis should be placed in fragile states on stand-alone anticorruption achievements (such as the number of individuals sanctioned for corruption or improved public perception of the incidence of corruption).

- *The importance of local partners and triangulation and coordination:* While the government is and will remain the key counterpart of international financial institutions and development partners, a more engaged approach in fragile settings calls for broadening of the engagement. This includes routine visits and direct engagement with oversight and control institutions, such as supreme audit institutions, anticorruption agencies, and enforcement agencies, to underscore the importance international financial institutions and development partners attach to these institutions, and the empowering function such visits and engagement can have. That engagement also ideally should build on reports such agencies have developed. Other societal local partners, such as professional organizations and CSOs, should be engaged to address anticorruption. In some countries religious organizations can play an important development role and should be engaged.

While development partner coordination is often mentioned in reports and documents, the precise nature of that coordination often is left vague and undefined. It helps to flesh this out when considering the engagement on anticorruption measures in fragile states. This principle carries important implications for the need to establish priorities shared across domestic and international partners. It likewise requires commitment to a pathway to improved governance and forsakes the mirage of transformational magical governance solutions that have underpinned and undermined countless reform efforts in fragile contexts. The challenges are significant and call for a coordinated approach that uses all of the scarce resources available to achieve concrete outcomes. These outcomes can serve as platforms for further reform and rallying points for expanding reform constituencies.

CONCLUSION

The prospects of fragile states are sobering. Even before the COVID-19 pandemic, the figures pointed at a trend of general and significant slippage, of which the OECD commented, “poverty reduction is not off-track, it is in reverse” (Welsh 2020). The slippage on achieving the SDG on hunger, health, and gender equality is across the board, with the separation between the 13 extremely fragile states relative to other states widening even more. On United Nations SDG 16 (which promotes peace, justice, and strong institutions), progress has stagnated or declined in 12 of the 13 countries of extreme fragility, as it did for a significant majority of other fragile states (OECD 2020a). The COVID-19 crisis is projected to aggravate significantly this situation. These trends occurred despite bilateral official development assistance to fragile states having increased every year since 2014 and having reached unprecedented levels as the pandemic hit (\$76 billion in 2018). In extremely fragile states this ODA significantly exceeded FDI and remittances (OECD 2021). These worsening conditions generated a call “to do things differently” (Commission on State Fragility, Growth and Development 2018, p. 5).

This chapter explored the role of corruption in state fragility, notably in sub-Saharan Africa. It set out how corruption is a key component of state fragility and discussed the extensive and locally driven history of anticorruption efforts in many of the countries in the region. It considered the approach taken to address the issue by the IMF, with a focus on the evolution of the IMF’s policy framework due to its accumulation of experience dealing with corruption and its insight into the dynamics of corruption drawn from salient cases from the field. Review of lending programs demonstrates the continuing challenge of establishing operational conditions that are fully aligned with new analytical models and policies. Previous anticorruption interventions in fragile states heavily relied upon an approach featuring the adoption of best-practice legal and organization models to maximize access to international markets. Better results may be achieved in fragile contexts by linking work on anticorruption more closely with sustained efforts to

develop resilient institutions that are fit for function through an engagement that builds upon the existing political, organizational, and social context.

The final section offered suggestions on the way forward, including the need for more local knowledge (a deeper understanding of the political economy); a greater role of local ownership in an approach that is more embedded in country contexts; and a different engagement of international institutions, including through a more sustained in-country presence and engagement, an engagement that is more multidimensional (rather than single issue) and tailored and sequenced to country conditions and capacity. The chapter closed by discussing the benefits of a closer integration of capacity development with other institutional instruments (surveillance and lending), by arguing for a more outcome-based approach, and finally, by stressing the importance of a more intensive triangulation, in which the role of market and societal partners is given added weight next to government agencies as the traditional counterparts.

ANNEX 7.1. FRAGILE STATES AND GOVERNANCE AND CORRUPTION INDICES—

Annex Box 7.1.1 Fragile State Indices 2020–2021

The World Bank, the IMF, and the OECD provide the following definitions of fragile states:

World Bank: The World Bank Index defines fragile states as follows:

Those with one or more of the following: (a) the weakest institutional and policy environment, based on a revised, harmonized CPIA score for IDA countries (for which CPIA scores are disclosed) that is below 3.0; or (b) the presence of a UN peacekeeping operation because this reflects a decision by the international community that a significant investment is needed to maintain peace and stability there; or (c) flight across borders of 2,000 or more per 100,000 population, who are internationally regarded as refugees in need of international protection, as this signals a major political or security crisis; and

Those that are not in medium- or high-intensity conflict, as such countries have gone beyond fragility.

IMF: The IMF defines fragile states (FS) as having either weak institutional capacity measured by the World Bank CPIA score (average of 3.2 or lower) or experience of conflict (signaled by presence of a peace-keeping or peace-building operation in the most recent three-year period).

OECD: The OECD defines fragility “as the combination of exposure to risk and insufficient coping capacity of the state, systems and/or communities to manage, absorb or mitigate those risks. Fragility can lead to negative outcomes including violence, poverty, inequality, displacement, and environmental and political degradation. Fragility is measured on a spectrum of intensity and

expressed in different ways across the economic, environmental, political, security and societal dimensions, with a sixth dimension (human capital) forthcoming in States of Fragility 2022. Each dimension is represented by 8–12 indicators—44 in total across all 5 dimensions—that measure risks and coping capacities to fragility” (OECD 2020a).

In addition, the OECD offers the following definitions:

Extreme fragility: In its 2021 report, the OECD qualifies the 13 worst performing countries as “extremely fragile” (OECD 2020a, p. 24).

Chronic fragility: In its 2018 report, the OECD qualifies 27 countries as chronically fragile. Chronic fragility refers to countries that have consistently been listed in the biannual OECD reports since 2008 (OECD 2018, p. 26, box 1).

Almost all countries that are extremely fragile are also chronically fragile, with the exception of South Sudan (which did not exist as an independent state in 2008) and the Republic of Congo.

ANNEX TABLE 7.1.1.

Fragile State Indices			
World Bank FCS 2021 (37 countries; grouped, unranked)	IMF 2021 (42 countries; ungrouped, unranked)	OECD States of Fragility 2020 (57 countries; ungrouped, ranked)	OECD States of Fragility 2018 (Ungrouped, unranked)
High-Intensity Conflict	African Department	Extreme Fragility	Chronic Fragility
Afghanistan	Burundi	Yemen	Afghanistan
Central African Republic	Central African Republic	South Sudan	Burundi
Libya	Chad	Somalia	Cameroon
Somalia	Comoros	Central African Republic	Central African Republic
South Sudan	Congo, Republic of	Congo, Democratic Republic of the	Chad
Syrian Arab Republic	Congo, Democratic Republic of the	Syrian Arab Republic	Comoros
Yemen	Côte d'Ivoire	Chad	Congo, Democratic Republic of the
Medium-Intensity Conflict	Eritrea	Afghanistan	Democratic People's Republic of Korea
Burkina Faso	Gambia, The	Haiti	Eritrea
Burundi	Guinea	Burundi	Ethiopia
Cameroon	Guinea-Bissau	Iraq	Guinea-Bissau
Congo, Democratic Republic of the	Liberia	Sudan	Haiti
Iraq	Madagascar	Congo, Republic of	Iraq
Mali	Malawi	Other Fragile States	Kenya
Niger	Mali	Mali	Liberia
Nigeria	São Tomé and Príncipe	Venezuela	Myanmar
Sudan	Sierra Leone	Zimbabwe	Niger

High Institutional and Social Fragility	South Sudan	Equatorial Guinea	Nigeria
Chad	Togo	Libya	Pakistan
Congo, Republic of	Zimbabwe	Cameroon	Sierra Leone
Eritrea	APD	Uganda	Solomon Islands
Gambia, The	Kiribati	Democratic People's Republic of Korea	Somalia
Guinea-Bissau	Maldives	Pakistan	Sudan
Haiti	Marshall Islands	Eritrea	Timor-Leste
Kosovo	Micronesia	Nigeria	Uganda
Lebanon	Myanmar	Mozambique	Yemen
Liberia	Papua New Guinea	Madagascar	Zimbabwe
Myanmar	Solomon Islands	Kenya	
Papua New Guinea	Timor-Leste	Ethiopia	
Venezuela	Tuvalu	Guinea-Bissau	
Zimbabwe	European Department	Guinea	
West Bank and Gaza	Kosovo	Bangladesh	
Small States	MCD	Papua New Guinea	
Comoros	Afghanistan	Mauritania	
Kiribati	Djibouti	Honduras	
Marshall Islands	Iraq	Liberia	
Micronesia	Lebanon	West Bank and Gaza	
Solomon Islands	Libya	Nicaragua	
Timor-Leste	Somalia	Guatemala	
Tuvalu	Sudan	Zambia	
	Syria	Comoros	
	Tajikistan	Niger	
	West Bank and Gaza	Tajikistan	
	Yemen	Sierra Leone	
		Lao People's Democratic Republic	
		Angola	
		Burkina Faso	
		Eswatini	
		Lesotho	
		Togo	
		Tanzania	
		Myanmar	
		Côte d'Ivoire	
		Solomon Islands	
		Iran	
		Djibouti	
		Cambodia	
		Gambia, The	

Sources: Compiled by authors from World Bank (FY21), IMF (2019), and OECD (2020) lists of fragile countries.

Note: "Grouped" refers to an index grouping countries according to certain shared characteristics (for example, conflict, small states), without ranking them. "Ranked" refers to an index ranking countries in terms of severity of the problem. The World Bank FCS 2021 index groups but does not rank. The IMF neither groups nor ranks. The OECD 2020 index does not group but ranks based on severity. The OECD 2018 index on chronic fragility is neither grouped nor ranked.

ANNEX BOX 7.1.2. CORRUPTION INDICES 2020–2021¹

These indices cover the 30 countries with the worst scores on corruption and the rule of law in the WGI and the CPI 2021. These show that all these countries are fragile states, with extremely fragile states clustered near the end.

ANNEX TABLE 7.1.2.

Corruption Indices		
World Governance Indicators Control of Corruption (Ranked)	World Governance Indicators Rule of Law (Ranked)	Corruption Perception Index 2021 (Ranked)
South Sudan	Somalia	South Sudan
Equatorial Guinea	Venezuela	Somalia
Somalia	Syria	Syria
Syria	South Sudan	Yemen
Yemen	Libya	Venezuela
Libya	Congo, Democratic Republic of the	Sudan
Korea, Democratic People's Republic of	Yemen	Equatorial Guinea
Congo, Democratic Republic of the	Central African Republic	Libya
Turkmenistan	Iraq	Korea, Democratic People's Republic of
Venezuela	Afghanistan	Haiti
Burundi	Korea, Democratic People's Republic of	Congo, Democratic Republic of the
Guinea-Bissau	Eritrea	Turkmenistan
Chad	Burundi	Guinea-Bissau
Congo, Republic of	Equatorial Guinea	Congo, Republic of
Afghanistan	Turkmenistan	Afghanistan
Eritrea	Chad	Burundi
Sudan	Guinea-Bissau	Iraq
Haiti	Zimbabwe	Eritrea
Iraq	Tajikistan	Comoros
Tajikistan	Guinea	Chad
Cambodia	Nicaragua	Cambodia
Zimbabwe	Congo, Republic of	Nicaragua
Central African Republic	Sudan	Zimbabwe
Cameroon	Bolivia	Honduras
Uganda	Cameroon	Tajikistan
Lebanon	Timor-Leste	Nigeria
Nicaragua	Comoros	Mozambique
Nigeria	Myanmar	Madagascar
Lao People's Democratic Republic	Angola	Lebanon

Sources: Transparency International, Corruption Perception Index, <https://www.transparency.org/en/cpi/2020/index/nzl>; and World Bank, World Governance Indicators, <https://info.worldbank.org/governance/wgi/Home/Reports>.

¹ The CPIA has not been included because it is very selective in the country coverage and does not cover those countries routinely.

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Reaping the Benefits of Good Governance in the Democratic Republic of Congo¹

Nicholas Staines and Mauricio Villafuerte

ABSTRACT

Concerns about weak governance and corruption have been a recurrent theme in the Democratic Republic of Congo (DRC), with adverse implications for inclusive growth and development. Centralized corruption in the DRC is well documented, but survey indicators also point to widespread decentralized corruption. The deficiencies have their roots in the country's political economy, and any fundamental resolution needs to be addressed at that level, including through extensive participation by civil society. The IMF's engagement plays a supporting role, with a narrower scope relating to economic governance in the core areas connected to its mandate and expertise. It focuses on several of the state functions that are most relevant to economic activity and where there is scope to strengthen governance and constrain corruption. Tackling deficiencies in those areas would go a long way towards addressing the DRC's broader challenges in economic governance and corruption, with positive spillovers to the economy.

BACKGROUND

The DRC is a large, resource-rich country of some 80 million people, with a history that is a paean to its people's resilience. It was taken over in 1885 as a corporate state and privately controlled by the Belgian monarch until put under the administration of the Belgian state in 1908. It became independent in 1960 and was ruled by Joseph Mobutu shortly after. Mobutu was overthrown by rebel forces that were backed by Rwanda in 1996 and replaced by Laurent Kabila in 1997. A multisided civil war that began in mid-1998 embroiled much of the region until hostilities ended in mid-2002. A formal peace agreement was reached

¹ This chapter is based on two papers: (1) a draft working paper (Staines, forthcoming) that captures information available through early 2018; and (2) a Governance and Anti-Corruption Assessment report (IMF 2020) based on work undertaken in late 2019 and early 2020.

in mid-2003, though militia groups have continued to operate in parts of the country. Joseph Kabila, who became president after his father's assassination in 2001, won elections in 2006 and 2011. Presidential elections due to be held in 2016 were delayed until late 2018. The resulting election of Felix Tshisekedi as president was the DRC's first peaceful change of head of state since the country gained independence.

Concerns about governance and corruption have been a recurrent theme in the DRC, with implications for inclusive growth and development. Deficiencies in governance have likely undermined economic growth and, when there has been growth, diverted some of the ensuing benefits from the general population. Indeed, the country's growth record has been weak in absolute terms and compared to its peers: over the span of the past four decades, the country's output per capita has fallen by half when measured in purchasing power parity and even more, by four-fifths, when measured in US dollars. Output per capita in 2019 was less than half its level in 1980, while income levels in sub-Saharan Africa rose by about a third, pushing the country's ranking from among the highest in the region to among the lowest. Economic growth was more robust after the end of the civil conflict in the early 2000s, up until the onset of the commodity-price shock in 2015. Per capita growth averaged nearly 4 percent in the decade to 2015, driven by the post-conflict recovery and surging output in the extractive sector. However, this growth brought only modest benefits to the general population because of limited spillovers from the mining sector, high population growth, and, arguably, weak governance and corruption.

The long history of the DRC's generally deficient performance regarding governance and corruption could be attributed to several interrelated factors that revolve around its political economy:

- *Macroeconomic management:* Traditional practice gave customary chiefs considerable authority over communal resources, an authority that was accompanied by obligations to the public interest. However, state governance during the colonial period and after independence leaned² toward benefiting the few, which evolved into centralized predation. This, in turn, led to emergence of decentralized bureaucratic corruption, eroding civic mores and normalizing corruption.
- *Natural resources:* The country has an abundance of natural resources (rubber and timber in earlier years and, more recently, copper, cobalt, gold, oil, and precious metals) that is often associated with higher levels of corruption in developing countries (Leite and Weidmann 1999). The DRC's resource wealth has also fueled and financed conflict in the resource-rich eastern regions, and there are reports that state officials and neighboring governments are complicit in the illegal resource business and related conflicts (Collier and Hoeffler 1998; 2000; 2002a; 2002b; Collier, Hoeffler, and

² For a historical background, see Hochschild 2014; Pakenham 2015; Ponyo Mapon 2016a and 2016b; Van Reybrouck 2014.

Söderbom 2001; United Nations Security Council 2003, 2010; 2017; 2018). An OECD study and Transparency International's Perceptions of Foreign Bribery Report reveal that the resource industry is deeply implicated in the bribery of government officials in countries where the resources are exploited (OCED 2014; Transparency International 2011). And the Paradise Papers—a set of 13.4 million confidential electronic documents relating to offshore investments leaked and shared with the International Consortium of Investigative Journalists in 2017—exposed corruption by major foreign investors in the mining sector in the DRC.

- *Political fragility*: The political environment is very fractious; much of it is driven by regional political tensions, exacerbated by the disparity of resource endowments, and accompanied by repeated internal conflicts that started soon after independence. The fractious environment has made for a weak central authority, increasing pressures for corrupt payments and appointments to forge political alliances.
- *Communal pressures*: The affluence of earlier years has left a residue of high expectations of entitlement among the privileged in spite of a large decline in income levels. However, in the presence of chronic insecurity and widespread poverty, informal systems of social support (that is, through family, friends, churches, or other charitable organizations) have blossomed in lieu of a formal state-financed system. Those managing these informal systems face considerable pressures that expose them to corruption.

Centralized and decentralized forms of corruption have affected the DRC's development. Large-scale centralized diversion of public funds by some senior state officials has been a major issue in the DRC. Global experience suggests that when corruption is centralized to the benefit of a few central state actors, the channels and extent of corruption can conceivably be coordinated and managed to optimize the benefits to those actors, while containing the damage to the broader public interest. Natural resource rents are ideally suited to centralized corruption. Yet the form of corruption more commonly experienced by the public is the decentralized misuse of office by civil service employees to extract supplementary payment for public services (for example, in collecting taxes and fees). Once corruption is decentralized and proliferates, central coordination of rent extraction from decentralized sources is much less feasible. As in the tragedy of the commons, a multitude of individuals in the state bureaucracy seek to extract rents regardless of the adverse cumulative impact on the broader public interest. An important by-product of decentralized corruption in the DRC is that corruption has become widespread in the public sphere and has spread to the private sector, with large implications for competitiveness.

More positively, the legal and institutional framework for addressing weak governance and corruption is relatively comprehensive. The failings are more those of implementation, and there are positive signs. Substantial progress has been made in the transparency of natural resource: all mining and oil contracts signed since late 2019 have been published, as have over 100 earlier contracts,

including key contracts sought by NGOs. Similarly, the 2018 Central Bank Law introduces important steps to enhance the central bank's governance.

Addressing these governance challenges could give a significant boost to the DRC's economic development. There is ample evidence that poor governance and corruption reduce economic growth.³ The consensus results on the cost of governance imply that bringing the DRC's performance to the regional average of 2005–17 would conservatively have raised annual real per capita GDP growth in the non-resource sector by between 0.6 and 1 percent.

This chapter looks at the evolution and status of economic governance in the DRC. It first provides a broad overview of economic governance in the DRC until the elections and change of government at the end of 2018 with data then available. It then takes a closer look at areas of immediate macroeconomic significance based on information available at the end of 2019.

GAUGING GOVERNANCE AND CORRUPTION

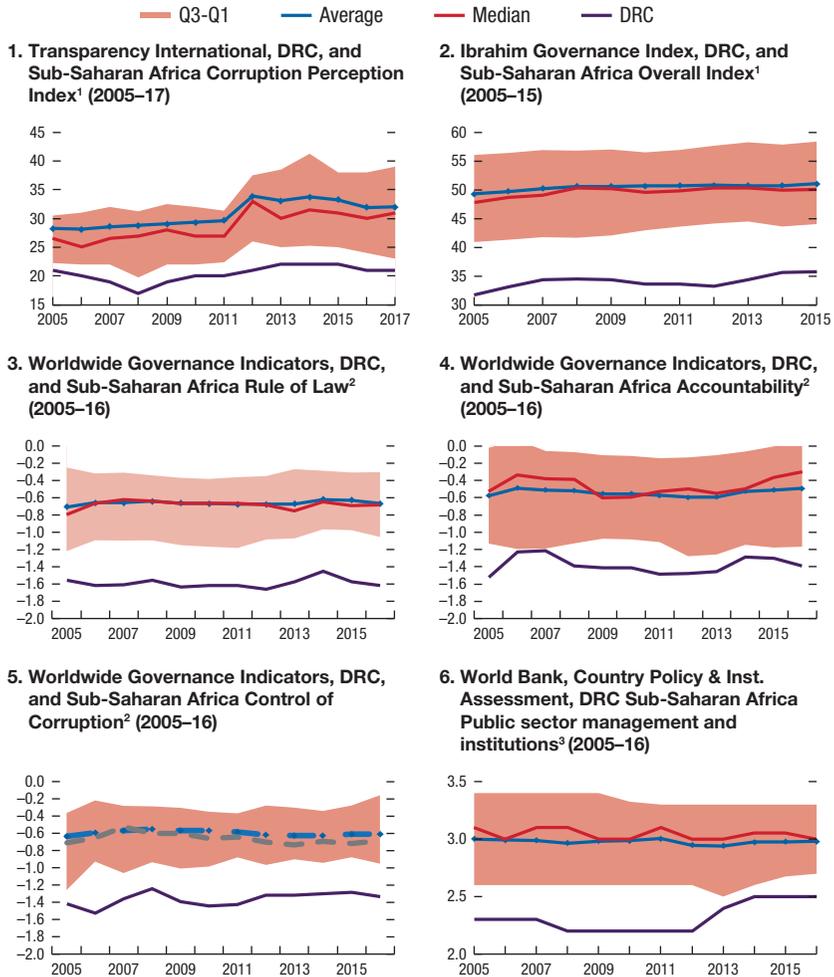
Third-party surveys would suggest weak governance and high corruption in the DRC.⁴ Indicators from various sources (for example, the Worldwide Governance Indicators, the Ibrahim Index of African Governance, the World Bank's Country Policy and Institutional Assessment Indicators, and Transparency International's Corruption Perception Index) show that the DRC typically scores well below the regional average (Figure 8.1). However, the DRC's scores appear in a better light when compared, perhaps more appropriately, to a narrower set of more similar peers: fragile states and nonoil, resource-rich, low-income countries in sub-Saharan Africa. This is pertinent since political fragility and natural resource endowments often appear to be entangled with weak governance and corruption.

Centralized corruption in the DRC is well documented, and survey data also suggest a worsening of decentralized corruption in recent years, up to 2018. Transparency International's Corruption Barometer looks more closely at the broader public's perception and experience of corruption, making it more suited to assessing decentralized bureaucratic corruption. The DRC stands out in that public perceptions of corruption are both high and have continued to increase over time: 80 percent of respondents in 2013 considered corruption a serious problem, and 66 percent thought it had increased in the preceding three years—both higher than the regional average. The 2019 Barometer survey reported that DRC saw an 85 percent increase in perceptions of corruption in the previous 12 months to early 2018—the highest in the region. The public sector is viewed as being notably more corrupt than the private sector, largely in the delivery of services, and the incidence of bribery in public institutions exceeded regional

³ See, for example, Ghura (2018); IMF (2018); and Ugur and Dasgupta (2011). For a summary of the evidence, see Chapters 1 and 2 of this volume.

⁴ Use of survey indicators should be considered carefully, as they are derived in part from perceptions-based data and there is uncertainty around any point estimates.

Figure 8.1. Selected Governance Indicators for the DRC and Sub-Saharan Africa, 2005–17



Sources: Ibrahim Index of African Governance; Transparency International Indicator; World Bank CPI; and Worldwide Governance Indicator.

Note: Use of these indicators should be considered carefully, as they are derived in part from perceptions-based data and there is uncertainty around any point estimate. All figures show data for DRC and the average, median, and interquartile range for SSA.

¹The score ranges from 0 (poor) to 100 (strong).

²The score ranges from –2.5 (poor) to +2.5 (strong).

³The score ranges from –3 (poor) to +3 (strong).

rates—the provision of medical services being one significant exception. There was also broad skepticism about the government’s effectiveness in tackling corruption and the ability of the public to make a difference.

Business surveys support the conclusion that decentralized corruption is an issue. The 2006 and 2013 World Bank Enterprise Surveys look at corruption from the business perspective from 2006 to 2013—the latest available survey (Table 8.1). Over this period, the proportion of businesses that identified corruption as a major concern rose from 20 to 58 percent, and those that saw it as the primary obstacle to business activity went from 1 percent to 12 percent. Similarly, the latest World Economic Forum Executive Opinion Survey available for the DRC (2017) found that 14 percent of firms viewed corruption as the primary obstacle. According to the World Bank survey, about half or more of businesses reported receiving a bribery request or having to pay a bribe to obtain a government contract, an import license, a construction permit, a water or electricity connection, or generally to get things done. These rates were again substantially higher than the regional average.

TABLE 8.1

World Bank Enterprise Survey: Corruption and Regulatory Environment in the Democratic Republic of Congo (DRC) and Sub-Saharan Africa (SSA) (Percent of firms responding)

	DRC			SSA
	2006	2010	2013	2013
Corruption				
Corruption as the Biggest Obstacle	1	2	12	8
Corruption as a Major Constraint	20	73	58	42
At Least One Bribe Payment Request	69	57	57	24
Public Transactions Where a Gift or Informal Payment was Requested	64	53	51	18
Expected to Gift Government Officials for Taxes, Licenses, and Permits	63	45	46	21
The Court System as the Biggest Obstacle	1	0	1	1
The Court System as a Major Constraint	11	33	33	19
Believing the Court System Is Fair, Impartial, and Uncorrupted	20		27	51
Regulatory				
Tax administration as the Biggest Obstacle	2	6	6	5
Tax Administration as a Major Constraint	40	57	38	30
Business Licensing and Permits as the Biggest Obstacle	2	0	0	2
Business Licensing and Permits as a Major Constraint	23	32	23	18
Customs and Trade Regulations as the Biggest Obstacle	2	3	4	5
Practices of the Informal Sector as the Biggest Obstacle	8	9	12	12

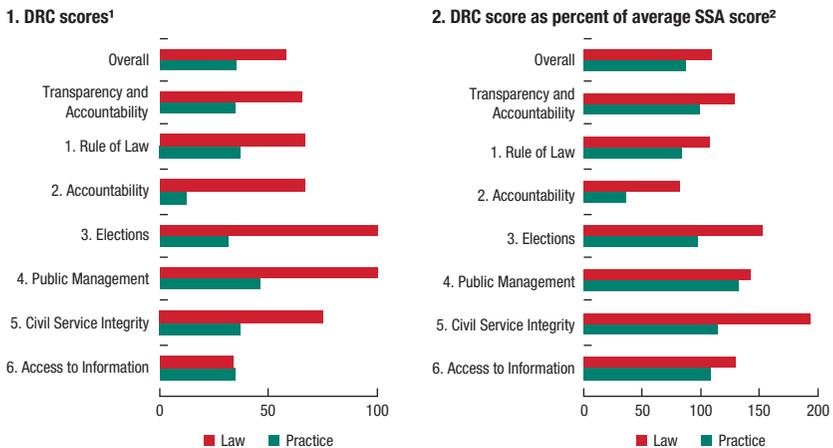
Source: World Bank Enterprise Survey, 2006, 2013.

Note: Use of perceptions-based data should be considered carefully, as results can be affected by respondents’ biases.

An important aspect for gauging governance is the gap between the legal framework and practice—and the DRC falls short on implementation. The Global Integrity Indicators, in their 2017 report, provide some insight as they

differentiate between these aspects, covering all 54 countries in Africa and drawing on evidence-based expert assessment (Figure 8.2). While the DRC is rated even more highly than the regional average, the indicators also reveal a sharp disconnect between the legal framework and practice for both the DRC and for the region, with implementation falling short. The DRC tends to score better than its peers on its legal framework, especially in relation to elections and public management (full score) and civil service integrity (almost twice the score compared to peers). But the DRC also tends to underperform its peers on enforcement, especially on accountability. Indeed, the overall gap between legal framework and practice in the DRC is double the regional average and is particularly large in the areas of accountability, elections, and civil service integrity.

Figure 8.2. DRC and SSA: Global Integrity Indicators
(Law versus practice)



Source: Global Integrity Indicators, 2017 and authors' estimates.

Note: The Global Integrity Indicators gives scores based on expert responses to 114 questions that are divided into 6 main categories, but does not provide scores for each category. The category scores are obtained as the average of the individual scores. Use of these indicators should be considered carefully, as they are derived in part from perceptions-based data and there is uncertainty around any point estimate.

¹ Score range from 0 (poor) to 100 (strong)

² The DRC score expressed as a percent of the average score for the sub-Saharan region

A CLOSER LOOK AT ECONOMIC GOVERNANCE AND ANTICORRUPTION EFFORTS IN THE DRC

Widespread corruption and challenging governance outcomes in the DRC have their roots in the country's political economy, and any fundamental resolution needs to be addressed at that level, including through extensive participation by the civil society. The IMF's engagement plays a supporting role, with a narrower

scope relating to economic governance in the core areas connected to its mandate and expertise.

This section describes governance shortfalls and vulnerabilities to corruption in specific economic areas in the DRC. The analysis follows the IMF's new framework for enhanced engagement on governance and corruption issues. It focuses on several of the state functions that are most relevant to economic activity and where there is scope to strengthen governance and reduce corruption: public financial management, the tax system and revenue administration, natural resource management, central bank governance and operations, financial sector supervision, the rule of law, market regulations, and anticorruption.

Public Financial Management

Weaknesses in public financial management in the DRC are mainly due to lack of implementation of established procedures. Budget execution is undermined by a lack of respect for the expenditure chain process, whose purpose is to control spending and make it secure, and the wide use of emergency spending procedures. The expenditure chain procedure consists of four phases: the first two (commitment and liquidation) are currently under the authority of sectoral ministries, while the last two (authorization and payment) are the responsibility of the Ministry of Finance and of the central bank (as the state's cash office), respectively. However, the share of expenditure executed according to the standard procedures in 2018 was only 1 percent of noncompensation expenditures, while execution under emergency procedures became preponderant that year. In addition, a significant part of bank disbursements takes the form of transfers of funds to natural or legal persons responsible for the final expenditure stage, as there is not yet a properly structured network of treasurers and accountants. This presents a significant risk for fraud.

The lack of budget credibility fosters a reliance on nonstandard budget execution procedures. Budget revenue and expenditure projections tend to be unrealistically optimistic, so that budget execution bears little relation to the approved budget. Unrealistic revenue projections appear to be less a result of capacity constraints than of political pressures to accommodate higher spending. The government is then forced to compress spending well below budget allocations, thereby eroding expenditure management, as it permits itself to change the composition of budget spending without formal parliamentary approval. Therefore, the lack of budget credibility undermines the oversight role of Parliament and makes room for the discretionary allocation of public resources. In addition, the large gap between budget projections and outcomes negatively affects the government's capacity to formulate sound and predictable macroeconomic policies.

Government procurement procedures, particularly for capital investment projects, are particularly vulnerable to corruption. The legal and institutional framework has been in place since 2010 and set competitive bidding as the general principle for procurement. However, the practice is very far from principle. In fact, the use of noncompetitive procedures (private agreements, direct

agreements, or mere consultation with suppliers) became the rule in 2018, with just 14 percent of government contracts made through competitive bidding. This trend is mainly due to the diversity of state institutions (public establishments, funds, and public enterprises) and would explain the weak performance of public investment in the DRC. This contributes to the widespread sentiment of collusion between economic operators and public decision-makers.

Improving the quality and coverage of budgetary reports and financial statements and expanding the scope of audit institutions would help improve overall accountability in the management of public resources. General accounting is still prepared using a single-entry system, and budget execution reports cover only expenditures. As of 2019 there was no consolidation throughout the entire country and the public sector. The government reportedly publishes a budget summary, monthly updates on budget revenue and expenditure execution, and biweekly updates on treasury accounts and foreign exchange transactions. However, the final report on budget execution, published a year after the end of the fiscal year, is typically scant. The annual report by the supreme audit institution, the Court of Auditors (Cour des Comptes) is not published. The Court of Auditors is functionally independent, but its oversight is weak as it has no independent and proper budget. The Office of the Inspector General of Finance (IGF) should also play an important role in controlling public finances. It is part of the executive and has the authority to audit the executive accounts and to impose administrative sanctions. Its location under the aegis of the presidency affords the IGF more authority to tackle issues in the ministries, but still leaves it financially dependent and exposed to administrative pressures from the executive branch.

Expanding the scope of the treasury general account (TGA) at the central bank would improve treasury management. The present banking arrangement does not apply to considerable amounts of public resources, making the government more financially fragile. For instance, special accounts and funds with earmarked taxes (for example, the Road Fund and the Industrial Development Fund) and “budget annexes” (around 800 institutions, mostly in health and tertiary education, legally separate from the central government and that collect user fees and receive transfers from the budget to cover any deficit) are exempted from using the bank revenue circuit and the requirement of depositing into the TGA. Numerous transfers of funds to parties responsible for carrying out expenditures also take place outside the TGA. These exceptions have reduced the TGA coverage considerably. In December 2019 the TGA was the depository of only 28 percent of public liquidity. That means that two-thirds of government funds were managed outside the TGA in accounts in commercial banks, in the name of *de facto* managers, some of whom are not legally authorized to handle public funds. All of this stymies the ability of Parliament and civil society to play their oversight role and opens ample space for corruption.

Improving the oversight mechanisms for state-owned enterprises (SOEs) in the DRC could help reduce the risks for corruption. SOEs in the DRC operate in critically important sectors of the economy, including key utilities and the mining sector. SOEs tend to record large losses and remain a high source of fiscal

risks. According to the World Bank, total SOE losses in the DRC amounted to more than 8 percent of GDP in 2017. Large operational inefficiencies, weak management, and poor oversight explain these losses. A governance reform process was initiated in 2008, including to properly separate commercial from non-commercial enterprises. The state has centralized the management of public enterprises in the hands of the portfolio ministry and has created two consultative entities to conduct financial supervision and to implement public enterprise reforms. However, practice shows that reforms are largely determined by senior management without the involvement of their teams. In addition, the quality of financial information remains poor, disclosures are minimal and, overall, it is unclear which agency has the authority to demand reliable and timely financial data from public enterprises. In fact, conversion of SOEs into commercial entities has had the unintended consequence of shielding them from direct public scrutiny. This issue is particularly important in the mining sector (see the subsection “Resource Revenue Management,” later in this chapter).

Tax System and Revenue Administration

The Congolese tax system is marked by a large number of taxes and charges, creating significant incentives for corruption and abuse of power and harming the business environment. The standard taxes (VAT, income tax, excise duties, customs duties), while accounting for about 80 percent of the central government’s revenues, are fraught with discretionary (and even arbitrary) exemption regimes. In addition, sectoral ministries charge a plethora of nontax revenues managed by a specialized revenue agency, DGRAD. On top of that, there are levies charged by special accounts and funds, by hundreds of organizations in the budgetary annexes, by provinces, and by decentralized territorial entities. The absence of unified tax texts complicates things further, reducing transparency for economic agents. In fact, there is no proper general tax code, other than a collection of texts that currently includes only the main taxes of the state. This incredible complexity is partly due to the lack of credibility of the government’s budget, but also to decentralized rent-seeking behavior. Furthermore, failure to understand the nature of nontax revenue or the normal methods for financing public services leads to strong resistance to reform, since public entities and civil servants believe they are justified in requiring payment for all their interactions with the general public.

Automating currently largely manual processes and addressing distorted incentives would help reduce vulnerabilities to corruption in revenue administration agencies (DGI, DGDA, and DGRAD) (see Chapters 14 and 15). Laws, rules, and procedures have issues in terms of clarity and consistency, while the legal framework does not always provide for an appropriate balance between taxpayers’ rights and the powers of the revenue administration agencies. Despite some improvements at the customs administration, overall revenue administration processes and procedures remain largely manual, fostering direct interactions between agents and taxpayers. On the human resource management front, the

existence of remuneration bonuses linked to the issuance of sanctions and penalties and the lack of dissuasive sanctions on agents who act unethically discourage performance and can considerably increase the cost of taxpayers' compliance with tax obligations. The latter is compounded by the absence of a charter of rights and obligations for taxpayers, which exposes them to the discretionary powers of tax administration agents.

Resource Revenue Management

The Congolese conflict of 1997–2002 had a lingering impact on resource revenues accruing to the treasury. The mining sector was nationalized during Mobutu's government, and the main natural resource assets were largely held by SOEs, especially Gécamines for copper and cobalt. However, after years of mismanagement and then civil conflict, Gécamines' capacity to sustain mining operations was much diminished. During and in the immediate aftermath of the civil war, the government's needs were high, and the balance of bargaining power lay in the resource firms' favor. The government therefore sold valuable mineral concessions to private firms on favorable purchase and tax terms in exchange for upfront payments that underpriced the assets and that often reportedly failed to reach the treasury. After the civil war, the government sought to improve resource revenue management through the 2002 Mining Code. The code gave favorable fiscal terms to mining companies to attract investors to a high-risk and high-cost operating environment, with the expectation that it would be revised once the operating environment stabilized. While the 2002 code introduced a mining registry, tasked with allocating mining titles transparently, it also assigned mining rights attached to the public domain to SOEs.

A revised mining code, approved in 2018, was aimed at increasing what was then the low revenue yield to the treasury while maintaining the SOEs' monopoly on mining rights. In fact, as of 2019 Kamo-Kakula was the only major developed project not associated with any of the SOEs. The original intent of the revision was to increase the budget's revenue by raising tax rates and curtailing tax exemptions, but the 2018 revisions went much further. They raised royalty tax rates, with yet higher rates for minerals discretionarily declared to be strategic, introduced a super-profit tax, increased the required rate of participation by the state and Congolese private interests, and raised the obligatory portion of export receipts that must be repatriated (though with issues on their measurement). The revised code repudiated the stability clauses in the 2002 code that protected existing mining projects from changes to the fiscal regime for 10 years from the beginning of the project. The revised code also imposed a requirement—to pay part of the royalties directly to subnational governments—which raises questions about the lack of accountability frameworks within those subnational governments and the very limited transparency regarding the management of these resources—and allows the granting of operating exemptions in certain provinces.

Several initiatives have sought to increase transparency in the mining sector, though challenges remain. A 2012 government decree mandated the publication

of all mining contracts, but actual publication was lagging substantially until 2019. In fact, more than 100 mining and hydrocarbon contracts or related covenants were published between late 2019 and late 2020, including some key contracts identified by NGOs. The DRC also strengthened the transparency of its resource revenue management by joining the Extractive Industry Transparency Initiative (EITI) and published its first report in 2010 (for 2007) and has subsequently published reports for each year up to 2017, albeit with some delay. The EITI reports show only a minor divergence between payments made by the resource sector and the amounts received by the public sector, including the central government, provincial governments, and state enterprises, such as Gécamines, involved in the mining sector. However, the EITI only covers payments that are legally obligated by registered firms and does not, for example, encompass payments made by resource sector firms that are not yet registered or payments transiting outside formal channels. A requirement to disclose beneficial ownership interests in the sector is contained in the 2018 code, but an implementing decree to be drafted by the EITI will have to define materiality, politically exposed persons (PEPs), and other important elements to concretely identify who the ultimate beneficiaries of these payments are.

Implementing EITI recommendations should enhance resource revenue management in the DRC. Despite its membership in the EITI, the DRC's resource management is still rated poorly by the Natural Resource Governance Indicators. In the 2017 assessment, the DRC generally ranks low (but not in all aspects) in the management of its resource sector compared to other countries in the region. On the legal aspects, the DRC is rated more highly than its peers in the mining sector on both the legal framework and on practice—but not in the oil and gas sector—but there is a large gap between the legal framework and its implementation. A key issue pertains to the oversight and control of SOEs. Currently, the boundaries of oversight and control of the Ministry of Portfolio do not include indirect participation of the state. This leaves out any contract that SOEs enter in with other partners. Consequently, the enforcement of the disclosure of their mining contracts is limited and audited financial statements of mining SOEs are rarely, if ever, published. Gécamines hires an external auditor but releases only the auditor opinion.

Central Bank Governance and Operations

Persistent fiscal dominance and recurrent monetary financing of the government's deficits have severely undermined the autonomy of the DRC's central bank, BCC. The BCC's claims on government of \$1.8 billion at the end of December 2018 (about 60 percent of total assets or 4 percent of GDP) are indicative of government pressures on it. The claims include unremunerated advances granted to the government in violation of prohibitions in the legal framework for the BCC, government securities that are remunerated below market rates, and past losses pending recognition and securitization by the government. Furthermore, the advances have been mostly the result of the processing of government

payments outside the budget's expenditure chain. Monetary financing has led to surges in inflation and exchange rate depreciation, seriously undermining achievement of the BCC's policy objectives. In 2019 some loans contracted by the government were guaranteed by the BCC's deposits in foreign currency held at domestic commercial banks, encumbering a portion of the foreign official reserves. BCC's interventions in the foreign exchange market are not fully transparent, and banks have complained that it has not always accepted the winning bid in the auction market. In a similar vein, there have been concerns about the consistent application of regulations for liquidity provision to banks.

Actual implementation of welcome reforms under the 2018 Central Bank Law should enhance the BCC's governance. The law provides for the autonomy of the BCC in executing its mandate of achieving price stability and strengthened governance arrangements, accountability, and financial transparency. Among other things, and in addition to stopping monetary financing, the BCC needs to (1) fully constitute its board according to the law to be able to make decisions and avoid legal uncertainty risks, (2) appoint a board audit committee and a management committee to improve institutional oversight and avoid the concentration of powers with the governor, and (3) adopt international financial reporting standards as the accounting framework.⁵ Financial independence and the ability to implement monetary policy should be facilitated by a regularization of outstanding credit to the government and remuneration of outstanding government advances.

Financial Sector Supervision

Banking sector supervision has been vulnerable to enforcement that is not sufficiently stringent or consistent, though some reforms are being implemented. As of 2019 the banking system had a relatively high level of nonperforming loans (21.1 percent of total gross loans in December 2019, IMF Country Report No. 21/168). Following the identification of financial sector supervision weaknesses by the IMF, as part of its assessments of the Basel Principle in 2013 and bank failures in 2016, the BCC has been strengthening its banking supervision, including through an extensive review of prudential regulations. A process to adopt risk-based monitoring has started, and methodological guidelines on on-site risks and off-site training on monitoring and evaluation processes are being developed. Regarding prudential regulations, standards on corporate governance, transactions with related parties, internal controls and risk management for banks are being adopted. A draft commercial banking law that would strengthen bank intervention and resolution practices is pending discussion by Parliament.

The AML/CFT regime presents significant deficiencies and, as of 2019, was not compliant with the 2012 FATF standards. The banking system in the DRC has experienced a significant loss of correspondent banking relations due to concerns about the transfer of funds from ill-gotten sources, funds used illicitly to

⁵ In particular, international financial reporting standards (IFRS) 9.

finance internationally sanctioned organizations, and deposits held by politically connected individuals facing international sanctions. The DRC is particularly exposed to money-laundering risks linked to the integration of proceeds from corruption generated by senior public officials into its financial system, often laundered domestically through the real estate sector and abroad as revealed by several cases involving prosecutorial actions initiated by foreign authorities. The country's financial intelligence unit (CENAREF) has received few suspicious transaction reports (STRs), with only one resulting in prosecution, which stands in stark contrast to the country's risk profile. The legal framework for AML/CFT does not sufficiently cover all financial institutions in the DRC.

The Rule of Law

The judiciary faces many governance problems and has limited resources, capacity, and independence. The Worldwide Governance Indicators rate the rule of law in the DRC well below its regional peers. Transparency International's Corruption Barometer and the World Bank Enterprise surveys also point to the judiciary as particularly vulnerable to corruption. Similarly, the World Economic Forum Competitiveness Index rates the DRC well on formal legal rights but highlights concerns about judicial independence. The judiciary is independent under the constitution and judges are supposed to be selected on merit. However, the judicial system is under-resourced, and underpaid judges are reportedly amenable to side payments. Moreover, the judiciary is subject to political pressure and interference from the executive. Weak governance in the judiciary has implications for economic activity. The Competitiveness Index raises concerns about the efficiency of the legal framework in settling disputes. Parties to civil and commercial disputes reportedly do everything in their power (negotiations, out-of-court settlements, and so on) to avoid bringing a case before the formal judicial process. The situation is further exacerbated by the fact that when official court decisions are made, few are published.

Reinforcing the justice system in the DRC should help tackle serious problems in the execution of commercial contracts and in registering real estate. Resolving contractual disputes is problematic in the DRC, and intimidation is reportedly rampant in commercial disputes. There is a perception that the justice system is fueled by corruption and can be manipulated. The process of registering real estate in the DRC is laborious and fraught with pitfalls. Expensive, time-consuming, and inefficient processes are among the main areas of concern. Newly issued land documents are kept only on paper, which increases the risk of losing or misplacing documents. Overall, the DRC has no reliable system to enforce property and contractual rights and resolve disputes

Market Regulation and Business Environment

The regulatory environment for business has improved recently, but continues to face many challenges. The DRC ranks low in the World Economic Forum Global Competitiveness Index, though there have been improvements over the last decade. In

recent years, the government has taken steps to liberalize the country's trade and investment regimes (for example, by introducing a single electronic registration system to consolidate different agencies involved in business creation—except for the tax agency—into one central point) and implemented the Organization for the Harmonization of Business Laws in Africa (OHADA) framework, which supersedes all contradictory provisions of national legislation dealing with the formation, incorporation, management, and dissolution of companies. Still, the private sector complains strongly about the impact of complex and costly tax and nontax systems, excessive discretionary application of regulations, and political interference on the business environment and competitiveness. These conditions are propitious for rent-seeking activities and corruption, leading to an unlevel playing field that favors businesses with political connections. Some critically important sectors (electricity, telecommunications) are stifled by malfunctioning regulatory agencies, either because a decree is missing or because regulators have not yet been appointed. Failing to quickly resolve the issues could create a serious drag on the economy and entrench the current monopolistic or oligopolistic structure of these industries.

Anticorruption Framework

A centralized and updated anticorruption framework, augmented by a number of key elements, could significantly improve the fight against corruption in the DRC. The DRC is a signatory to various international conventions on corruption (for example, the United Nations Convention against Corruption, UNCAC), but has not made progress in establishing a centralized and updated anticorruption strategy and enforcement framework. The current government has made the fight against corruption a priority. Law enforcement agencies are not able to investigate and prosecute public officials for corruption-related offenses, as they enjoy constitutional immunity from investigation. The asset declaration regime provided by Article 99 of the Constitution of the DRC has not been implemented. Although the Observatory for Monitoring Corruption and Professional Ethics (OSCEP) seeks to raise awareness of corruption, it has no investigative or enforcement powers and suffers from a general lack of resources. In this regard, the country does not have an independent anticorruption agency with the power to investigate corruption offenses and report to Parliament. The creation of such an agency is an obligation of the signatories of the UNCAC.

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Madagascar: Institution-Building in a Fragile State¹

Lars Engstrom

ABSTRACT

Madagascar's governance indicators weakened significantly during the five-year transitional period following the military coup in 2009. Governance indicators that generally were on par with middle-income countries in sub-Saharan Africa regressed to close to the average of fragile sub-Saharan African countries by 2013. After the return of constitutional order in 2014, the new government started to address governance weaknesses through the introduction of new laws and broad-based public financial management (PFM) reforms. Going forward, the priority is to ensure that the anti-corruption legislation meets international good practices, to implement existing laws and regulations fairly and effectively, and to sustain the momentum of PFM reform.²

INTRODUCTION

The evolution of Madagascar's institutions during the last twenty years can be divided into three distinct periods. Several ambitious institutional reforms were launched during the first period (2002–08). The second period (2009–13) was characterized by a rapid and generalized institutional decay following a military coup in early 2009. The third period (starting in 2014) began when a new democratically elected government assumed power and took steps to rebuild public institutions. While the reforms starting in 2014 stopped the general deterioration documented in responses to perception surveys, those responses have barely improved in recent years. A likely reason is that continued reforms and time are needed to rebuild credibility in public institutions, as trust in Madagascar's institutions has been lost.

Most of the theoretical literature, as well as case studies and micro evidence, suggests that poor governance and corruption severely impede economic

¹ The chapter is based on an analysis of governance in IMF (2017). The author is grateful for comments from Marshall Mills, Gabriel Leost, Dominique Fayad, and other colleagues at the IMF.

² The discussion in this chapter relies partly on survey-based perception indicators. Caution is needed when comparing these indicators across countries and over time. See Box 9.3 for further information.

performance.³ Corruption reduces social welfare by diverting resources for private gain; by weakening institutions, reducing government legitimacy, and increasing the risk of conflict; by eroding the business climate and lowering the quantity and quality of investment; and by sapping fiscal stability. Corruption weakens the state's capacity to raise revenue as well as its other core functions. Higher public spending is less likely to lead to better outcomes in countries with poor governance. Corruption reduces the efficiency of public spending, and higher spending will thus have limited positive effects in countries that are rated as very corrupt or as having a very ineffective bureaucracy.⁴ Based on an index measuring the perception of the control of corruption, IMF staff have estimated that if Madagascar could reduce corruption back to the level it had reached in 2005 (prior to the period of institutional decay), annual growth would, all else equal, be 0.5–0.8 percentage points higher, a significant amount of lost wealth when considering the compounding effect (IMF 2017).

In the following sections, this chapter gives a few reasons for the rapid institutional decay that started in 2009, summarizes the institutional reforms that have been implemented since 2014, and discusses the results of the reforms based on performance evaluations and perception surveys. The chapter also makes a few recommendations on reform priorities going forward.

2009–13: A COSTLY PERIOD OF INSTITUTIONAL DECAY

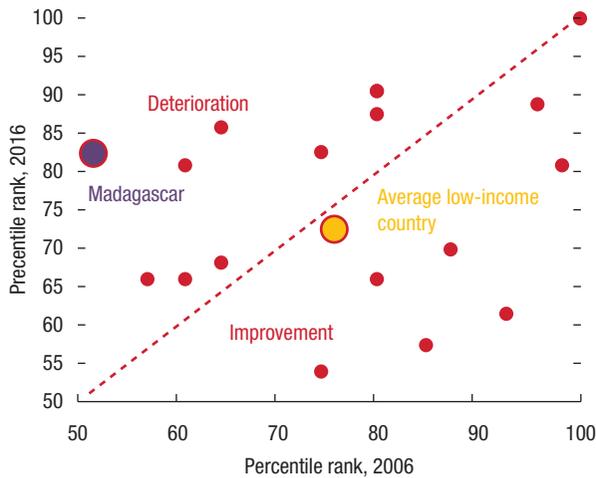
Prior to the military coup in 2009, many ambitious institutional reforms to improve governance had been launched. Madagascar signed the United Nations Convention against Corruption (UNCAC) in 2003; the independent anticorruption authority with investigative powers (Bureau Indépendant Anti-Corruption, BIANCO) was established in 2004; a special group of anticorruption prosecutors and judges (Chaîne Pénale Economique et Anti-Corruption, CPEAC) was also established in 2004; and the financial intelligence unit (SAMIFIN) was founded in 2008. In addition, the organic budget law adopted in 2004 was followed by a PFM reform package.

The years following the military coup in 2009 were characterized by generalized institutional decay, increasing corruption, and stalled momentum for reform. Notwithstanding the reforms launched after 2002, governance indicators that were on par with middle-income sub-Saharan African countries deteriorated and had approached the average of fragile sub-Saharan African countries by 2014. In terms of governance as measured by Transparency International, no sub-Saharan African country regressed more than Madagascar over 2006–16 (Figure 9.1). While governance improved slightly among low-income countries, Madagascar fell back on all aspects of governance (control of corruption, government

³ See Svensson (2005, chapters 1 and 2).

⁴ See Rajkumar and Swaroop (2008, chapters 1 and 2).

Figure 9.1. Low-Income Countries in Sub-Saharan Africa: Transparency International Corruption Index (2006 and 2016; higher = more corruption)



Source: Transparency International.

effectiveness, political stability, regulatory quality, rule of law, and voice and accountability).

What explained this rapid deterioration in governance? An interaction of several factors created a fertile ground for growing corruption:

- *Political culture:* Corruption has challenged Madagascar's political system for a long time. It is rarely a common program or ideology that unites party members. Instead, political parties depend on wealthy individuals who use the parties to maintain power through the distribution of favors (Box 9.1). Large-scale development projects have in the past been "white elephants in the service of grand corruption" (International Crisis Group 2010, p. 16). While Madagascar's economic system gradually changed from a centrally planned economy to a market economy starting in the 1990s, the political culture remained relatively constant, with a state that many perceive to be authoritarian and to favor a small group of people. It is thought-provoking that several events prior to Madagascar's 2009 crisis reinforced the perception that the state was not impartial (International Crisis Group 2010).
- *Lack of legitimacy:* The interim government that assumed power in 2009 dissolved Parliament and the Senate, ruled by decrees, and appointed the 22 heads of regions, who were normally directly elected. The interim government was never recognized by the international community.
- *Large informal economy:* Madagascar has a large informal economy with high usage of cash and limited financial deepening, which makes it more difficult to track and control corrupt transactions.

Box 9.1. Taxonomy of Corruption in Madagascar

Corruption, defined as the abuse of public office for private gains, is often divided into three main categories in Madagascar:

- *Petty corruption*: People perceive petty corruption to be a frequent feature in interactions with the administration, the police, the gendarmerie, and the judicial system. A large majority of the population believes that some civil servants are corrupt.¹ This form of corruption has always been present in the Malagasy context.
- *Grand (political) corruption*: The political system is based on patron-client relations and informal networks. Political parties serve as a tool to maintain influential individuals in power by using favors. Some politicians, in turn, misallocate public resources or create red tape to ensure that resources are transferred to specific individuals.
- *Trafficking*: Madagascar's weak central government and long and inadequately monitored coastline make it vulnerable to trafficking. The weakening of the rule of law created a fertile ground for illegal logging and trafficking in rare woods and smuggling in illegal mining, gemstones, and protected flora and fauna, such as turtles. There are also reports of men, women, and children who are subjected to trafficking and forced labor (US Department of State 2016).

¹ According to the Transparency International Database, 78 percent of the responders in Madagascar believed that some government officials are corrupt. <https://www.transparency.org/en/publications/gcb-africa-2019>

- *Lack of judicial independence*: The independence of Madagascar's anticorruption bodies has been undermined by the executive's control over them (Transparency International 2014). Allegations of widespread corruption and executive interference in the Malagasy judiciary, including CPEAC, have been common.⁵ The relatively independent anticorruption authority (BIANCO) with investigative powers was lacking a similarly independent court that could turn its investigations into effective prosecutions and convictions. The experience of anticorruption agencies (like BIANCO in Madagascar) is that they have not been very successful in most countries. Effective law enforcement requires a generally honest bureaucracy and judicial system (Voigt, Feld, and van Aaken 2008).
- *Weak and underfunded institutions*: Starting from a situation with limited fiscal resources, following the 2009 military coup Madagascar became subject to international sanctions, which further reduced available resources. Aid fell from about 35 percent of government finances in 2008 to about 15 percent in 2012. Civil servants and the general population looked for other means of subsistence, and corruption became more generalized. Also, (largely) development-partner-financed anticorruption agencies were

⁵ In May 2015 the Union of Malagasy Judges voiced concerns about arbitrary placements and transfers of judges without justification based on official criteria. All appeals were reported to have been systematically rejected by the Supreme Council of Magistrates (CSM), the entity that is charged with the appointment, transfer, and dismissal of judges and that is chaired by the president of the republic.

deprived of funding, and for several years the auditor-general (cour des comptes) did not receive the fiscal resources required to be effective.

Fiscal management faced significant challenges:

- Corruption weakened the state's capacity to raise revenue and discharge its other core functions. The culture of compliance was weakened, and tax evasion increased. While other fragile countries in sub-Saharan Africa had improved their tax and customs collections to about 13 percent of GDP by 2013, collections in Madagascar declined from 10.3 percent of GDP in 2008 to 8.0 percent of GDP in 2013. The level of development was not enough by itself to explain the low revenue collections. Other countries with a comparable GDP per capita had significantly higher tax revenue collections (IMF 2015).
- Weak revenues and waning aid flows forced sharp expenditure cuts, targeting public investment and social spending, but also goods and services. Additional budgetary pressures came from subsidized fuel prices, losses at the state-owned utility company (JIRAMA), and financial imbalances at the civil service pension fund. PEFA assessments based on data for 2008 and 2014 concluded that the general control and management of public expenditure had deteriorated.⁶ The government also accumulated a significant stock of budgetary arrears to domestic suppliers, and the central bank became undercapitalized because of financing of quasi-fiscal spending.

Weaknesses in governance also manifested themselves in other forms. Traffic in rosewood and precious stones, smuggling of rare and protected species, corruption among customs and tax officials, drug smuggling, and kidnapping were symptoms of more generalized corruption. Because of the weakening of institutions, activities such as money laundering through real estate purchases and trafficking in precious stones, to cite just two examples, were spreading and could not easily be punished by the legal system. At the same time, lack of information (for example, an inadequate property registry), imperfect tax and bank records, and limited international cooperation were obstructing the use of domestic and foreign information to tackle financial crime. Between 2004 and 2017, the courts only tried four cases of suspected money laundering, and this resulted in two convictions.

2014: THE RETURN OF CONSTITUTIONAL ORDER

The democratically elected government that assumed power in 2014 took the following steps to rebuild public institutions, strengthen governance, and fight corruption:

- A new initiative, the National Strategy to Fight Corruption, 2015–2025, was launched to put in place an effective rule of law by strengthening state capacities, sanctioning corruption, and reducing risks and opportunities for corruption (Republic of Madagascar 2015a). The strategy aimed to (1) strengthen anticorruption legislation, (2) increase the independence and

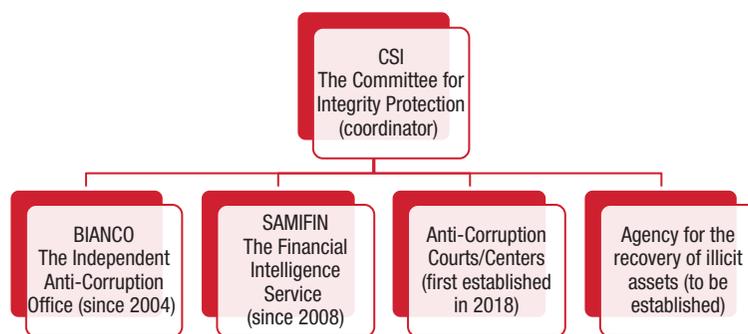
⁶ PEFA (2014) and PEFA (2018).

Box 9.2. Anticorruption Institutions and Legislation in Madagascar

New laws passed in recent years have strengthened the legal framework and established new institutions with the purpose of fighting corruption more effectively:

- The Anti-Corruption Law (2015) is essential for the prevention and detection of the laundering of the proceeds of corruption. The law makes modifications or adjustments to the mechanisms for preventing corruption, including a more specific definition of corrupt actions and a requirement for senior officials and politically exposed persons to declare their assets.
- The Law on Anti-Corruption Courts/Centers (2016) establishes specialized and independent tribunals. Evaluations had concluded that the existing court, the CPEAC lacked effectiveness and independence. The first anticorruption court was opened in Antananarivo in June 2018.
- The Law on International Cooperation (2017) ensures that anticorruption agencies can effectively participate in international cooperation.
- The Law on Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) (2018) requires that financial and nonfinancial institutions carry out customer due diligence and report suspicious activity. The law also establishes new administrative and criminal sanctions.
- The Law on Asset Recovery (2019) ensures that judicial authorities can freeze, seize, or confiscate illegally acquired assets.

Figure 9.2.1. Key Anticorruption Institutions



Source: Author's summary.

resources of the public anticorruption agencies, (3) develop an information system to track all legal anticorruption cases, and (4) improve the integrity of the judicial system. The new anticorruption legislation was intended to bring Madagascar closer to international standards, and several important laws have been passed in recent years (Box 9.2).

- In PFM, the new government put in place an immediate action plan limited to 21 priority actions, and many reform plans and strategies were prepared by all the sectoral ministries and directorates of the finance ministry. A list of PFM assessments during 2014–16 illustrates the needs (Table 9.1).

TABLE 9.1

Major PFM Assessments Conducted during 2014–16		
Name	Organization	Date
Public Expenditure and Financial Accountability (PEFA) Assessment	PEFA	2014
Debt Management Performance Assessment (DEMPA)	World Bank	2014
Elaboration of Medium-Term Expenditure Frameworks for Six Ministries	European Union	2014
Tax Administration Diagnostic Assessment Tool (TADAT)	World Bank, IMF	2015
Formulation of a Medium-Term Budget	IMF	2016
Public Investment Management Assessment (PIMA)	AFRITAC South, IMF, World Bank	2016
Evaluation of the Procurement System (MAPS)	African Development Bank, World Bank	2016
Institutional Audit of Control Bodies	European Union	2016
Data Quality Assessment	IMF	2016

Source: IMF (2018a).

The domestic tax administration was performing far below international best practice (Republic of Madagascar 2015b). Low tax collections were the result of noncompliance and tax exemptions. About 600 so-called free-zone companies were exonerated from payment of profit tax during their first five years and later paid a reduced profit tax of 10 percent. An indication of the size of these benefits is that the free-zone companies generated 9 percent of the turnover covered by Madagascar's large taxpayer unit in 2013, but their corresponding share of tax collections was 2 percent.

In addition, the tax and customs administrations developed medium-term strategies and action plans to improve their efficiency and effectiveness. Within the tax administration, the aim was to improve tax compliance and fight corruption more effectively by refocusing limited staff resources on real challenges and compliance risks. Key areas with revenue potential and measures to recover missing payments of tax and duties included (1) establishing systems to identify all taxpayers and determine their tax liabilities, (2) making the best use of modern technologies to ease payment of taxes, (3) making compliance as easy as possible through adequate taxpayer services, (4) estimating the potential tax base (and thus the amount of tax evasion), and (5) establishing an adequate penalty structure to deter tax evasion. To identify taxpayers, it is crucial to coordinate the databases used by different bodies (tax administration, customs, pension providers) and to make a complete annual reconciliation between, on the one hand, taxes paid, recovery of tax arrears, and new tax arrears, and on the other, inflows to the consolidated revenue fund.

Customs aimed to move from strictly transaction-based controls to greater use of post clearance audits (PCAs). Customs administrations that are focused on transaction-based controls often inspect a significant share of imported goods, and thus long delays at the border occur frequently and there is often room for corrupt practices to grow and flourish. For example, the customs in Madagascar's

main port, Toamasina, inspected about half of all containers that passed through the port in 2014. In comparison, PCAs use a more comprehensive and holistic evaluation (including checks of bank statements and contracts) for the calculation of duties and taxes to be paid. Goods are released upon arrival at the port, and clearance is completed and duties paid later after the PCA, which typically takes the form of periodic and cyclic audits, usually at the premises of the importer.

To improve spending efficiency, the authorities launched reforms to strengthen all aspects of budget and expenditure management. Such measures included improving the budget process, investment and debt management, transparency and efficiency of public procurement, cash management (including implementation of the treasury single account), improving the quality of reporting and statistics, and strengthening internal audit and inspection bodies. Measures to strengthen the budget process focused on (1) forecasting fiscal revenue and spending based on consistent macroeconomic projections, (2) adopting and presenting a clear budget strategy with a medium-term (three-year) perspective, (3) establishing transparent procedures with clear directives for collection of inputs from line ministries, and (4) presenting a timely and comprehensive budget to the legislative assembly as input for debate before approval.

The reforms aimed to make the Ministry of Finance the engine of change and to transform the ministry from just a manager of public funds to the leader of Madagascar's budgetary and financial strategy. The ministry would (1) take charge of the knowledge-sharing among line ministries and coordinate the reform process; (2) develop the capacity for budget analysis and results-based management, giving it a new and more strategic role in monitoring performance; and (3) ensure that the budget was consistent with the economic strategy of the government.

Public investment had fallen and was insufficient to support economic growth and reduce poverty. Public investment was crowded out during the transition period and amounted to only 2½ percent of GDP by 2013, with the result that the stock of public capital was deteriorating and the infrastructure deficit was growing. The estimated efficiency of public investment was also less than the efficiency of public investment for the average low-income country. In response, the new government elaborated a national development plan for the period 2015–19 and development partners pledged project funding amounting to about 50 percent of GDP in 2016. Ministries were instructed to program their spending over three years to ensure consistency between planned investment projects and their ministerial strategies and to start new investment projects only if full financing was available. A ceiling for indebtedness and loan guarantees was added to the budget law based on a regularly updated medium-term debt strategy. The authorities also established an organization (OCSIF) for coordinating and monitoring of both public and private investment projects and their financing. In addition, the authorities improved the framework for management of public-private partnerships (PPPs). A PPP unit attached to the ministry in charge of infrastructure became responsible for promoting PPPs and validating the technical studies carried out by line ministries (IMF 2019).

Weaknesses in public procurement had been exploited. While Madagascar had a strong legal framework for public procurement, numerous public contracts had been awarded without competitive bidding, and the public had limited access to procurement documents (Global Integrity 2016). A revised public procurement code issued in 2017 strengthened the principles of competition and transparency. The National Public Procurement Commission (CNM) was separated from the regulatory authority. The contracting authority became obliged to draw up a public procurement plan to be approved by CNM before the start of the fiscal year (with any subsequent modification or update of this plan to be allowed under specific conditions only). A new procedure with increased competition through more transparent publication of procurement information replaced the previous procedure, which had focused more on price comparisons. The mandate of staff responsible for public procurement was limited to three years.

The system for the control and audit of fiscal spending was in urgent need of repair. Control mechanisms had eroded and were close to nonexistent. The internal monitoring of actual service delivery was inadequate with, for example, no collection of performance data from primary schools or basic health centers during the transition period (2009–13). The budget review act covering spending in 2008 was transmitted to the auditor-general with a long delay in November 2013—four years and eleven months after the end of the year to be audited. At the end of 2013, the last budget review act examined by the parliament covered data on actual spending in 2006. The new government took actions to restore the control and monitoring system.

Reforms of the central bank aimed to increase its independence and reduce the risk that previous misconduct would be repeated. The government in place during the transition period had used the central bank to finance quasi-fiscal spending, and thereby eroded the central bank's governance and financial autonomy. The new government recapitalized the central bank by securitizing its claims on the central government. The new Central Bank Act adopted in 2016 strengthened the bank's independence, including by tightening limits on central bank lending to the government and mandating timely recapitalization in the event of new losses, and the central bank reinforced its audit oversight and control environment.

THE RESULTS (SO FAR)

The implementation of the National Strategy for the Fight against Corruption, which started in 2015, has improved the framework for the repression of corruption. New laws and decrees have been adopted, more transparency has reduced room for corrupt activities, and the general public is more aware of corruption challenges today.⁷ A civil society that is better organized and with somewhat

⁷ Several studies show a positive correlation between corruption and lack of public budget transparency (IMF 2016).

higher access to public financing has also enhanced the fight against corruption (UNDP 2020). Tax and customs revenue collections have improved.

That said, reforming public institutions is a complex and difficult task, and time is needed to reap the full benefits of these efforts. While the government has implemented broad-based measures, the visible results still seem limited. Notwithstanding new laws, the general public appears suspicious about the judicial system. Tax collections have increased but remain below the average of low-income countries and fragile states, and below Madagascar's estimated tax potential. Reforms do not seem to have had a strong positive impact on the delivery of public services and control of corruption so far. The COVID-19 pandemic has also created challenges. Despite the authorities' stated willingness to align their priorities to improved governance and the fight against corruption, the COVID-19 pandemic delayed the finalization and publication of the updated national anticorruption strategy and progress in reforms to public financial management.

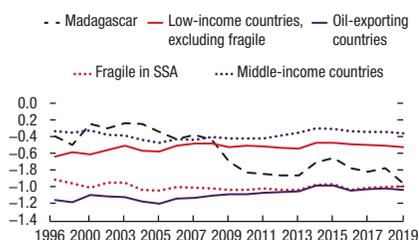
Rule of Law and the Judicial System

Perception data confirm lingering widespread distrust of the judicial system. The Worldwide Governance Indicator (WGI) on rule of law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Starting from a position typical of a sub-Saharan African middle-income country in 2008, Madagascar's score had fallen to slightly above that of a sub-Saharan African fragile country by 2013. While this was followed by some improvements for a few years, the score measuring the confidence in the rule of law has been decreasing again in recent years and reached a new low in 2019 (Figure 9.2). Likewise, the percentage of respondents who trust the courts of law had fallen from an already low 43 percent in 2005 to 29 percent by 2015. While data from 2018 indicated a slight improvement, Madagascar remained well below the sub-Saharan African average.

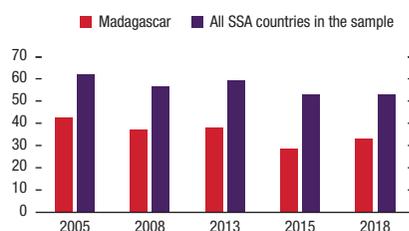
Figure 9.2. Sub-Saharan Africa: Indicators of Judicial Performance

1. Rule of Law

(Estimate; higher = better)



2. Trust in the Courts of Law (Percent of respondents who answered "a lot" or "somewhat")



Sources: Afrobarometer database; and Worldwide Governance Indicators.

Note: Based on a 95 percent confidence interval, Madagascar's score on rule of law was in the range of -0.73 to -1.18 in 2019.

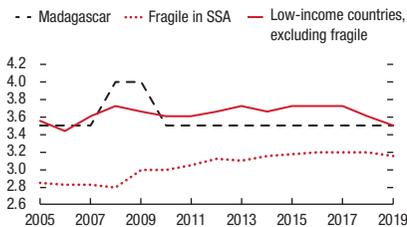
Some observers caution that the new anticorruption legislation ratified in recent years is being unraveled. While new anticorruption courts were expected to be established in all six provinces, only the courts in Antananarivo and Mahajanga were operational in 2020. A bill to reform the anticorruption courts is also under discussion. The National Assembly is proposing major revisions in the legislation, including barring the anticorruption courts from dealing with cases of economic and financial offences, and dismantling the provision that permits the freezing of assets before indictment in corruption cases. These revisions would be a major step back according to CSI.⁸

Revenue Mobilization

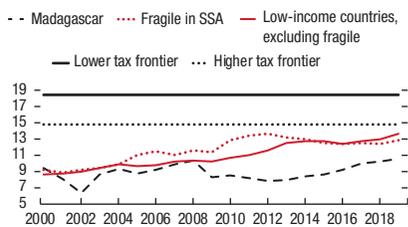
Madagascar's tax and customs revenue collections have increased in recent years. In 2018 the tax-to-GDP ratio was back to the level it had held in 2008, thereby reversing the revenue loss from the rapid drop in the ratio after 2008. Notwithstanding this recovery and tax and customs reforms, the tax potential remains largely unexploited based on evaluations of the tax and customs administration (IMF 2020b). Revenue collections are well below the average of other fragile and low-income countries in sub-Saharan Africa and the estimated tax frontier (Figure 9.3). Madagascar's revenue performance is also weak when controlling for background data on the level of corruption (the lower tax frontier) (IMF 2018b). In addition, the CPIA rating on the efficiency of revenue mobilization published by the World Bank has not improved in recent years.⁹ Against the background of the COVID-19 pandemic, the tax ratio is estimated to have fallen back to about 9 percent of GDP in 2020.

9.3. Sub-Saharan Africa: Indicators of Revenue Performance

1. Efficiency of Revenue Mobilization (Rating: 1 = low to 6 = high)



2. Tax and Customs Revenue Collections (Percent of GDP)



Sources: IMF (2018c, Annex Table 2.1.2); IMF, WEO database, October 2020; and World Bank Group, CPIA database.

⁸ Comité pour la Sauvegarde de l'Intégrité, "Loi Pole Anti-Corruption: Une question à approfondir," press release, July 5, 2020, <http://www.csi.gov.mg/loi-pole-anti-corruption-une-question-a-appfondir/>.

⁹ The CPIA rates countries against a set of 16 criteria. The criterion on the efficiency of revenue mobilization assesses the overall pattern of revenue mobilization—not only the de facto tax structure, but also revenue from all sources as actually collected.

Budgetary and Financial Management

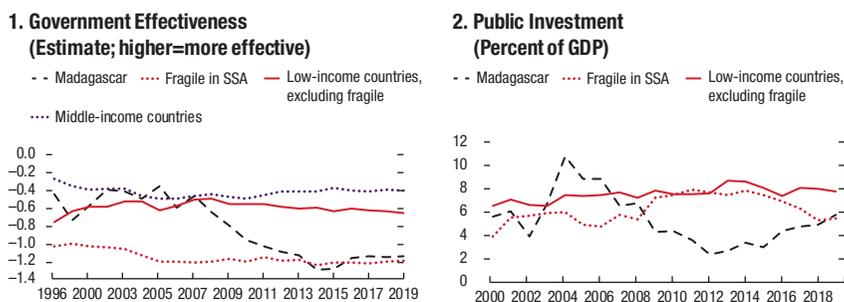
While some features of budgetary and financial management have improved, the impact on the delivery of public services remains less clear. Regular reporting procedures have been reestablished, but work remains to adapt the accounting standards to international norms. Transparency has improved, with better access to complete budget documentation and better access to and more transparent information on tax obligations, and debt management is more professional. Key remaining weaknesses include the supervision and control of public establishments and enterprises (and the budgetary risks from these entities are very high) and the role of the parliament. While the auditor-general is auditing the budget review acts, the recommendations are rarely implemented, and the parliamentary examination of the auditor-general's report could be improved.

The Worldwide Governance Indicator on government effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Starting from a position typical of a sub-Saharan African middle-income country in 2008, Madagascar's score had fallen to that of a sub-Saharan African fragile country by 2013 with only minor improvements in recent years (Figure 9.4). The World Bank's Country Policy and Institutional Assessment (CPIA) ratings on the quality of budgetary and financial management as well as public sector management and institutions reveal a similar pattern. These perceptions-based ratings are paralleled by the evolution of public investment—an indicator of public sector delivery—which has been slow to recover.

Control of Corruption

The public information on corruption has become more transparent in recent years. Quarterly statistics on corruption cases based on investigations made by BIANCO

Figure 9.4. Sub-Saharan Africa: Indicators of Budgetary and Financial Management



Sources: IMF, WEO database, October 2020; and WGI.

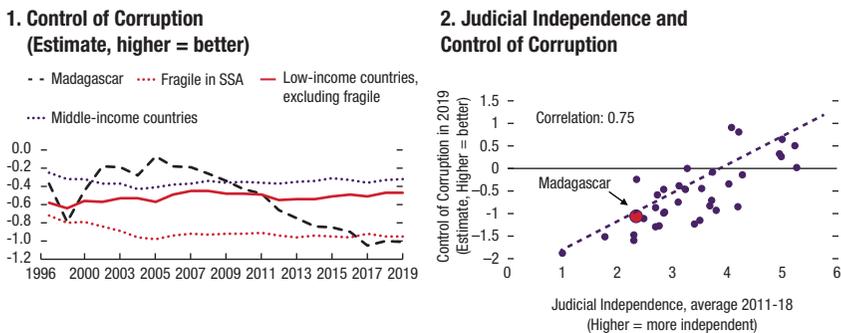
Note: With a 95 percent confidence interval, Madagascar's score on government effectiveness was in the range of -0.77 to -1.51 in 2019.

and the financial intelligence unit, SAMIFIN, have been published regularly since 2018, and there were five times as many reported suspicious transactions in 2019 compared to 2018. The detection, declaration, and reporting of illicit transactions are expected to increase further as a result of stronger collaboration between the tax and customs administrations and the five-year AML/CFT strategy, which should improve technical conformity and the coverage of vulnerable sectors such as mining and real estate. An online platform to publish all final court decisions by the anticorruption courts has been operational since December 2018. All reports and decisions made by the auditor-general since February 2019 are available (IMF 2020a).

The perception of the control of corruption had been deteriorating up until 2017. The Worldwide Governance Indicator on control of corruption captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as capture of the state by elites and private interests. Starting from a situation with a more favorable score than that of an average middle-income country in sub-Saharan Africa around 2005, Madagascar has scored slightly below that of a fragile sub-Saharan African country since 2017 (Figure 9.5).

The perceived inefficiency in control of corruption is linked to the lack of independence of the institutions fighting corruption, political pressure, and the power of money (Bertelsmann Stiftung 2020). Strong and independent institutions are necessary to ensure a fair and effective execution of the anticorruption laws. Existing laws give the president of Madagascar extensive power over the judiciary.¹⁰ A variety of cases have illustrated the widespread impunity for

Figure 9.5. Sub-Saharan Africa: Indicators of Control of Corruption



Sources: World Economic Forum, Global Competitiveness Index dataset; and Worldwide Governance Indicators.

Note: With a 95 percent confidence interval, Madagascar's score on government effectiveness was in the range of -0.73 to -1.28 in 2019.

¹⁰ The Superior Council of the Judiciary (Conseil Supérieur de la Magistrature, CSM) manages the career of the judges, with the president as the chairman and the minister of justice as the vice chairman. The Constitutional High Court (Haute Cour Constitutionnelle, HCC) also has limited independence from the executive power. HCC has nine members, of which the president directly nominates three, including the HCC president, and the CSM nominates another three members. Against this background, judges can be extremely cautious and often anxious to avoid contradicting powerful decision-makers.

officeholders who break the law, especially regarding the trafficking of natural resources. A plot of judicial independence (as classified by the World Economic Forum Global Competitiveness Index) and control of corruption supports a strong correlation between these variables. Madagascar is classified as having one of the least independent judicial systems in sub-Saharan Africa, and this is matched by the low score on control of corruption.

Box 9.3. Perception Indicators Quoted in the Chapter

Afrobarometer: Produced by a pan-African research network that conducts public attitude surveys on governance, economic conditions, and related issues in more than 35 countries in Africa, the work of the Afrobarometer is conducted through a partnership of research institutions based in Benin, Ghana, Kenya, South Africa, and the United States. The surveys are based on a series of face-to-face interviews with a random sample of 1,200, 1,600, or 2,400 respondents in each country.

Transparency International: An international nongovernment organization based in Berlin, Germany, Transparency International publishes the Corruption Perceptions Index, which provides perceptions of business people and country experts regarding the level of corruption in the public sector within the past two years.

Worldwide Governance Indicators: Produced by Daniel Kaufman of the Natural Resource Governance Institute and Brookings Institution, and Art Kraay of the World Bank Development Research Group, this dataset summarizes views on the quality of governance provided by many enterprise, citizen, and expert survey respondents in over 200 countries. These data are gathered from several survey institutes, think tanks, nongovernmental organizations, and private sector firms.

CONCLUSION

The democratically elected government that assumed power in 2014 started to rebuild the public institutions that had been disintegrating since the military coup in 2009. Perception indicators measuring the quality of Madagascar's institutions, which had been on par with middle-income sub-Saharan African countries in 2008, had deteriorated and were comparable with fragile sub-Saharan African countries by 2013. The reforms aimed to rebuild the anticorruption framework; strengthen all aspects of revenue, budget, and expenditure management; and reinforce the independence of the central bank.

The reforms were able to stop and reverse the institutional decay. The judicial framework for the repression of corruption has improved with new laws, decrees, and special anticorruption courts and centers. The management of fiscal revenue and spending is more robust. In 2018 the tax-to-GDP ratio was back to the level it had reached in 2008, thereby reversing a rapid drop over 2008–13. Regular control and reporting procedures have been restored, and the auditor-general is once again auditing public spending. There is more transparency with, for example, better access to information on public procurement, fiscal spending, and tax

obligations as well as access to regular judicial statistics on corruption cases. The civil society is also better organized to fight corruption.

Notwithstanding these achievements, current performance evaluations and perception surveys indicate remaining challenges. While tax collections have increased, they remain below the average of low-income countries and fragile states, and below Madagascar's estimated tax potential. Perception surveys of government effectiveness and control of corruption have barely improved since 2014, and respondents doubt the impartiality of the judicial system. These responses seem to confirm that continued reforms and time are needed to rebuild credibility in public institutions.

The reform priorities going forward include the following:

- *Ensuring that the anticorruption legislation meets international good practices:* International standards like the FATF recommendations offer a pragmatic approach to improve governance and are increasingly used.
- *Implementing existing laws and regulations fairly and effectively:* Judiciary and anticorruption institutions with appropriate human and financial resources are essential for a credible and effective enforcement of the anti-corruption legislation. Avoiding political interference is also critical for the predictability and effectiveness of the enforcement and should have a positive impact on governance, the business climate, and ultimately economic growth.
- *Continuing broad-based fiscal governance reforms:* Many assessments have confirmed the general weakness of Madagascar's PFM system. To improve the delivery of public services and guarantee maximum value for money, the authorities aim to deepen revenue reforms, ensure that public investment projects are prioritized based on rigorous cost-benefit criteria, strengthen the monitoring and management of public enterprises, and establish procedures for systematic follow-up of recommendations made by control institutions like the auditor-general.

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Strengthening Governance and Reducing Vulnerability to Corruption in Comoros

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ABSTRACT

As of 2020 Comoros faced governance weaknesses in several areas that are critical for macroeconomic performance, including administrating the civil service, managing fiscal operations, ensuring the rule of law, and implementing AML/CFT measures. Addressing these challenges would help spur inclusive growth and yield significant development gains, including by lowering vulnerability to corruption, increasing revenue mobilization, and reducing the reliance on volatile windfall revenue.

INTRODUCTION

Comoros is a small, poor, and fragile three-island state with limited natural resources and weak connectivity to the rest of the world, but with high potential for future development. The authorities hope to transform Comoros into a dynamic emerging market over the next decade by strengthening human capital, infrastructure, and governance and by reducing the scope for corruption. However, pronounced fragility arising from the presence of two interlocking vicious circles—institutional and economic fragility—has been putting the realization of these hopes at risk.

Over the past decades, political instability, weak governance and institutions, and low capacity for policy implementation have pointed to institutional fragilities. Since independence from France in 1975, Comoros's history has been marked by inter-island tensions and conflicts, which have led to political instability illustrated by a series of coups and secession attempts during the 1990s. Tensions lessened in the early 2000s as a result of the rotation of the presidency among the islands, but reintensified following a 2018 constitutional reform that allowed President Azali Assoumani to be reelected in 2019. The country also faces significant challenges in the areas of rule of law, regulatory framework, fiscal governance, and anticorruption and AML/CFT. These challenges have had a

dampening effect on business activity and economic growth. The pervasiveness of corruption also diverts resources away from spending on the eradication of poverty and other social priorities. The capacity for policy implementation has been further constrained by an insufficient focus on merit for civil service hiring and promotion (World Bank Group 2020), which constitutes another governance challenge. Results include weak outcomes in many areas of government activity, including persistently low fiscal revenue mobilization and weak institutional capacity.

Economic fragility, on the other hand, has manifested itself in severe constraints on domestic resources and pronounced vulnerability to shocks. Comoros's fiscal challenges have included weak revenue, a reliance on volatile one-off revenues, a high public wage bill, and drains from weakly supervised state-owned enterprises (SOEs), which have restricted public investment and social spending. The government budget also depends heavily on volatile aid inflows. Between 2005 and 2015, the ratio of external grants to total expenditure was slightly above 46 percent (excluding assistance under the HIPC, this number is still high at an average of 39 percent). Together with the government's limited access to financial markets, revenue volatility has resulted in recurring liquidity shortfalls that have led to abrupt cuts in priority spending and arrears to domestic and external creditors. Comoros is also highly vulnerable to natural disasters, as seen when Cyclone Kenneth wrought substantial damage in April 2019.

This chapter discusses Comoros's governance challenges and makes recommendations for addressing them. After a short overview of Comoros's governance strategy, and its legislative framework and architecture, it focuses on four substantial macrocritical governance challenges: (1) fiscal management, (2) the rule of law, (3) anticorruption and AML/CFT, and (4) the management of the civil service. The chapter also estimates the economic and political costs associated with these challenges and proposes a set of reforms after each section.

GOVERNMENT EFFORTS TO ADDRESS GOVERNANCE AND CORRUPTION CHALLENGES

Many of Comoros's legislative, legal, and institutional foundations to address governance challenges are less than a decade old. For example, the government adopted Comoros's National Anti-Corruption and Prevention Strategy in 2012. The strategy aims to strengthen fiscal controls and enhance public accountability and transparency through advances in the criminal justice system, the streamlining of legislative procedures, and capacity improvements in the Public Procurement Authority and the Accounts Section of the Supreme Court.

Several laws set the legal framework for anticorruption efforts in Comoros, but many of their elements are not implemented:

- *Anticorruption law*: In July 2008 the National Assembly passed the law on the transparency of public, economic, financial, and social activities (promulgated in June 2011). The law requires asset declarations for senior public

officials, defines criminal activity under the penal code, and specifies the role of the National Commission of Prevention and Fight against Corruption (NCPFC). Moreover, a September 2012 decree was issued to reinforce the objectives of the anticorruption law by strengthening the legal requirements of asset declarations for public officials to increase accountability. However, the law has not been operational since 2016, due to the dissolution of the NCPFC, which was itself accused by the current administration of corruption and ineffectiveness.

- *Anti-money laundering and fighting terrorism law*: In June 2012 the National Assembly adopted a law in the fight against money laundering and the financing of terrorism (promulgated in August 2012). The law defines the offenses and specifies the preventative measures that financial and credit institutions are mandated to implement. It also spells out the terms of reference of the Financial Intelligence Service. However, the latest analysis reports by the Intergovernmental Action Group against Money Laundering in West Africa (GIABA) identify several shortcomings in the legal framework for AML/CFT, including administrative weakness to mitigate the potential for criminal activity in the registration of offshore accounts and granting of economic citizenship; the omission of some offenses in the Comorian Criminal Code (including human trafficking, migrant smuggling, and environmental crimes) as designated by the Financial Action Task Force of the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG); and noncompliance with obligations relative to the criminalization of terrorism financing, as set forth by the 1999 United Nations Convention for the Suppression of the Financing of Terrorism.
- *Public-private partnership law*: In December 2017 the National Assembly adopted a law that specifies the legal framework of public-private partnerships (PPPs). The law was promulgated in January 2018. It specifies the types of contracts permissible under the PPP framework, the institutional framework, and the rules governing contract awards.

A range of institutions were set up to implement the laws and to support other efforts to address the country's governance challenges:

- *The National Committee to Fight against Money Laundering and Terrorism Financing*. This committee has the following objectives: (1) define the AML/CFT national policy, (2) propose any legislative, regulatory, or administrative reform necessary to achieve its objectives, (3) coordinate the various actions to be implemented in accordance with international bodies, (4) ensure permanent monitoring of progress made in the field, (5) monitor the commitments made by the country at the international level, and (6) define the necessary vocational training actions.
- *The Financial Research Service (SRF)*: This service receives and analyzes suspicious reports relating to money laundering and the financing of terrorism. The SRF works in close collaboration with the central bank and may use

correspondents in the police, gendarmerie, customs, state judicial, and other agencies involved in detecting infractions of laws relative to AML/CFT.

- *The National Directorate for Controlling Public Contracts and Public Service Delegation (NDCPCPSD)*: Article 7 of Law 17-019/AU (December 2017) introduced the NDCPCPSD as the entity overseeing PPP contracting operations.
- *The Public Procurement Regulatory Authority (PPRA)*: The PPRA presides over disputes under PPP contracts (Article 7, Law 17-019/AU, December 2017).
- *The Public-Private Partnership Support Unit*: This unit is the state technical entity presiding over the identification of suitable PPP projects (Article 8, Law 17-019/AU, December 2017).
- *The Ad Hoc Tender Committee*: This committee is responsible for preparing tender documents, evaluating tenders, and selecting candidates (introduced in Article 9, Law 17-019 /AU, December 2017).

Despite the setup of the legal and institutional framework, challenges to governance and combating corruption persist. Progress is constrained by administrative weakness and lack of political will in some cases. Capacity constraints include insufficient resources and a weak judicial system to oversee enforcement. The following section discusses ongoing challenges to governance in Comoros and suggests some reforms going forward.

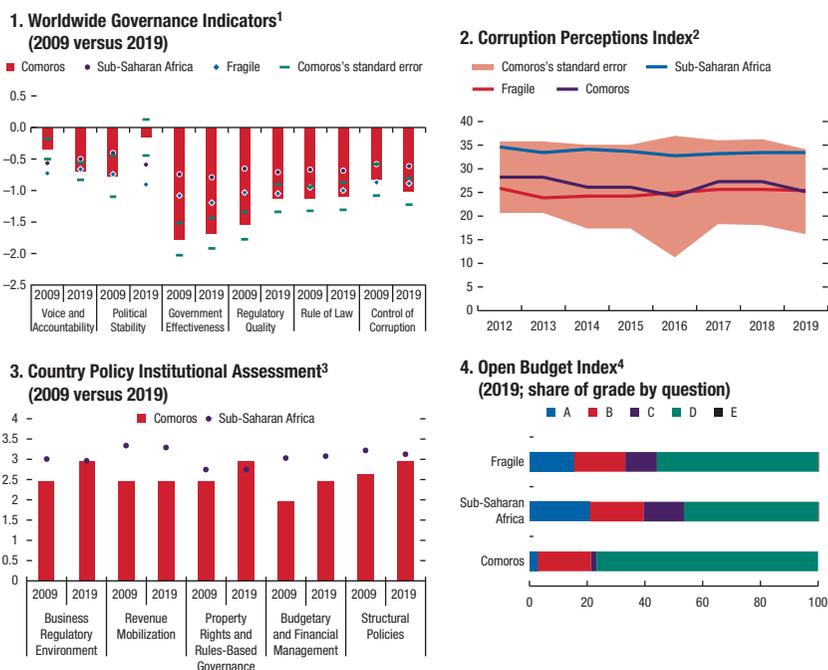
MACROCRITICAL GOVERNANCE CHALLENGES AND SUGGESTIONS FOR REFORM

Although Comoros performs well below the sub-Saharan African average and other fragile countries, recent developments and trends point to some progress over the years, as seen both in the Worldwide Governance Indicators (WGI) and in the Country Policy Institutional Assessment (CPIA). However, the country's performance has deteriorated across some areas, including voice and accountability and control of corruption (Figure 10.1).

Governance Issues in Managing Fiscal Operations

As highlighted in Chapters 1 and 2, weak governance in fiscal operations can drain public resources, and Comoros is no exception. Weak compliance in revenue administration is associated with high rates of tax evasion in Comoros. Large tax exemptions and investment incentives can further erode the tax base. Complex processes and the lack of transparency undermine the credibility and effectiveness of public financial management. Overoptimism in revenue and expenditure forecasts and the lack of a medium-term budget framework result in a weak multiyear perspective, thus harming effective planning decisions. Substantial leakages in the budget accrue from overpricing of low-quality products and services in the public procurement process, insufficient enforcement of

Figure 10.1. Comoros: Governance Indicators



Source: Worldwide Governance Indicators; Transparency International Corruption Perception Indicators; World Bank Country Policy and Institutional Assessment; International Budget Partnership; and IMF staff calculations.

Note: Use of these indicators should be considered carefully, as they are derived from perceptions-based data.

¹ The WGI estimates give scores on aggregate indicators, in units of a standard normal distribution (ranging from -2.5 to 2.5).

² The CPI uses a scale of 0 (highly corrupt) to 100 (very clean).

³ The CPIA ranges from 1 (low) to 6 (high).

⁴ The Open Budget Index score measures the extent to which key budget documents are made available to the public in a timely and comprehensive manner, with responses grouped as “A” (good accessibility of data) to “D” (no accessibility of data).

expenditure controls, and lack of transparency in reporting requirements. The following paragraphs discuss some of these challenges in more detail.

Revenue mobilization and public financial management in Comoros suffer from a pronounced lack of transparency due to the complexity of laws that hold back compliance (Table 10.1). Complex processes and a tax system that allows untransparent and arbitrary decisions, and discourages business registration and tax compliance, adversely affect domestic revenue generation. As a consequence, the number of active taxpayers in Comoros remains very low, with only 256 active taxpayers being followed in the Medium-Taxpayers’ Office (almost all located in the capital, Moroni), while fragile country norms for economies of comparable size

TABLE 10.1

Comoros: Impact of Governance Weaknesses on Fiscal Management ¹		
Category	Weak Governance and Corruption Transmission Channels	Application to Comoros
Public Resources		
Revenue Administration	<ul style="list-style-type: none"> • Weakened compliance culture leading to high rates of tax evasion. • Large tax exemptions and investment incentives erode the tax base. 	<ul style="list-style-type: none"> • Tax revenue stood at only 8.3 percent of GDP in 2018 due to excessive exemptions, complexity in the tax system contributing to taxpayer noncompliance, a large informal sector, and weak administration.
Natural Resource Wealth	<ul style="list-style-type: none"> • Insufficient transparency around petroleum licensing and negotiation of production-sharing arrangements. 	<ul style="list-style-type: none"> • Recent news coverage of heightened public concerns about a lack of transparency about possible oil exploration and production-sharing agreements.
Public Financial Management		
Budget Credibility	<ul style="list-style-type: none"> • Overly optimistic revenue and expenditure forecasts. • Lack of a multiyear perspective due to lack of medium-term budget framework. 	<ul style="list-style-type: none"> • Overly optimistic revenue and investment spending forecasts, contributing to budget overruns and arrears accumulation. • High volume of in-year spending reallocations. • Absence of a medium-term budget framework and lack of budget alignment with the Comoros development strategy. • Inter-Island redistributive and allocational issues.
Wages and Pensions Transparency	<ul style="list-style-type: none"> • Leakages: ghost workers and pensioners, resulting in a deadweight loss. • Bloated, inefficient civil service that crowds out socioeconomic spending. 	<ul style="list-style-type: none"> • A large civil service and high public wage bill that crowds out other priority spending. • A civil service payroll that has not yet been fully audited for ghost workers and pensioners.
Public Procurement and Public Expenditure Controls	<ul style="list-style-type: none"> • Leakages: overpricing of low-quality products and services, resulting in wasted resources and lack of value for money. • Insufficient enforcement of expenditure controls, giving rise to off-budget commitments. 	<ul style="list-style-type: none"> • Expenditure controls remain weak (see PEFA assessments), allowing misallocation of public resources, extrabudgetary commitments, and a buildup of arrears.
Public Investment Management	<ul style="list-style-type: none"> • Investment decisions that lack transparency and are based on bribes and patronage—including bid-rigging, kickbacks, and conflicts of interest. 	<ul style="list-style-type: none"> • While the government's investment plan could provide clearer assessments of the rates of return of envisaged projects, little is known about the transparency of investment spending.
Treasury Financial Management	<ul style="list-style-type: none"> • Theft from unmonitored accounts outside the TSA. • Embezzlement enabled by weak financial controls. 	<ul style="list-style-type: none"> • Continued use of an "investment account" in parallel with the TSA facilitates off-budget expenditures and limits transparency.
Extrabudgetary Funds and Public Enterprises	<ul style="list-style-type: none"> • Lack of transparency and compliance with fiscal reporting requirements. • Misappropriation of budget and own funds. 	<ul style="list-style-type: none"> • Fees and charges below cost-recovery levels, insufficient accountability in the absence of performance contracts, and cross-arrears between the state and SOEs reduce and undermine transparency.
Foreign Assistance, External Borrowing, and Public Debt		
Debt, Aid, and Other Foreign Inflows	<ul style="list-style-type: none"> • Diversion of funds by bureaucrats. 	<ul style="list-style-type: none"> • Large Comorian citizenship and passport scandal reinforcing concerns regarding AML/CFT and reportedly leading to large-scale misappropriation of funds.

¹ This table builds on Figure 2.3 from IMF (2019, p. 42).

and macroeconomic characteristics suggest that 1,500–2,000 taxpayers would be more appropriate. The relative lack of transparency also characterizes revenue from SOEs, which are put under financial strain by below-cost recovery tariffs, thereby limiting their ability to contribute to government revenue. Weak oversight and cross-arrears between SOEs and the government further limit the scope for transparency. Overly ambitious budgeting through 2018 also undermined the transparency and credibility of public financial management by creating large deviations between budget forecasts and realized revenue and spending. Low scores in the 2019 Open Budget Survey and PEFA assessments (for 2016) point to the low levels of transparency in Comoros relative to comparators.

Sustainably improving revenue mobilization, based on realistic and attainable budgetary targets, is key for financing Comoros's medium- to long-term development goals without endangering debt sustainability. Broadening the tax base and thereby increasing the tax ratio to develop more predictable budgetary financing sources will aid the execution of Comoros's ambitious investment program, which underpins the country's development strategy. At the same time, it will help to improve the execution of investment expenditure and limit the recourse to potentially unsustainable external borrowing. Simplification and better application of tax and customs laws offer substantial potential for quick wins. In the meantime, strengthening the framework for internal controls—including the control environment, authorization, and approval procedures (for example, mandating the use of payment vouchers for all procurement transactions), risk assessment, and monitoring—and adoption and enforcement of sanctions for extra-budgetary spending would help prevent further accumulation of arrears.

Challenges in Upholding the Rule of Law

The rule of law, particularly the enforcement of contracts, remains fragile in Comoros. The judicial system is weak and cases tend to linger in the courts for years, and judgments are frequently not enforced. The causes of judicial sector weakness likely include some combination of insufficient funding and political interference.

To overcome this weakness, the authorities should strengthen the effectiveness of the judiciary in protecting property rights and enforcing contracts and create an enabling environment for private investment through regulatory reform. In addition to curtailing political influence, actions could include seeking a judicial system diagnosis from a credible outside partner, enhancing funding of the judicial system, improving staffing in a low-cost manner by complementing the corps of professional judges with laymen judges, and strengthening arbitration options.

Anticorruption Efforts and AML/CFT Measures

Comoros's implementation of anticorruption measures faces significant challenges. The NCPFC has been dismantled, leaving a gap in the architecture and increasing the ambiguity regarding the obligation for senior public officials to declare their assets to the Commission. GIABA, to which Comoros belongs, has

identified important shortcomings in Comoros's fight against money laundering and the financing of terrorism, and has asked the authorities to adopt a time-bound action plan to strengthen the legal framework, to amend the penal code to adequately criminalize money laundering and the financing of terrorism, and to amend the AML/CFT law to strengthen customer due diligence.

To address additional weaknesses within the legal framework for AML/CFT, financial institutions should be expressly required to report transactions that may be related to money laundering and proceeds of corruption or to suspected financing of terrorism. (This is currently not the case, as the framework only requires reporting of transactions of funds of unlawful origin.) Adjusting the laws to prevent the misuse of legal persons (for example, companies) and arrangements (for example, trusts) for money laundering and corruption and ensuring that information on the beneficial owners of these persons and trusts is available to competent authorities will also be critical.

Implementation of the framework for AML/CFT will also be critical. The SRF, which oversees implementation of AML/CFT laws, and the central bank's Supervision of Financial Institutions Unit have extensive capacity building needs. Overcoming these gaps is key in the process of strengthening the implementation of the framework for AML/CFT. In addition, strengthening the asset declaration regime for high-level officials—including by requiring publication of the declarations and reoperationalizing the anticorruption commission or creating a similar body and bolstering its powers to promote investigations of acts of corruption—will be important.

While the government has formulated and begun implementing an action plan for addressing deficiencies in efforts regarding AML/CFT (including the promulgation of a revised penal code in May 2021), effectiveness of the national regime remains weak, and stronger efforts are needed. Substantial additional efforts are required to address deficiencies regarding AML/CFT by promptly implementing the outstanding recommendations of the GIABA and ensuring the effectiveness of the national regime for AML/CFT.

Governance Issues in Managing the Civil Service

Finally, civil service management in Comoros suffers from hiring and promotion decisions based in part on considerations other than merit (such as patronage), contributing to skills mismatch, high turnover, and weak accountability (World Bank 2019). These challenges in turn impede results in many areas of public administration, including in key areas such as revenue mobilization, public financial management, and education services. Success in improving governance of the civil service will enable better performance in all areas of government activity. Capacity development efforts by international development partners have suffered from implementation challenges. In addition, ghost workers on the payroll undermine transparency in public sector wages and pensions.

The authorities are undertaking initial steps to strengthen the civil service and should broaden and deepen these efforts. Initial attempts to address absenteeism

and detect and remove ghost workers and recover wages paid to them have begun. The authorities are considering strengthening hiring through an entrance exam in all parts of the civil service, as is already the case at the central bank; strengthening the training of civil servants by creating a school of administration; and enhancing performance management. These efforts should be strengthened and broadened.

CONCLUSION

The potential for reform and consequent development gains is large, despite persistent weaknesses in Comoros's political and economic environment. Fragilities in public financial management, civil service, and the legal and regulatory frameworks have long constrained the business climate and economic growth in the island nation. Initial actions taken by the government must be followed by a commitment to reform and by efforts to increase resource mobilization. A robust strategy to improve governance in Comoros can bring higher revenues, provide more legal and institutional transparency, and reduce leakages in the system—all crucial elements for strong and sustainable economic development.

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Accountability in Supporting the Emergency Response to a Crisis: Lessons from COVID-19 Funds

Richard Allen and Fazeer Rahim

ABSTRACT

When a country's system is inefficient and ill prepared, the need to respond quickly to a national emergency can create significant governance vulnerabilities. This chapter considers an approach taken by some countries during the COVID-19 pandemic to accelerate the execution of emergency spending by creating a dedicated fund outside the budget to support the emergency spending. The chapter discusses the benefits of this approach and warns against the risks. Drawing from the experience of these funds, the chapter offers some guiding principles for the creation and operation of special funds, and broader lessons for strengthening PFM systems.

INTRODUCTION

During a pandemic, governments are faced with immediate demands to take action to save lives, protect livelihoods, and support the economy. These demands for action include calls for fast-tracking expenditure on health and containment measures, for the continuation of essential public services, and for assistance to support affected households and businesses. To meet these demands, governments must quickly reprioritize their existing budget allocations and secure additional resources both domestically and externally. Once the situation is more controlled, governments are expected to scale up their efforts to support aggregate demand, while standing ready to respond to future waves of the pandemic.

A country's PFM system is typically geared to meet its budgetary needs in normal times. Its authorities make policy decisions—and allocate resources for their implementation—as part of an annual or multiannual budget process, in which various entities (parliament, the cabinet, the ministry of finance, and line ministries) have well-defined roles. Regular checks and controls are employed during budget execution, and public procurement processes, reporting frameworks, and external oversight arrangements are aligned with the annual budget cycle.

A PFM system may not be prepared to deal with an exceptional situation like a pandemic, which can also expose many of its weaknesses. An effective response may require new forms of coordination and collaboration across the government. For example, close coordination among sectors that do not typically work together, such as health, social services, police, and customs agencies, is critical during a lockdown. The typical processes behind the planning and execution of the budget, including procedures for procurement, necessary in normal times, may constrain the speedy deployment of resources in an emergency. In the absence of specific institutions and processes to deal with emergencies (whether officially in place or informally practiced), the authorities may need to create new ones as they respond to the crisis. In situations when prior controls are relaxed, there is a need for compensating improvements in the monitoring and audit of emergency spending or which existing capacities are typically weak in developing countries. These weaknesses, coupled with the scale of the response, can create significant exposure to corruption and other governance vulnerabilities.

This chapter reviews some of the governance vulnerabilities that can occur during a crisis and considers ways in which countries have addressed these vulnerabilities during the COVID-19 pandemic. It examines the benefits of setting up an extrabudgetary fund to support transparency and accountability while still facilitating the overall response to a crisis, and it warns against the inherent risks. The chapter draws from lessons emerging from the experiences of the many countries that set up dedicated funds during the COVID-19 pandemic, and from these lessons identifies good practices for managing these funds and for strengthening PFM systems in general.

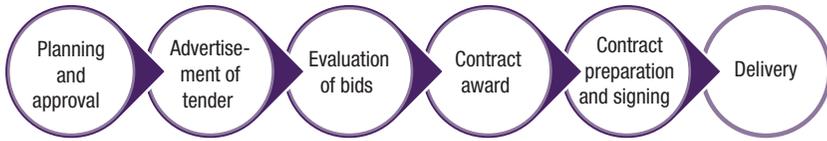
GOVERNANCE VULNERABILITIES DURING A CRISIS AND WAYS TO ADDRESS THEM

The Main Vulnerabilities

The main governance vulnerabilities of a PFM system that emerge during a crisis will depend on the nature of the country's response and the inherent weaknesses of its PFM system. Emergency responses to a pandemic take various forms, which include (1) public procurement—for health-related spending at the peak of the pandemic and for infrastructure spending during the recovery phase; (2) policing and border controls to enforce lockdowns; (3) cash transfers to poor citizens and vulnerable groups; (4) schemes to support companies in financial difficulty; and (5) unemployment benefits and other support for employees. Each of these types of support may give rise to vulnerabilities and corruption risks, which the weaknesses in its PFM system, discussed in the introduction to this chapter. Consider the following examples:

- *Public procurement:* Figure 11.1 illustrates the various stages of the public procurement cycle. Vulnerabilities can arise at every stage. Rigorous needs assessment and planning are needed to ensure that the appropriate projects

Figure 11.1. Stages in the Public Procurement Process and Sources of Vulnerability



Source: Based on UNODC (2020).

are selected and that they are competitively priced. Ensuring that the request for bids is widely advertised, and that the tender process is fair and competitive, will help to encourage competition, prevent overpricing, and discourage the delivery of goods of inferior quality. The screening of bids is required to identify signs of collusion among bidders. Transparency on beneficial ownership is needed to provide confidence in the process. Technical audits will allow officials responsible for overseeing the procurement process to perform due diligence and identify irregularities.

- *Cash transfers to vulnerable groups:* Much needed during a pandemic, cash transfers have proved challenging to implement and are vulnerable to abuse (Una and others 2020a). Key governance vulnerabilities include the absence of (1) clear, transparent, and objective criteria to define beneficiaries; (2) mechanisms to authenticate and validate beneficiaries' applications for support and to cross-check data; (3) reliable and context-specific cash distribution systems, such as commercial banks, money transfer operators, and so on; (4) robust monitoring and evaluation systems that can be established in collaboration with NGOs; (5) procedures for disclosing the policy objectives of the cash transfer programs—their design, beneficiaries, budgets, delivery mechanisms, and so on; (6) timely and reliable recording of payments in the budget to permit robust internal controls and reporting; and (7) ex-post inspections or audits, ideally carried out on a real-time or monthly basis by a country's supreme audit institution (SAI) or a reputable external audit firm.

The Ebola crisis of 2014–2016 provides a good example of PFM weaknesses and governance vulnerabilities. In Sierra Leone, the office of the auditor-general reported many sources of irregularities in the management of the Ebola funds (see also Chapter 12). These irregularities included undocumented payments for supplies, disregarded or misapplied procurement procedures, bribes paid to circumvent security protocols, suspicious payments to parliamentarians and NGOs, and undocumented loans. Many of these irregularities arose from weaknesses in the country's PFM system, especially its internal controls—or lack thereof—including inadequate management of payroll, inefficient data collection and record-keeping, and poor tracking of foreign aid and emergency spending (Audit Services of Sierra Leone 2014).

Better Transparency and Accountability

During the COVID-19 pandemic, many governments have been transparent in formulating, budgeting for, and reporting on their emergency response. In many countries, specific policies to mitigate the impact of the pandemic have been prepared, costed, and approved by the parliament as part of supplementary budgets. Countries with good programmatic budget frameworks, such as Armenia and France, have introduced special COVID-19 programs that cut across spending agencies for better visibility and tracking, and facilitate impact assessment. Countries with a comprehensive financial management information system (FMIS) and a well-defined chart of accounts, such as Rwanda, have prepared specific COVID-19 codes to support tracking along the spending chain. Some countries (for example, Uganda) have prepared dedicated reports on their COVID-19 responses. Some have increased the frequency of their financial reporting (for example, from a quarterly to a weekly cycle in the Maldives). Other countries, such as Brazil, Colombia, France, Honduras, Peru, and the Philippines, have created dedicated transparency portals to provide both an overall picture of their COVID-19 related support and ready access to information on procurement processes and beneficiaries.

Some countries have also supplemented standard external scrutiny procedures to improve accountability. For more timely accountability, the SAIs in Sierra Leone and South Africa have undertaken interim audits (see Chapter 9). These exercises are meant to complement audits of emergency spending and the regular end-of-year audits that these SAIs will perform at a later stage. The example of South Africa (see Box 11.1) shows how interim audits have improved the government's accountability. In Latin America, the SAIs in Honduras and Peru have undertaken concurrent controls of emergency payments and procurements to check the validity of these transactions.

To centralize their response to the pandemic and keep an audit trail, many countries have created dedicated COVID-19 funds. The next sections examine the benefits and risks associated with this approach.

ROLE OF EXTRABUDGETARY FUNDS

Even before the onset of COVID-19, extrabudgetary entities (EBEs), which are outside the control of the budget, were widely used in countries at all levels of development. An EBE can be defined as a set of accounts or a government entity engaged in “financial transactions, often with separate banking and institutional arrangements, that are not included in the annual state budget law” (Allen and Radev 2006, p. 4). Excluding social security and health funds, EBEs account for about 15 percent of central government expenditure across a range of advanced, middle-income, and low-income economies, or close to 50 percent if social security and health funds are included.¹ Examples include special-purpose funds (of

¹ Figures are derived from IMF (2018, p. 14).

Box 11.1. South Africa: The Use of Interim Audits during COVID-19

The auditor-general of South Africa has undertaken two audits and published two reports (in September 2020 and November 2020, respectively) on the financial management of the country's COVID-19 response. These reports cover real-time audits of payments, procurements, and deliveries as they occur.

Audience: The reports were ultimately intended for Parliament: prior to submitting them, the auditor-general shared the findings with the accounting officers in implementing agencies to enable them to deal with any shortcomings immediately and tighten controls to prevent recurrence.

Audit team: The audit exercises have been unique in bringing together financial auditors, fraud examiners, IT specialists, and sector-specific experts to provide insights into COVID-19 spending management.

Scope: The first report focused on (1) the payment of benefits and grants to relieve economic and social distress; (2) the procurement of personal protective equipment; and (3) the frontline initiatives to protect against and manage the impact of COVID-19. The second report had a similar focus, extending its reach to spending by provincial governments and municipalities and assessing the progress made since the first report.

Findings: The first report found instances of benefits and grants directed to unintended beneficiaries, including government officials. The government's IT systems were slow to respond and failed to share data across various government platforms to enable reconciliation and cross-verification. The report also provided evidence of overpricing, unfair processes, and potential fraud, as well as of instances in which supply chain management legislation was sidestepped.

Sources: Auditor-General of South Africa (2020a; 2020b).

which COVID-19 funds are an example), development funds, savings funds, trading funds, and investment funds.

EBEs have traditionally been created to facilitate coordination among government agencies and to promote efficiency. Stronger-than-usual coordination may be needed to implement policy decisions that cut across many public agencies, whether in normal times or in emergency situations (as with the COVID-19 pandemic). An EBE, with well-organized management structures and accountability arrangements, can also be created to simulate private market conditions and ensure the efficient delivery of certain public services (Allen and Radev 2006; Allen 2013). Another motivation for the creation of an EBE can be to address the consistent underfunding of some activities that are generally overlooked during budget negotiations because they are politically unattractive. A classic example is the maintenance of public infrastructure, often neglected in favor of investment in new assets. An EBE with earmarked resources—such as for roads or other public infrastructure—can potentially bring benefits in terms of the predictability of financing and accountability, an argument often used to justify the existence of extrabudgetary road funds (Potter 2005).

The creation of EBEs is often justified as a temporary and second-best solution to address structural weaknesses in existing budget systems. PFM practitioners generally agree that the best budget practice is one in which (1) the budget process is unified and includes all areas of public spending within a single framework; and (2) the central budget authority exerts strong oversight over the spending decisions of implementing entities. The aim is to avoid fragmentation of policy-making, enforce top-down fiscal discipline, and prevent a dilution of accountability and a weakening of fiscal control by entities with independent fiscal authority. In the real world, budget systems may be far from perfect, especially in low-income countries. Cumbersome processes (often manual and paper-based) may lead to delays and rigidities; weak checks and controls of line ministries and subnational governments often lead to poor budget execution and create corruption vulnerabilities; and decisions on budget allocations may be dominated by political considerations. An EBE with a clear mandate and well-defined PFM processes, subject to heightened standards of accountability, can be a way to circumvent these weaknesses, especially in a situation of crisis and fiscal stress (Allen and Radev 2006).

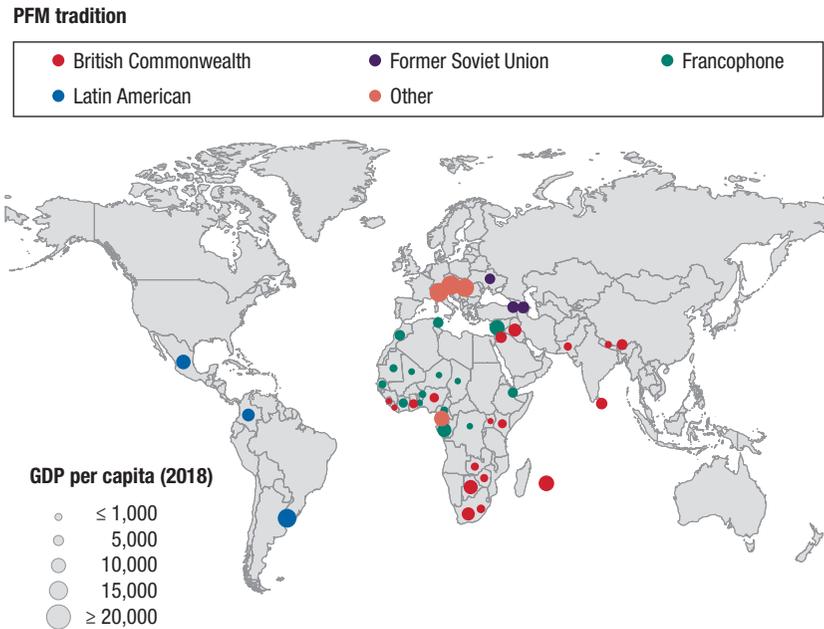
In the context of the COVID-19 pandemic, many of these issues have gained prominence. Governments have responded by adopting measures that allow funds to be programmed and disbursed more quickly than would be possible under the conventional budget process, with simplified execution and procurement procedures.² As noted, the budget system, especially in many low-income countries, faces the challenges of low capacity and governance vulnerabilities, both of which may be better addressed by an EBE with heightened standards of transparency and accountability. With many COVID-19 funds set up to receive voluntary contributions from the private sector and development partners, governments are under pressure to manage these funds efficiently and effectively, which may require separate arrangements. Finally, COVID-19-related interventions span several areas, such as health, social services, internal and border security, and local governments, which requires strong coordination, as noted earlier.

As of February 2021, more than 45 countries around the world (27 in sub-Saharan Africa) have set up COVID-19 funds since the beginning of the pandemic (Rahim and others 2020). These funds usually take the form of EBEs.³ The list spans countries with different administrative and PFM traditions (including both Anglophone and Francophone countries, among others), legal frameworks, and income levels (see Figure 11.2).

Several reasons have been advanced for the creation of these funds. First, there was a need to establish high-level political control of COVID-19 policies (for example, under the president's office in Kenya and Sierra Leone) and bring

² This is further discussed in Barroy (2020) and Barroy and others (2020).

³ The term “extrabudgetary fund” is often used in the literature, but “EBE” is a broader and more appropriate concept because it includes the government agencies and entities used to manage emergency financing, as well as the accounts and funds set up for receiving revenue and making payments.

Figure 11.2. COVID-19 Funds around the World

Sources: © 2020 Mapbox. © OpenStreetMap.

Note: The classification of PFM traditions is based on Pattanayak (2016).

Disclaimer: The boundaries, colors, denominations, and any other information shown on the maps do not imply, on the part of the International Monetary Fund, any judgment on the legal status of any territory or any endorsement or acceptance of such boundaries.

together different sectors and entities affected by the crisis to facilitate implementation of these policies. Second, some countries decided to centralize their funding by pooling together public and private resources, which their standard budget practices may not have allowed. Delays in implementing PFM processes have also motivated some countries to start afresh with streamlined budgeting, payment, and procurement processes within a new structure to speed up their response. Finally, as mentioned earlier, many countries preferred the creation of a separate channel for COVID-19 spending to enhance transparency and accountability and create a clearly defined audit trail.

THE RISKS

EBEs may also create significant risks that need to be balanced against their potential benefits. Their freedom to take independent actions may bypass normal budgetary and expenditure controls, especially when these controls are weak and ineffective. The insulation of EBEs from the budgetary process can, in the absence of full and timely information, distort a finance ministry's picture of

public finances. For both reasons, EBEs are often regarded—particularly in countries where administrative capacity is limited and challenges in reporting and fiscal consolidation exist—as potential sources of financial malpractice and corruption, and are often referred to as “little empires” of limited accountability and as silos for financing political operations (Allen 2013).

The context of the COVID-19 crisis heightens many of these risks. The need for governments to respond swiftly, under high public pressure, has often led to the relaxation of ex-ante financial controls and standard procurement processes without any safeguards being put in place. While such policies can effectively accelerate spending in some contexts, they can also create significant governance vulnerabilities, particularly when the funds (1) operate outside government systems; (2) are managed by officials not familiar with good principles of PFM; or (3) are not subject to robust transparency and reporting standards. Finally, the very availability of COVID-19 funds carries with it the risk that some governments may seek to broaden the operational mandate of these funds and to extend their use well after the pandemic has ended.

As discussed below, it is possible for these risks to be managed, and they should be balanced against the inherent weaknesses and corruption vulnerabilities in the budget systems of many low-income countries. Overall, a COVID-19 fund, backed by strong safeguards, can be a pragmatic approach when PFM systems are weak (for example, where key processes and controls are not automated). These safeguards include a strong legal backing, a clear sunset clause, well-defined PFM processes, and robust accounting, reporting, and audit procedures.

LESSONS DRAWN FROM COVID-19 FUNDS

Countries have followed diverse approaches in setting up their COVID-19 funds. While some of the funds have drawn mainly from budgetary resources, most have pooled private donations, public resources, and external sources of finance (Rahim and others 2020). Some funds are fully integrated into countries’ existing PFM systems and processes (for example, Francophone countries such as Chad, Morocco, and Senegal), but most operate through separate banking, financial management, and reporting arrangements, outside the regular channels of PFM. While all funds have an explicit mandate to collect resources, some have broad responsibility for coordinating policy responses to the crisis (for example, Sierra Leone), while others have a more restricted role, limited to executing pandemic-related spending. In addition, some (but not all) funds have been set up with a strong legal backing, with their scope and mandate well defined (Rahim and others 2020). This diversity of approaches provides valuable lessons on what constitutes good practice in establishing such funds.

A Clear and Strong Legal Mandate

A clear legal mandate is essential to clarify the purpose of the fund and its sources of finance, its management and oversight structure, its business processes and

reporting standards, and the accounting and auditing requirements it is expected to fulfil. Early in the crisis, some countries that operate within the British Commonwealth tradition of public administration, such as Botswana, Ghana, Kenya, and Mauritius,⁴ created COVID-19 funds through government-issued regulations under their general budget law. Other countries took longer to provide a legal basis for their funds. In Sierra Leone, for example, the fund operated in a legal vacuum for around four months, before regulations were finally issued in August 2020. The country's SAI noted that this gap had an impact on the soundness of the fiduciary management of the fund (see Audit Services of Sierra Leone 2020).

A Single Fund with a Well-Defined Mandate

To avoid duplication, limit fragmentation, and ensure coordination across activities, a single fund is generally preferable. The areas of the fund's operations and revenue sources should be defined in some level of detail, which should be done in consultation with relevant government ministries and other stakeholders to ensure that the fund's mandate is commensurate with the resources at its disposal. Most countries have resorted to creating a single COVID-19 fund in line with good practice, with rare exceptions (Côte d'Ivoire, for example, has established five funds). The law in Botswana describes in detail the various areas where fund interventions are permissible, such as for wage subsidies, loan guarantees, and citizen evacuation, and for building up stockpiles of strategic grain reserves, and medical supplies and equipment. In Ghana, on the other hand, the fund's mandate has been defined more loosely in terms of "activities that complement the efforts of the government to combat the pandemic." (COVID-19 National Trust Fund Act 2020)

A Well-Defined Sunset Clause

To ensure that these funds do not outlive their purpose, the law should stipulate a sunset clause and a mechanism for determining how any remaining financial balances should be used. In cases where the funds are expected to continue during the recovery phase of COVID-19—for example, to ensure continued support from external partners—the conditions under which they will operate should be clearly stipulated.

The COVID-19 fund regulations in Kenya stipulate that the fund shall be terminated when the president declares that the pandemic no longer poses a threat to the country, but they do not specify the use of any remaining balances. On the other hand, the regulations in Mauritius do not establish any sunset clause but require that the remaining balances of the fund accrue to the country's

⁴ Mauritius's COVID Solidarity Fund is relatively small. The majority of the pandemic spending in Mauritius is through the central government, special funds, or the Mauritius Investment Corporation, a special-purpose vehicle fully owned by the central bank.

consolidated fund. More loosely, in Côte d'Ivoire, the establishing decree requires that after the fund's dissolution its net assets should be remitted to "any structure assigned to continue its mission or to a major public financial corporation." (Projets de loi – Fonds de riposte au COVID-19)

Management and Oversight

A sound management structure for a COVID-19 fund could be composed of an independent and high-level executive board responsible for making strategic decisions and a chief administrator responsible for managing the fund's day-to-day activities. A technical team of specialists in health, national security, and other relevant areas could assist the board on policy and operational issues, while a fiduciary team of specialist financial managers, accountants, procurement experts, and internal auditors could assist the administrator. Ideally, the ministry of finance should also have a strong oversight role, through representation on the executive board, for example, and by staffing the fiduciary team.

The management structure of the COVID-19 fund in Sierra Leone contains some of these key elements. An administrator manages the fund, supported by teams of experts that guide operations and policy across six pillars of interventions, and a fiduciary team that manages the fund's finances. The fund, however, does not have an independent board, and oversight by the country's ministry of finance is weak. By contrast, in Botswana, Kenya, and Mauritius the ministry of finance plays a leading role in either the administration of these countries' respective funds or in their oversight through representation on the executive board.

Clearly Defined PFM Processes

Efficient delivery of emergency relief measures depends on how swiftly interventions can be rolled out on the ground, while ensuring full transparency and accountability. In some countries, the COVID-19 funds utilize elements of the regular budget and PFM process. In countries where these channels are bypassed, standards of operational practice (SOPs) should be prepared and published, and should include (1) the submission of a proposal to provide emergency funding; (2) the approval of the proposal; (3) the execution of spending and procurement process; and (4) reporting requirements. These published standards should also clarify the role and responsibilities of the fund itself, its chief officers, the finance ministry, and implementing agencies, such as health and internal security. The standards should also prevent potential duplication of approvals and controls, and hence the risk of delays.

Ghana provides a good example of a governance system where the main elements of sound financial management processes have been incorporated into the operations of the COVID-19 fund. The fund receives both private and public funding (private funds are collected through a separate bank account). The resources are then transferred to the Coronavirus Alleviation Programme, which is managed by the Treasury Department of the Ministry of Finance. Similarly, in

Francophone countries, such as Chad, Morocco, and Senegal, while resources for the fund are earmarked through special accounts (*comptes d'affectation spéciale*), the treasury still manages the spending, albeit through simplified, lighter-than-usual authorization procedures.

Making Use of Electronic Transactions

E-transactions and e-procurement will lend speed and accuracy to the delivery of emergency services, simplify records management, and reduce operating costs. The funds should be granted access to relevant government databases (for example, financial management, tax administration, social security, health care, and public procurement). The COVID-19 Solidarity Fund in Mauritius requires that all potential beneficiaries make their applications online. The fund uses the databases and payment system of the Mauritius Revenue Authority and the country's social services agencies to means-test and pay eligible beneficiaries.

High Standards of Transparency

To offset the potential risks of diluted accountability and corruption risks created by an EBE, there is a need for enhanced reporting standards, including the disclosure of detailed information on procurement tenders and contracts. It is good practice for governments to disclose the existence of COVID-19 funds on their website and describe these funds' legal mandate, objectives, and policy rationale; sources of revenue, governance, and management arrangements; and operating rules and procedures. Ideally, the revenue and expenditures of the funds should be reported monthly or quarterly on a gross basis.

The regulations in Kenya require the COVID-19 fund's administrator to submit a report of its activities every quarter. In Ghana and Sierra Leone, on the other hand, the funds are only required to report annually. The Solidarity Fund in South Africa has been set up as an independent charity under private law and is subject to the same reporting requirements as other nonprofit ("public benefit") organizations. In Honduras, a dedicated portal provides comprehensive information on COVID-19-related spending, including the activities of an EBE that accounts for around half of this spending.

Transparency requires putting in place a tracking mechanism to monitor the activities and transactions of these funds. While some of their operations may be captured in the government's FMIS, others, such as in-kind donations, may fall outside of it. Benin and Pakistan have each complemented their FMIS with other information systems to monitor their COVID-19 funds' activities and spending.

Effective Audit during and after the Pandemic

Strengthening ex post controls during and after a pandemic is particularly important when ex ante and upstream controls are streamlined for rapid response. Countries should ensure that their SAIs have a clear mandate for auditing COVID-19 funds

and undertake and publish these audits in a timely manner. To the extent possible, interim audits (in addition to the regular annual financial audits) should be encouraged. The successful audits done in Sierra Leone during the Ebola crisis and the COVID-19 pandemic are good examples.

CONCLUSION

The lessons from COVID-19 funds can help shape future emergency responses, whether to pandemics or natural disasters. When there is a strong need to coordinate activities across sectors, to bring together public and private resources, and to work around existing PFM weaknesses, there is a case for setting up a special fund outside the regular budget process. The potential risks, however, need to be carefully mitigated. This could be done by (1) setting up a sound legal framework that defines the mandate of the EBE, its governance structure, and its accounting and reporting requirements; (2) resourcing adequately the EBE with staff that have relevant finance skills and experience in managing complex organizations; and (3) enforcing higher-than-usual standards of transparency and external scrutiny (Rahim and others 2020).

The experience gained from countries' use of COVID-19 funds also sheds light on the reforms needed to strengthen budget and PFM systems. The proliferation of these funds indicates that PFM systems in many developing countries are not doing a good job in managing resources efficiently and nimbly. Lessons learned from the governance and transparency challenges experienced by the COVID-19 funds, as described in this chapter, could be applied to strengthen core PFM systems in these countries.

Going forward, digital solutions have a role to play to ensure effective service delivery in normal times and in emergency situations. Such digital solutions include FMISs, the use of e-transactions and e-payments, fiscal transparency portals, and procurement platforms. Two IMF notes provide guidance on how PFM systems can leverage digital solutions to support emergency responses (see Una and others 2020a; 2020b). In some countries, the measures recommended in this chapter could be implemented relatively rapidly to streamline spending and control processes embedded in their information systems, enhance FMIS functionalities for cash management, and improve transparency of emergency responses through digital solutions. They should also be an integral part of PFM modernization programs in the future, a welcome if unexpected spinoff of the COVID-19 crisis.

In conclusion, while an EBE provides a solution to address the immediate needs of a national emergency such as the COVID-19 pandemic, PFM systems need to be strengthened to improve service delivery in normal times and enable countries to respond quickly and effectively to future crises. Important safeguards should be put in place to minimize some of the risks inherent in establishing an EBE.

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The Role of Supreme Audit Institutions in Addressing Corruption, Including in Emergency Settings

Sebastian Pompe, Alice French, Martin Aldcroft, Camilla Fredriksen, and Alain Memvuh, with contributions by Lara Taylor-Pearce, Daniel Domelevo, Monique Newiak, and Fazeer S. Rahim

ABSTRACT

This chapter considers supreme audit institutions (SAIs) as a key pillar of accountability in the management and oversight of public funds, notably in emergency settings. It acknowledges that the primary role of SAIs is to ensure the effectiveness and integrity in the use of public resources, and focuses on how SAIs can contribute to the prevention and detection of corruption, including through agile compliance audits (real-time audits) in emergency settings. The chapter illustrates some of the challenges SAIs face and explores the IMF's approach to audits. Sub-Saharan African country cases showcase how the role of SAIs in addressing corruption has been strengthened, and a discussion of agile compliance audits in sub-Saharan Africa highlights the role of SAIs in emergency settings.

INTRODUCTION

Supreme audit institutions are the national public sector's external auditors, a country's pillar of integrity. They can also play an important role in preventing and detecting corruption. By auditing all public financial operations, they are a critical element in the ecosystem of budgetary control and oversight in the public sector. Their audit reports and recommendations contribute to accountability and transparency in Public Finance Management (PFM), and in turn to good governance. In practice, SAIs audit expenditures, accounting, and reporting of public financial operations; compliance with laws and regulations; and performance of policies and programs. Through delivering on their mandates, SAIs may uncover irregular conduct (noncompliance), mispending, mismanagement, and poor performance. They also consider risks for misuse, evaluate entities' control environment, and uncover weaknesses (or red flags) that

may be indicative of corruption and fraud.¹ As external auditors, they examine the effectiveness of internal audits.

SAIs are particularly important during crises, in part because crises exacerbate corruption vulnerabilities (see Chapter 11). Crises and emergencies call for sudden and expedited budgetary adjustments and extraordinary procedures, such as extrabudgetary funds or bypassing of normal procurement rules, to expedite the fiscal response. These adjustments can weaken established safeguards and increase vulnerabilities to fraud or corruption. The fast-tracked budgetary responses should invite an equally timely and targeted response from the oversight agencies, such as the SAI, to ensure adequate transparency and accountability. As time passes, reconstituting the necessary paper trail or ensuring the effectiveness of the accountability framework becomes more difficult, rendering more distant oversight less effective. The emergence of the COVID-19 pandemic, and its impact on public health systems, economies, and public finance systems, has rapidly brought increased attention to the role of SAIs.

However, SAIs can only be successful if their role is well defined, well understood by stakeholders, and coherent within the national integrity system, and if they are equipped with the resources, powers, and tools to discharge their duties effectively. In that context, the International Organization of SAIs (INTOSAI) continues to underscore the importance for global norms (principles and standards) to be applied at the country level with respect to the role of SAI in assuring accountability and transparency. Through the *Lima* and *Mexico Declarations* (INTOSAI 2019c; 2019d), INTOSAI has established the importance of SAIs' independence for their credibility and effectiveness. The *Mexico Declaration*, or INTOSAI-P 10, further lays out eight pillars of SAI independence, including a framework ensuring their independence both in law and in practice, a broad mandate covering the use of public funds, and sufficient resources to discharge their mandates. These pillars are essential for any SAI to be effective and to maintain public trust.

SAIs can play a critical role in strengthening the institutional framework to fight corruption as part of their mandate. In ensuring accountability, SAIs can contribute to the broader fight against corruption by strengthening systems to detect corruption, although detecting corruption is not their primary goal. SAIs with jurisdictional responsibilities operate within administrative, not criminal, law, and therefore seek to remedy a wrong, rather than to punish a crime. Suspicions of corruption, as a criminal offence, are taken forward by prosecuting agencies. Nevertheless, in the 2013 *Beijing Declaration*, all INTOSAI members (SAIs of 193 countries and one supranational body) unanimously declared that “[SAIs] can help by enhancing transparency, ensuring accountability, promoting performance, and fighting against corruption and thus improve national good governance” (3). More specifically, INTOSAI has recognized that SAIs play a critical role in the fight against corruption through their audit reports and their

¹ Corruption and fraud share similarities in that both categories of crime involve the misappropriation of funds through, broadly speaking, dishonesty. Yet unlike fraud, corruption is defined as “the abuse of public office for private gain” (IMF 1997:3; 2018:9).

broader links with the enforcement environment. This enforcement environment of detection, investigation, and prosecution of illegal activities requires specific powers, techniques, and competencies, which the legislature typically assigns to the police and anticorruption agencies.

In addition, the contribution of SAIs to addressing corruption and fraud hinges on close collaboration with law enforcement agencies. The audit work of SAIs often provides leads for law enforcement agencies to pursue criminal investigations into corruption. Arrangements for exchange of information between SAIs and these agencies exist in most countries, but for effective collaboration often there is a need to create explicit procedures for referrals and sharing of findings with relevant law enforcement agencies along the audit process. Indications of irregularities detected by SAIs and passed on to enforcement agencies would have to meet the legal burden-of-proof requirement if such agencies wanted to use this information as evidence in court. However, the work of SAIs involves collecting audit evidence to provide assurance and identify noncompliance or areas in which to enhance performance; except for some SAIs with jurisdictional powers, this is not intended to meet the legal burden of proof. In some countries this gap is addressed by the SAI supporting enforcement agencies in their investigations, for example through forensic audit support. The work of SAIs may result in action against corruption being undertaken, but other agencies lead and take forward investigations and prosecutions, with possible support from SAIs. The impact of SAIs on corruption therefore depends heavily on strong collaboration with other agencies and parts of the public administration.

This chapter considers SAIs as a key pillar of accountability in the PFM cycle, notably in emergency settings. After an overview of norms and standards, it focuses on how SAIs can contribute to the prevention and detection of corruption, including through audits, notably via agile compliance audits in emergency settings. The chapter illustrates some of the challenges faced by SAIs, identifies specific challenges for sub-Saharan Africa, and explores how the IMF has approached audits in the IMF-supported programs in the region. Country cases in sub-Saharan Africa highlight ways in which challenges have been overcome and how the role of SAIs in addressing corruption has been strengthened. A discussion of agile compliance audits (real-time audits) in sub-Saharan Africa highlights the role of SAIs in emergency settings.

GLOBAL NORMS AND GUIDANCE TO HELP SAIs FIGHT CORRUPTION

INTOSAI principles call on SAIs' audits to respond to the risks of corruption by promoting transparency, including within their own operations.² INTOSAI's *Lima Declaration* (INTOSAI 2019c) defines "audit" as a part of a broader system

² See *INTOSAI-P 12: The Value and Benefits of SAIs—Making a Difference to the Lives of Citizens* (INTOSAI 2019e), principle 2, point 3; principle 5, point 3; and *INTOSAI-P 20: Principles of Transparency and Accountability* (INTOSAI 2019f), section 1, page 5; principle 4, bullet 2.

designed to reveal violations of principles and to hold those responsible to account.³ Audits focus on material matters, that is, those likely to influence the decisions of users of the audited information.⁴ Matters may be material based on their value, nature, or context. For example, the operations of high-profile public programs and the actions of high-profile public figures are often considered material by their nature, and thus may be examined for red flags indicative of corruption.

In addition to these principles and standards, INTOSAI has issued a specific guideline document, *GUID 5270: Guideline for the Audit of Corruption Prevention* (INTOSAI 2019b).⁵ INTOSAI's guideline documents, or GUIDs, constitute additional guidance, rather than being part of the core principles and standards SAIs are encouraged to adopt. *GUID 5270* postulates that it is better to prevent than to detect corruption and identifies five main tasks SAIs can consider to increase their contribution in the fight against corruption: (1) incorporate corruption issues into routine audit work; (2) heighten public awareness of corruption through public disclosure of audit findings; (2) improve methods and tools for combating corruption; (4) provide a means for whistleblowers to report suspicions of corruption; and (5) cooperate with other institutions in the fight against corruption. This guidance can also help SAI auditors in auditing the institutional framework for fighting corruption.

GUID 5270 can be used by auditors as a tool that also explains and illustrates the relevant features of anticorruption approaches and presents practical solutions for SAI auditors. It covers the setting up of anticorruption structures, the approaches for risk assessment and analysis, and monitoring processes. It emphasizes anticorruption drivers, such as segregation of duties, job rotation, role of internal review, and human capital. The guideline does not cover fraud investigations, although some SAIs have forensic audit units. Auditees (government departments or institutions) can use it to implement their own anticorruption programs and activities.

Finally, *GUID 5260: Governance of Public Assets* (INTOSAI 2019a) emphasizes the proper management of public assets to prevent corruption and promote good governance. It also suggests an understanding of basic governance terminology in the context of SAIs' work, including accountability, assets, corruption, fraud, good governance, integrity, money laundering, risk management, SAI stakeholders, and transparency, and proposes a comprehensive framework for asset management.

SAI INSTRUMENTS AND INSTITUTIONAL ARRANGEMENTS

SAIs have different audit disciplines at their disposal, as part of their regular mandates, which can help identify corruption. How the findings of such audit disciplines are then processed, depends on the particular institutional arrangements

³ See *INTOSAI-P 1: The Lima Declaration* (INTOSAI 2019c), section 1.

⁴ See *ISSAI 100: Fundamental Principles of Public-Sector Auditing* (INTOSAI 2019h), paragraph 41.

⁵ Originally issued as *ISSAI 5700*.

within which audit institutions are embedded. It may include reporting to the legislature, as well as other authorities (including law enforcement). In some systems the SAIs also have a judicial function.

Audit Disciplines at the Disposal of SAIs

SAIs have three main audit disciplines at their disposal: financial, compliance, and performance auditing (ISS100 Para 22 deals with all three types of audit). While each has its own specific objectives, each contributes to fighting corruption as follows, including by revealing red flags indicative of possible corruption.

Financial audits aim to assess whether financial information is free from material misstatement from fraud (wrongful or criminal deception intended to result in financial or personal gain) or error. Standards require financial audits to be planned to detect material instances of corruption and fraud, and to identify corruption vulnerabilities. Red flags could be incorrect reporting or budgeting, suspect transfers, over- and underspending, or excessive transfers of funds made just before, at, or after year's end. Further, they can include incomplete, ill-timed, or irregular recording of transactions, missing documents, unavailable originals, or seemingly altered documents.

Compliance audits are designed to identify whether a subject matter is in all material respects in compliance with laws, rules, and accepted principles. Standards require compliance audits—as well as financial audits to be planned to detect material instances of corruption and fraud. Red flags could be breaches of—or lack of compliance with—laws, regulations, procedures, and good government practices; unauthorized transactions or use of assets; nonapproved budget adjustments; or individuals with access to systems and records outside their usual authority. For crisis settings, SAIs in a number of countries have applied compliance audits organized as a series of audits of the use of emergency funds. These agile compliance audits, also known as real-time audits, aim to address the sudden and expedited budgetary adjustments and extraordinary procedures that characterize these emergency settings, through audits conducted within a much shorter time frame, with shorter feedback loops to allow for faster policy action.

Performance audits examine whether government undertakings, especially in high-risk areas, are operating economically, efficiently, and effectively. It is not uncommon for these audits to identify inefficiencies and other red flags that indicate suspicions of fraud and corruption. Red flags could be low output, lack of delivery of services, low quality, lack of results, overlaps in programs or services, and poorly functioning systems. Performance audits have also been used to audit the institutional framework for fighting corruption, whether at the national level or within a specific sector.

Institutional Arrangements for SAIs

Institutional arrangements vary, with SAIs being formed in the image of their country's administrative traditions. In sub-Saharan Africa, this tradition mostly follows the legislature or the judicial model. In both models, the overall impact

of the SAI and its ability to properly discharge its mandate depend on the broader institutional framework and issues such as clarity of mandates, degree of independence, role in the PFM system, and adequacy of resources.

The legislature model, sometimes referred to as the Westminster model, suggests that the SAI, often referred to as the national audit office or office of the auditor-general, has strong formal independence from the executive, and reports to the legislature, often by tabling reports to the public accounts committee (PAC). Its reports include observations or recommendations designed to remedy deficiencies and improve performance, though they have no legal force. Legislature SAIs often have a single head of the institution, the auditor-general, though some follow a board model. Typically, they rely on the strength of the PAC for scrutiny of their work and impressing on the executive the need to implement their recommendations. When SAIs report to the legislature on findings, it improves the transparency of the PFM system and helps hold government and its officials accountable. Thus, its reporting requirements set expectations for its role in fighting corruption.

Most such SAIs can also refer suspicions of corruption to the appropriate authorities, including law enforcement agencies or the country's national anticorruption agency for further investigation, and the SAI may even support those investigations through forensic auditing.⁶ Between 2010 and 2020, some SAIs have been given, or have been mandated to use existing, powers to issue surcharges on responsible public officials to recover funds.

SAIs with jurisdictional functions have additional powers in relation to mismanagement of public funds.⁷ Following observations in a financial, performance, or compliance audit report, these SAIs can lead civil law proceedings within the framework of their jurisdictional activities.

The judicial model of SAIs, normally present in Francophone and Lusophone countries in Africa, are closer to the judicial system, such as a court of accounts or a chamber of accounts within the supreme court. In addition to strong formal independence from the executive, such SAIs are often considered to be equidistant between the legislative and judicial branches of government. Such SAIs undertake jurisdictional control of activities based on their audit findings. The objective of jurisdictional control is to make rulings in the form of specific decisions: orders, rulings, or ordinances on the personal and financial liability of public accountants. In some cases, the jurisdictional control results in a ruling on the legal liability of public accountants via collegial decisions and, potentially, issuing administrative sanctions for any irregularity. However, judicial SAIs operate within the realm of administrative law. Suspicions of corruption, as a criminal offence, are referred to appropriate authorities for further investigation and possible prosecution. The SAI may be called upon to aid these authorities in their work.

⁶ A forensic audit is an examination and evaluation of an organization's financial records to derive evidence that can be used in a court of law or legal proceeding.

⁷ See *INTOSAI-P 50: Principles of Jurisdictional Activities of SAIs* (INTOSAI 2019g), paragraph 1.1.1.

CONSTRAINTS ON THE EFFECTIVENESS OF SAIs IN FIGHTING CORRUPTION

How SAIs contribute to preventing and detecting corruption depends on both internal and external factors. Internal factors include the SAI's ability to utilize its resources effectively, carry out high-quality audits, correctly identify and systematically organize red flags and audit findings, and correctly address them. External factors are those around the government system.

The SAI's mandate and the extent of its powers define the type of work it can do. A mandate to audit all public financial operations in line with international standards can enhance the contribution of SAIs to the fight against corruption, though the specific powers and institutional setups can vary. According to the *Lima Declaration*, "All public financial operations, regardless of whether and how they are reflected in the national budget, shall be subject to audit by SAIs" (INTOSAI 2019c, Section 18). Limitations in their mandate to audit certain financial operations, such as the defense sector, which often holds large procurement projects, hamper the ability of the SAI to issue assurances of the quality of the consolidated public finances and create loopholes for illicit activities. Furthermore, extrabudgetary funds not covered by the SAI's mandate also create a risk. Limitations in mandate could also cover the SAI's ability to choose audit approaches, submit documentation to other institutions, and follow up on or sanction deviations.

Lack of independence from the executive branch is a serious constraint to the SAI's effectiveness. It is essential that SAIs have sufficient legal, operational, and financial independence, and in each there is not just *de jure* (in law) but also *de facto* (in practice) independence. Independence is particularly relevant to successfully challenge vested interests in settings of endemic corruption. This independence includes the element that SAIs can choose within their mandate which matters to audit and can access information without interference from the executive, or without fear of reprisals on the SAI's head, board members, or staff. The legislature may request certain audits but should not direct the SAI in selecting audits. Independence is also key to the SAI's credibility and the quality of its reporting. A lack of independence of the SAI from the executive—actual or perceived by the public and the legislature—would reduce the likelihood of the SAI fulfilling its mandate effectively and of its audits' recommendations being acted upon.

SAIs need to be appropriately resourced to discharge their duties and contribute effectively to the fight against corruption. However, many SAIs, especially in low-income countries (LICs), face an imbalance between their available resources and their mandates. This imbalance often stems from constant pressure to expand the mandate of SAIs in response to expectations from citizens, legislatures, and international bodies. At the same time, countries face limited fiscal space and growing needs in other sectors, especially during a crisis. The *Open Budget Survey 2019* (International Budget Partnership 2020) shows that in 93 percent of developed countries, SAI funding is broadly consistent with the resources needed to fulfill its mandate. However, this share drops to 57 percent for low-income

countries and to just 31 percent in sub-Saharan Africa. Any expansion of SAI mandates thus needs to be appropriately resourced.

Expanding the mandate of SAIs that are already insufficiently resourced, without remedying these resource constraints, runs the risk of diluting the SAI's efforts and undermining rather than enhancing its effectiveness.

The *Global SAI Stocktaking Report 2017* (IDI 2017) found that SAIs' mandate limitations are common, but particularly acute in sub-Saharan Africa. Globally, 77 percent of SAIs have the mandate to share information with specialized anti-corruption institutions. However, only 55 percent have the mandate to investigate corruption and fraud issues, and only 18 percent can sanction them. In sub-Saharan Africa, fewer than 10 percent of SAIs have the mandate to sanction corruption and fraud. The *Global SAI Stocktaking Report 2017* found that only 44 percent of the SAIs worldwide met an international benchmark on independence and mandate. The benchmark is a score of 3 or higher (out of 4) on the two SAI performance measurement framework (PMF) indicators assessing SAI mandate and de jure and de facto independence.⁸ For sub-Saharan Africa, the Mo Ibrahim Index of African Governance, built from the Global Integrity 2020 Dataset, finds that SAI statutory independence is not adequately secured in 35 of the 47 sub-Saharan Africa countries.⁹

Many countries with a robust statutory framework face implementation challenges: half of the countries with sound statutory regimes score 0 on implementation. In the Global Integrity 2019 Dataset, Angola, The Gambia, Guinea-Bissau, Mozambique, South Sudan, and Togo have a perfect score on statutory independence of the SAI but score 0 on implementation. This does not contradict the point that a SAI can do excellent work even with an imperfect statutory framework, as countries such as Kenya and Sierra Leone exemplify. In the Global Integrity 2019 Dataset, these countries received a weak score on the statutory framework, but scored well on implementation. Ultimately, however, even when de jure independence seems broadly adequate, the key challenges lie in implementation.

Regarding institutional arrangements, the *Global SAI Stocktaking Report 2017* points to some of the external factors, which sit outside the control of the SAI. Forty-eight percent of the legislatures do not hold public hearings of audit reports, which are critical for transparency and effective accountability. Only 50 percent of the SAIs worldwide publish most of their audit reports, with the trend declining, while the number of SAIs not publishing any reports has

⁸ The independence data quoted here is from the SAI PMF, not self-reported data.

⁹ <https://www.africaintegrityindicators.org/data>. The Global Integrity 2020 dataset, similarly to the *Global SAI Stocktaking Report 2017* (IDI 2017), points at a gap between the laws on the books and their implementation. In regard to this gap as it concerns SAIs, see the Natural Resource Governance Institute (NRGI), *The Resource Governance Index: From Legal Reform to Implementation in Sub-Saharan Africa* (NRGI 2017): "A key finding of the 2017 Resource Governance Index from 28 countries in sub-Saharan Africa is that there is a significant gap between the state of resource governance according to laws, and practices on the ground." See also Wilkins (2017).

increased. The publication of these reports is a key feature for public accountability. In 57 percent of SAIs, no reports are issued on follow-up steps taken to implement audit recommendations—a critical feature in the domain of anticorruption, where, in most cases, it remains incumbent on the enforcement agencies to follow up on audit reports (INTOSAI 2017).

These worldwide challenges seem to be particularly acute for sub-Saharan Africa. The Mo Ibrahim Index on African Governance finds that close to 60 percent of the sub-Saharan Africa annual reports and audits are not published in a timely or routine manner.¹⁰ Public Expenditure and Financial Accountability (PEFA)¹¹ reports from 25 sub-Saharan African countries indicate that, in 72 percent of cases, the legislature considers the SAI report 12 months or more after receipt of the report. In none of these countries does the legislature issue recommendations on actions to be implemented by the executive nor systematically follow up on their implementation. PEFA reports also found that in none of these countries did the executive nor the audited entity follow up on the audit report in an effective and timely manner.

Reports also flag internal challenges to SAIs in sub-Saharan Africa because of mandate or resource constraints. Analysis of PEFA reports finds that, for the majority of the 25 sub-Saharan African countries they cover, there is only partial financial audit coverage of the state budget. This may be the result of an interplay between mandate and resources allocations: in settings in which the SAI is not constitutionally or statutorily obligated to audit all state audit agencies, it may be more vulnerable to resource constraints than in settings where such obligations exist. This helps explain why the Republic of Congo's SAI audits about 30 entities annually, whereas for other countries in the region where the SAI is constitutionally mandated to audit all entities, more than 600 audits are conducted every year. In sub-Saharan Africa, in only 17 percent of the countries have all entire central government agencies been audited in the past three years. In 32 percent of the countries less than half of the expenditures and revenues is covered. Even though some parts of the budget are explicitly outside the SAI mandate in almost all sub-Saharan African countries, the largest parts of the gaps in coverage reflect inadequate resourcing of the SAI. In addition to the resource constraint, the lack of a systemic, risk-based approach to audit selection, and the discretionary dynamic that underpins audit selection, creates corruption vulnerabilities. Another internal challenge is late processing by the SAI itself. In 56 percent of the countries, the time lapse between receipt of the financial reports by the SAI and submission of its audit report to parliament exceeded 9 months. This is particularly relevant

¹⁰ The Global Integrity 2019 Dataset says that in 28 out of 47 countries, the SAI does not publish their annual or budget reports in a timely manner, or do not publish those at all. These reports may be accessible to the government authorities. For the 25 sub-Saharan African countries for which a PEFA report was conducted, this group is 64 percent.

¹¹ The PEFA program provides a framework for assessing and reporting on the strengths and weaknesses of PFM using quantitative indicators to measure performance. See <https://www.pefa.org/about>.

in emergency or crisis settings, where the paper trail and extraordinary administrative procedures need close tracking.

IMPLICATIONS FOR AND ENGAGEMENT WITH THE IMF

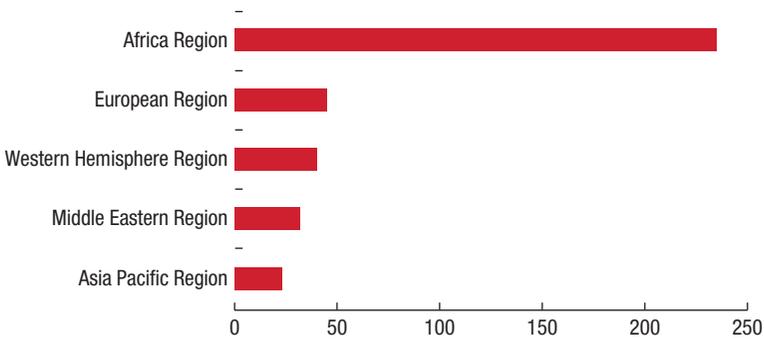
The constraints and implementation challenges have broader implications, including on the transparency and accountability of the PFM framework. For instance, in most sub-Saharan African countries, the SAIs have the mandate to audit oil companies. However, constraints and implementation challenges mean that audits can be inadequate (generating aggregate data only) or not conducted at all. Even in the countries where audits are conducted, only in one-third (Ethiopia, Sierra Leone, South Africa, Sudan, Tanzania, Uganda, Zimbabwe) are such audits released to the public (NRGI 2017). The outcome is that there is little transparency or accountability, notably regarding the activities of the 19 national oil companies in sub-Saharan Africa, which is a clear red flag for corruption in this sector (see “Constraints on the Effectiveness of SAIs in Fighting Corruption” in this chapter; and Chapter 6; NRGI 2017). These challenges have broader implications for the PFM framework and engagement of international financial institutions, including the IMF.

IMF-supported programs have sought to help countries address these challenges, including through targeted conditionality. Over the period 2002–2020, IMF programs with sub-Saharan African member countries included 234 structural benchmarks (SB) on audits (Figure 12.1).¹² This large figure is a result of an increasing number of programs and a higher number of SBs on audits in sub-Saharan African programs than for any other region. In addition, the audit benchmarks are rarely singular, and almost all IMF-supported programs carry numerous audit measures covering a wide range of issues and sectors, reflecting the extent of the implementation challenges.

For a number of sub-Saharan African countries, the domestic audit system faces vulnerabilities in both the public sector and the parastatal sector. The former has the largest number of benchmarks, ranging from audits of agencies (for example, central banks) to specific accounts or services (for example, domestic arrears, extrabudgetary funds, tax exemptions, customs services, special funds and social security, and wage bill). The latter, which covers the extractive industry and other state-owned enterprises (SOEs), was subject to 13 audit benchmarks on national oil companies and budget flows for several countries (for example, Angola, Côte d’Ivoire, Equatorial Guinea, Guinea, Gabon, Republic of Congo, and Senegal). IMF-supported programs also included audits of the oil revenue component in the budget, oil concession contracts, oil trader contracts, and so on. The need for these SBs points at weaknesses in the audits of the oil sector.

¹² See IMF, Monitoring of Fund Arrangements (MONA) database, <https://www.imf.org/external/np/pdr/mona/index.aspx>.

Figure 12.1. Number of Structural Benchmarks on Audits in IMF Programs in Sub-Saharan Africa (2002–2020)



Source: IMF, Monitoring of Fund Arrangements database, <https://www.imf.org/external/np/pdr/mona/index.aspx>

Other sectors are similarly targeted by benchmarks on audits, such as the more than 30 benchmarks on audits of SOEs spread across programs in the region. Some of these sectors may be statutorily subjected to private sector audits, and the numerous SBs in these sectors therefore seem to suggest that the entire audit sector is weak, whether public or private.

Only about half of the benchmarks request specifically a SAI, third-party, or internal audit. The third-party¹³ audit benchmarks are the most common (12.7 percent). Oil companies and other SOEs are subjected almost exclusively to third-party audits, which likely reflects absent or limited SAI audit reports of SOEs (including oil companies) in the region (which may arise from limitations in mandate or resource constraints, as discussed earlier). For several countries, the benchmarks also call for third-party audits for the public sector, almost always for narrowly defined issues—including domestic arrears (Côte d'Ivoire), financial statements of the central bank¹⁴ (Angola, Malawi, Rwanda), or special funds (Guinea Bissau's agricultural funds)—or areas within the mandate of the SAI. Third-party audits could be requested because the constraints hobbling domestic institutions are deemed to be too severe, and because addressing these issues requires sustained long-term reform, while what is needed is a short-term solution. At the same time, in some countries third-party auditors also face some of the constraints faced by SAIs, such as limited independence.

¹³ While the term “third party” in an audit sense is used to distinguish the auditor's role from that of the first party (the audited entity) and the second party (the user of audit reports), it has also in practice been used to refer to audits by an entity other than the SAI.

¹⁴ Auditing of the central bank often appears outside the SAI mandate, in part because many SAIs do not have the technical capacity for and experience in auditing complex financial institutions. Sometimes SAIs appoint external auditors to do the audit on their behalf (see Chapter 13).

While the vast majority of benchmarks aim to ensure that an audit is conducted, a modest number of SBs focus on the institutional framework. This includes benchmarks to strengthen the SAI statutory framework (Capo Verde), to ensure publication of the SAI report (Burundi, Uganda), or to ensure that recommendations made in the SAI's audit reports are implemented (Sierra Leone). These SBs seek to directly address some of the constraints identified in this paragraph and thus strengthen the domestic system of accountability.

BOLSTERING SAIS' CONTRIBUTIONS TO THE FIGHT AGAINST CORRUPTION IN SUB-SAHARAN AFRICA

Properly empowered SAIs can be very effective in reducing corruption. They can help strengthen the preventive system and the framework with which to deal with corruption cases, notably when using specialized (forensic and performance) audits (Menochal and others 2015; Transparency International 2015). Examples such as the Uganda SAI's audit (conducted in 2011), which uncovered the embezzlement of funds from development partners at the office of the prime minister, show the potential impact of these institutions (see Chapter 7). The role of Ghana's SAI in 2014 in addressing payroll fraud, which had been a challenge for close to two decades, is another example. Generally, the effectiveness depends on the capacity of the SAI involved and on the broader context within which it operates.

Audits of the Institutional Framework to Fight Corruption

Between 2015 and 2020, many SAIs began undertaking performance audits to assess the efficiency and effectiveness of the institutional framework for fighting corruption, building on *GUID 5270* (INTOSAI 2019b). Such audits help assess the functioning of the institutional framework, contribute to developing a systemic vision for addressing corruption, and support prioritization of remedial actions to strengthen the framework and address risks.

The SAI of Liberia conducted a performance audit related to the Liberian Anti-Corruption Commission in 2018. The audit looked at the Anti-Corruption Commission's performance in planning, implementing, and monitoring coordinated, consistent, and sustained interventions for the fight against corruption, both at national and sectoral levels. In its conclusions, the SAI audit pointed out the lack of coordination in implementing anticorruption measures in the country. It also recommended that the Anti-Corruption Commission strengthen collaboration with nonstate actors in support of a coherent agenda. The SAI of Liberia also undertook an audit of the country's legal framework and implementation of the asset declaration system. Acting under this initiative, Liberia's SAI undertook a special audit of the asset declaration system for public officials. It was found that the Liberia Anti-Corruption Commission (LACC) did not have a robust process in place for verifying and investigating asset declarations. Most

importantly, the SAI reported suspicious and unexplained wealth and false declarations by some officials, for which the investigators recommended application of sanctions.

Burkina Faso's SAI conducted an audit of its interests and asset declaration mechanism for public officials. In 2018 it conducted an audit of the effectiveness of mechanisms for managing declarations of interests and assets by public officials, including the president of the republic and members of government, members of parliament, members of the judiciary, and high officials in public administration. The audit stressed the lack of cooperation between the agencies involved in identifying public officials subject to interests and asset declaration, and in tracing their wealth as a major weakness that affected the scope and reliability of interests and asset information received by the country's SAI.

Since 2016 the INTOSAI Development Initiative (IDI) has been providing support to SAIs to undertake such performance audits under its SAIs Fighting Corruption Initiative.¹⁵ As part of this capacity development intervention, SAIs participated in a global program of cooperative performance audits addressing their whole government's institutional framework for fighting corruption, and one or more specific sectors. As part of the IDI's cooperative performance audit on institutional frameworks for fighting corruption, some SAIs undertook an assessment at the national level, focusing on themes such as the effectiveness and implementation of the national anticorruption strategy, assessment of corruption risks at the national level, asset declaration system for high-ranking public officials, and coordination between state anticorruption actors. Following are some examples of the audits of institutional frameworks for fighting corruption conducted by SAIs.

In 2017 the African Organisation of Supreme Audit Institutions (AFROSAI) signed the Yaoundé *Declaration on Curbing Illicit Financial Flows through Good Governance*.¹⁶ As part of this effort, 13 African SAIs committed to audit the implementation of the *United Nations Convention against Corruption*, focusing on

¹⁵ The INTOSAI Development Initiative's SAIs Fighting Corruption initiative is a capacity development intervention program created in 2016 for 58 SAIs in Africa, the Arabic world, Asia, Europe, Latin America, and the Pacific. The initiative "is supporting [SAIs] across the world in enhancing their effectiveness and their contribution to the fight against corruption." According to its website, the program aims to achieve this goal via the following strategies:

1. Auditing national institutional frameworks in place for fighting corruption
2. Establishing/strengthening cooperation between [SAIs] and their stakeholders in fighting corruption
3. Strengthening [SAIs'] own ethical behaviour and practice through sound integrity control systems

(See <https://idi.no/work-streams/well-governed-sais/sfc>.)

¹⁶ *Declaration on Curbing Illicit Financial Flows through Good Financial Governance* (signed in Yaoundé on May 2017), agreed between the African Organisation of Public Accounts Committee (AFROPAC), the African Organisation of SAIs, and the Collaborative Africa Budget Reform Initiative (CABRI). This declaration is not to be confused with the November 2017 *Yaoundé Declaration – Fighting Illicit Financial Flows in Africa*, which focused on international tax cooperation.

the implementation of asset declaration systems and public procurement.¹⁷ These audits led to an initiative, entitled “Cooperative Audit of Illicit Financial Flows,” (IFF) focused on corruption and coordinated by AFROSAI under the GIZ Good Financial Governance in Africa Program.

Cooperation with Law Enforcement Bodies

For SAIs, collaboration with the judiciary, including prosecuting and investigating agencies, and with anticorruption agencies, is critical, even if not sufficient, for effective follow-up on audit findings. Some SAIs—especially those with jurisdictional powers—have the mandate to impose sanctions directly; others do not. In either case, clearly defined working relations with the judiciary and prosecuting and investigating agencies should be established and maintained.

Examples of SAIs’ cooperation with law enforcement bodies in Francophone Africa include Chad and Comoros and Cameroon. The procedure between the Chad Court of Accounts and the enforcement agencies has been strengthened. The Chad SAI’s reports are communicated to the General Prosecutor’s Office of the Supreme Court, where prosecution procedures are mandatorily initiated on revealed irregularities. The collaboration between the Comoros Section of Accounts of the Supreme Court and the enforcement process has been tightened. The attorney general at the Supreme Court attends the SAI’s hearings in person or through its representative, and presents observations or conclusions on the facts discussed, for eventual further prosecutions. The authority of the Cameroon Supreme State Audit Office to engage the enforcement agencies has been enhanced. The SAI’s auditors may request police assistance during audits. Also, the SAI can be requested by courts to support investigations in financial crime with clarifications on facts from an audit report (generally a compliance audit) duly passed to the criminal justice (corruption, embezzlements, and so on).

Sanctions, Surcharges, and Other Legal Powers

SAIs with jurisdictional functions have additional powers in relation to mismanagement of public funds. In African countries where SAIs have such functions, the mandate generally includes exercising jurisdictional control over public accounting officers and public managers, and sanctioning liabilities. The mandate of a SAI defines the operational powers vested in it through the legal framework. In addition to having authority for carrying out performance, compliance, and financial audits, SAIs with jurisdictional functions generally have the power to issue formal rulings sanctioning the personal liability, either financial or disciplinary, of individuals (generally accounting officers and public

¹⁷ <https://gfg-in-africa.org/13-african-supreme-audit-institutions-join-forces-to-tackle-corruption-as-a-driver-of-illicit-financial-flows/>.

managers) found guilty of infringements to the public finance management regulation, as established in audit reports. In the case of public accounting officers, regular checks of records are undertaken by the auditors, both on- and off-site, to determine if books of public bodies are kept properly. Where accounts are in good order, the SAI generally delivers a discharge judgment. Where an irregularity in accounting operations is found and financial loss evidenced, the SAI registers the failure and declares the accounting officer a debtor of the public body. In such systems, public accounting officers are therefore personally and financially liable as established by the SAI, in the event of non-recovery of revenue or irregular expenditure. The same applies to de facto public accountants, that is, people who handle public money without being legally entitled to do so.

Public managers can also be fined by the SAI for their personal liabilities regarding mismanagement. They can be prohibited from exercising public office temporarily or indefinitely, also based on audit reports, but following a different procedure from the one used for public accounting officers. The principle of segregation of duties between public managers and public accounting officers applied in PFM systems in those countries also generally entails a segregation of liabilities, and therefore of the jurisdictions before which those liabilities can be adjudicated. In Cameroon, the Budget and Finance Disciplinary Board, a jurisdictional body presided over by the head of the SAI and in charge of judging public managers, has for the year 2019 rendered several rulings establishing public managers financially liable for a total of 2.7 billion CFA francs (about US\$5 million), for losses associated with cases of noncompliance reported in the SAI's audit reports (Cameroon National Anti-Corruption Commission 2019).

The Role of the Media and Civil Society Organizations

SAIs are paying increased attention to their contacts with the media and other sections of society, notably CSOs. Interactions with the media and CSOs are particularly relevant for identifying corruption, which is by nature a hidden transaction. In many countries, SAIs have strengthened communication channels and created an enabling environment for reporting concerns and suspicions to the SAI, including from third parties. These countries have established whistleblower support and protection (as envisaged under *GUID 5270* [INTOSAI 2019b]), witness protection programs, hotlines, and other reporting instruments, including ones operating through CSOs and the media.

The media and CSOs can also contribute to institutional empowerment. They can be important supporters of effective accountability in PFM systems and are typically supportive of giving SAIs more powers. In some countries, this has translated into specific institutional empowerment of SAIs. The close collaboration between CSOs, courts, and the SAI in Ghana is a case in point (see Box 12.1).

Box 12.1. Ghana: Combating Fraud and Corruption with “Disallowances and Surcharges”

by Daniel Domelevo

The following discussion highlights the close cooperation between CSOs and the Ghana Audit Service (GAS), and the role of the judiciary, which has resulted in the auditor-general assuming quasi-sanctioning powers (“disallowances and surcharges”) to combat misallocation of public funds.

The constitutional framework: The auditor-general of Ghana is required by the constitution to audit the accounts of the executive, legislature, judiciary, and any others and report to Parliament within six months after the end of the immediately preceding financial year to which each of the accounts relates. Additionally, Article 187(7)(b) provides, in common language, that the auditor-general may nullify any item of expenditure that is contrary to law (“disallow”) and impose the cost of that expenditure upon the person that effected it (“surcharge”).

The role of CSOs and the judiciary in implementing the constitutional framework: Although Article 187(7)(b) has been in the constitution since 1992, it had not been implemented. In 2014 OccupyGhana, a CSO, filed a suit before the Supreme Court for enforcement of the mandate. The Supreme Court unanimously upheld the claim and issued an order allowing the auditor-general to implement the power. After completing a special training course, the auditor-general conducted a special audit of government liabilities (as at December 2016) and in January 2018 issued a report that disallowed expenditures in the amount of GH\$5.5 billion (about US\$1.1 billion) out of total potential liabilities of GH\$11.8 billion.¹

Presidential support and rollout: This initiative received strong support from the president of the country. The auditor-general proceeded with the rollout of the powers and in December 2018 issued a report to Parliament on an additional 112 disallowances and surcharges for expenditures made contrary to law and for the recovery into the consolidated fund (a total of about US\$11 million). These included significant high-profile cases, involving over 200 senior state officials.²

Broad support from CSOs and the media: CSOs and the media played a major role in ensuring that the auditor-general exercised the mandate of disallowance and surcharge. Apart from enabling the auditor-general to exercise his constitutional powers through legal action, they exerted considerable pressure on the attorney general to follow up on the audit reports and prosecute the perpetrators of the fraudulent transactions. Press conferences and extensive media exposure sought to ensure that the audit reports would translate into effective accountability. CSOs also filed legal action to protect the auditor-general when he came under pressure.

Broader impact: Other countries, especially in Africa, have followed the steps of Ghana in enacting laws that mandate that the auditor-general hold public officers accountable.

¹ The auditor-general and 16 others went through training at the Judicial Training Institute on evidence-gathering for the purpose of disallowance and surcharges.

² In the State of the Nation address to Parliament on February 8, 2018, the president commended the efforts leading to the savings the nation achieved via the disallowance of some liabilities he had inherited from the previous regime. Also, during his address at the 61st anniversary of Ghana’s independence, the president stated: “A recent audit by the Auditor-General into the liabilities . . . led to the disallowance of some GH\$5.4 billion of claims. These are fictitious claims that would otherwise have had to be paid, but for the eagle eye of the Auditor-General. Can you imagine what we can do with GH\$5.4 billion? It can certainly finance the Free Senior High School for five years.”

These countries include Liberia, Sierra Leone, South Africa, and Zambia. The idea is to go beyond the annual reporting of infractions and abuses of public resources to parliament and grant SAIs powers to recover amounts wrongly spent by public officials or other persons whose negligence or misconduct leads to deficiencies or loss of public funds (see, for example, World Bank 2020).

AGILE COMPLIANCE AUDITS (REAL-TIME AUDITS) OF THE USE OF EMERGENCY FUNDS

Scope and Goals of Real-Time Audits

The term “real-time audits” conjures up the image of auditors certifying the legitimacy of expenditure as it is incurred. However, in reference to international audit standards, the term “agile compliance audits” appears to be more accurate. The audits are ex post audits—they review expenditures after they have been incurred, ensuring the auditor is independent from the audited expenditure control system. The approach is different from preaudit or ex ante audit, where the auditor is engaged in the expenditure approval process. Real-time audits involve a series of compliance audits (*ISSAI 400* [INTOSAI 2019i]), that is, an assessment of whether a subject matter is (in all material respects) in compliance with relevant laws, rules, and accepted principles.

Real-time audits, particularly in emergency contexts, need to be rapid and agile, conducted outside typical time frames and audit cycles to make them relevant and informative for corrective action. This means they should focus on high-risk systems and expenditures associated with the emergency. A series of short, focused audits with shorter-than-normal timelines and streamlined processes (as opposed to a single, larger audit) enable the examination of specific risk areas. Audit findings can then be shared with the audited entity on an ongoing basis to enable rapid adjustments. SAIs should then finalize each individual audit, submit it to the appropriate authorities, publicize it as soon as possible, and build learning points from each audit into the next series of audits. Real-time audits are neither defined in international standards, per se, nor widespread across the majority of SAIs worldwide but have evolved into modern-day practice. The slower uptake of these standards could be because, in some countries, these audits are not viewed as explicitly within the SAI’s mandate and therefore lack a clear legal basis. There can also be resistance from audited entities or capacity and underresourcing issues. The remote working environment during the COVID-19 pandemic has also posed challenges for some SAIs, in particular where digitalization of financial management is limited, or information and communications technology ICT, connectivity, and access to IFMIS systems make remote auditing difficult. Despite these challenges, real-time audits are becoming more widely acknowledged as more responsive and relevant to the needs of an ever-changing emergency environment.

Real-time audits will only realize their full impact if there is political support for the SAI to carry out this oversight function and if other actors in the accountability ecosystem are working well together—in particular the legislature. For example, in Jamaica, the SAI has been asked to conduct real-time audits of COVID-19 spending to account for any waste or fraud, but enhancements to the process as a result of audits will only be implemented if the appropriate legislative committee analyzes the report in a timely manner to impose corrective action (IBP IDI 2020). Building relations with the legislative committees responsible for tabling the audit report (particularly the PAC) is key for the SAI, and SAI officials will often testify in committee hearings.

Real-Time Audits during the Ebola and COVID-19 Crises

Many countries, including in sub-Saharan Africa, have been affected by the COVID-19 crisis, and have put in place emergency budget adjustments. The need to respond quickly to the emergency creates pressure for more rapid expenditure and approval processes, such that emergency spending rules are introduced or existing rules are relaxed. Both approaches increase the risks of less effective spending, error, misuse of funds, and corruption. Sudden surges in expenditure for other reasons can lead to similar situations in which corruption risks are heightened. For instance, in 2008 the Chinese SAI used real-time audits to verify sudden surges in expenditures related to the Beijing Olympics and to post-earthquake reconstruction.

Crisis and emergency situations result in significantly increased fund flows through specially affected financial systems, sectors, organizations, and emergency coordination units. During the COVID-19 crisis, many countries applied for emergency financing from international financial agencies, including the IMF, whose emergency support programs were designed for the expedited disbursement called for by emergencies.

The SAIs in some African countries were not unfamiliar with the crisis generated by a pandemic, having had to face up to the Ebola pandemic in 2014–2016. The Ebola crisis necessitated significant budget adjustments to strengthen the health sector and, more generally, the countries' crisis response. The adjustments were possible thanks to foreign support and significant private donations from the countries themselves. At the time, recognizing the immediate nature of the vulnerabilities on transparency and accountability of these emergency programs, SAIs in several countries commenced targeted compliance audits of the emergency financing, effected within a much shorter time frame of three to five months. The objectives were to ensure tighter audit controls through auditor presence during the emergency spending period to positively influence spending behavior and to shorten feedback loops between government expenditure and audit findings, enabling more timely remedial actions. These so-called real-time audits were effectively early-warning systems.

In particular, the real-time audit effected by the Audit Service Sierra Leone (ASSL) during the Ebola crisis is a classic example of how these agile audits are to be carried out in emergency settings (Box 12.2). These audits illustrate the added

Box 12.2. Sierra Leone: Real-time Audit during the Ebola Health Crisis¹

by Lara Taylor-Pearce, Monique Newiak, and Fazeer Sheik Rahim

This box highlights the lessons from a good-practice real-time audit undertaken by the Audit Service Sierra Leone (ASSL) on the management of funds during the early phase of the Ebola health crisis.

Context: The Ebola health crisis hit Guinea, Liberia, and Sierra Leone during 2014–2016. Sierra Leone reported its first case in May 2014, and case numbers rose to 14,000 people in the country throughout the crisis. Sierra Leone was declared Ebola-free in March 2016. The severity of the shock to the country's health systems, paired with a substantial commodity price shock, triggered substantial financial disbursements by the international community and private individuals. An emerging discussion on the need for transparent and accountable use of funds motivated ASSL to conduct its first real-time audit, covering the management of Ebola funds from May to October 2014.

Main lessons: ASSL identified several lessons from conducting the real-time audit that apply to the broader context of real-time audits in emergency contexts:

- *Focus of the audit:* Given the timing of the audit, a focus on decision-making and management processes, rather than an assessment of the final spending results, is appropriate. This focus on structures and processes (for example, which emergency procedures for procurement are in place, and how have they been followed?) allows the making of recommendations to influence the way funding is used in the remainder of the emergency response. At the same time, the provision for fast feedback in the early stages of the crisis allows for corrective action that may not be possible through a sole ex-post audit that would serve different purposes. In Sierra Leone, the September 2014 audit discovered a range of major weaknesses in the use of emergency funds. A second, subsequent, audit report, covering November 2014 to April 2015, found that many issues had been addressed, highlighting the benefits of a real-time engagement in shaping the emergency response when the need is most urgent.
- *Legal backing:* Experiences during the real-time audit revealed significant resistance to the audit, including to ASSL's legal mandate to do so. Although, as in many countries, the country's constitution empowered ASSL to audit the use of public funds, an amendment to the Audit Service Act 2014 was necessary to expand its role in carrying value-for-money and real-time audits.
- *Staff capacity:* Staff performing the audit should have experience in a combination of compliance, financial, and performance auditing. In Sierra Leone, limited staff size and training highlighted the need to scale up capacity for future audits.
- *Adequate IT and other communication infrastructure:* Communication infrastructure systems are also critical, in particular in the context of a health crisis when auditors need to work remotely. In Sierra Leone, obstacles due to documentation that was often paper-based highlighted the benefits of automating and digitalizing the spending process.
- *Communication:* During the audit, it is also critical to have constant engagement of stakeholders in order to obtain buy-in and allow for follow-up, including conveying goals and procedures of the audit. Prompt reporting to the legislature on the findings from the audit is also important to enable speedy reaction and follow-up. Finally, publication of the audit will increase accountability regarding the findings and inform the public.

(continued)

- *Visibility of the SAI:* SAIs have the responsibility to inform citizens through the legislature on how well public funds have been managed on their behalf. Real-time audits that bring out issues for prompt action in a timely manner, lend credence to the work of the SAI and ultimately improve the relevance and visibility of the SAI.

¹ ASSL has been widely sharing its experience on real-time audits, including during a training of sub-Saharan African country officials on good governance at the Africa Training Institute in November 2020.

value of this approach by revealing in the first round of audits high levels of expenditure lacking satisfactory supporting documentation and appropriate approvals and controls. Following publication of a first high-profile audit report, the second round of audit work found improved supporting documentation and a better functioning control system. This supports the notion that SAIs need to reinforce the expectation that emergency spending will be subject to audit and oversight from the outset, instead of at the end of the budget year, and the importance of being visible from the onset of a crisis.

With the COVID-19 crisis, several countries in sub-Saharan Africa have decided to apply the same model for auditing emergency financing. The first audit reports are being published to ensure the dual objective of exercising control over the emergency financing and its proper administration, even during the disbursement cycle, and to shorten feedback loops. Early examples include Sierra Leone, South Africa, and Zambia, with more audits to come out steadily (for example, from Kenya and Malawi).

The Sierra Leone report, which refers to itself as a “real-time” audit, was one of the first published audits on COVID-19 emergency financing in sub-Saharan Africa (ASSL 2020). Drawing on the experience of ASSL during the Ebola crisis, this report illustrates the benefits of real-time audits in crisis settings, including giving a heads-up on problem areas and transactions, raising a red flag to respect proper procedures, and keeping relevant documentation. The detailed report covers a range of issues, including procurement challenges, disbursement challenges (such as lack of proper documentation, failure to process withholding taxes, and informal payments to suppliers), payment of allowances, fixed asset management, payroll and ghost workers, hiring of vehicles, medical supplies, management of donations, and timing of payments.

The Zambia report’s focus and specificity also fully support the aim of real-time audits to serve as an early-warning system (Auditor-General of Zambia 2020). The report gives a detailed analysis of challenges, including irregularities in the administration of donations, the transfer of public funds, and cash withdrawals; overpayment of staff and abuse of allowances; various procurement issues, including acceptance of quotations after deadlines, delays in delivery, failure to pay suppliers or questionable payments to suppliers, questionable fuel calculations, and absence of receipts and proper documentation; and so on. All

items are documented in detail, with reference to contracts and specifics, and often include the response of the relevant authorities.

All three South African real-time audit reports cover a wide range of government initiatives, from wage protection to health care services, basic education services, agriculture, tourism, water, and other social relief. The first and second report give a largely qualitative overview together with audit opinions that highlight the significant deficiencies in the procurement and contract management processes. They report inadequate controls of payment processes and, at times, note duplicate payments or nonpayments, unfair awarding of government contracts, and a lack of attention to protect against overpricing, financial loss, fraud, and abuse of the system (Auditor-General South Africa). Recommendations are pitched at a higher level to address the systemic challenges in the PFM system that cause the issues reported, rather than addressing individual issues.

These examples of real-time audits on the financial management of expenditures related to the COVID-19 pandemic and Ebola public health crisis are encouraging and an important contribution to accountability of emergency finance. The reports are specific, cite concrete evidence for their findings, assess budgetary impacts, and make recommendations. The media coverage of these reports, including in international outlets, will play an important role in pushing toward greater accountability of emergency financing and reducing corruption vulnerabilities.

CONCLUSION

The primary role of SAI is in ensuring the effectiveness and sound use of public resources. They can also play a key role in supporting anticorruption efforts. Countries in sub-Saharan Africa that are at the forefront of innovations in this sector have illustrated the relevance and impact of SAIs in the fight against corruption. International guidelines support increased SAI engagement on corruption, even if this engagement will always remain dependent on other institutional actors, notably the enforcement agencies. The role of SAIs is even more marked in emergency settings, in which expedited budgetary adjustments and extraordinary procedures generate increased exposure and where stronger safeguards through timely and adequate accounting are important. Sub-Saharan African SAIs face internal and external challenges that are reflected in the large number of measures regarding audits in programs supported by international financial organizations, such as the IMF. The focus on audits sheds light on where the weaknesses sit and can be critical to transparency and accountability. In this light, the increasing support by international organizations for the SAIs is a welcome development.

This support from international organizations backs up long-standing capacity development programs such as from IDI. Challenges notwithstanding, SAIs in several sub-Saharan African countries have been forward-leaning on combating corruption, specifically in emergency settings. Notably, these SAIs have been highly innovative in agile compliance audits (real-time audits).

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Central Bank Governance in Sub-Saharan Africa: An Overview Based on Experience with the IMF's Safeguards Assessments

Julia Cardoso, George Kabwe, and Riaan van Greuning

ABSTRACT

Good governance arrangements are a critical organizational element for the proper management of financial resources. In the IMF safeguards assessment policy, governance is an overarching theme of the framework used to assess the central banks of all member countries that borrow IMF resources. Information from the assessments provides the IMF Board with assurance that resources used in lending operations will be managed properly. A sound legal framework that safeguards central bank autonomy and establishes strong transparency and accountability practices is the foundation for good governance for central banks. This chapter provides an overview of the safeguards assessment findings on governance arrangements, with a particular focus on sub-Saharan Africa. It also contains preliminary observations on challenges that arose during the COVID-19 pandemic.

INTRODUCTION

Governance is central to proper management of financial resources in both the private and public sectors. The 2019 biennial *OECD Corporate Governance Factbook*, which covers 49 jurisdictions, including all G20, OECD, and Financial Stability Board members, notes that nearly all countries covered by the report have national codes or principles. The systematic refinements to these codes and principles, with 84 percent of jurisdictions having amended their company or securities law to incorporate changes introduced since 2015, reflects both the close scrutiny paid to governance and the importance attached to it (OECD 2019).

The 1992 Cadbury Committee in the United Kingdom defined corporate governance as “the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place” (Cadbury Report 1992, p. 15). The 2018 UK Corporate Governance Code notes

that this definition of corporate governance remains true today (Financial Reporting Council 2018, p. 1). Although there is no universal definition of governance, the OECD notes that “good corporate governance helps to build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies” (OECD 2021).

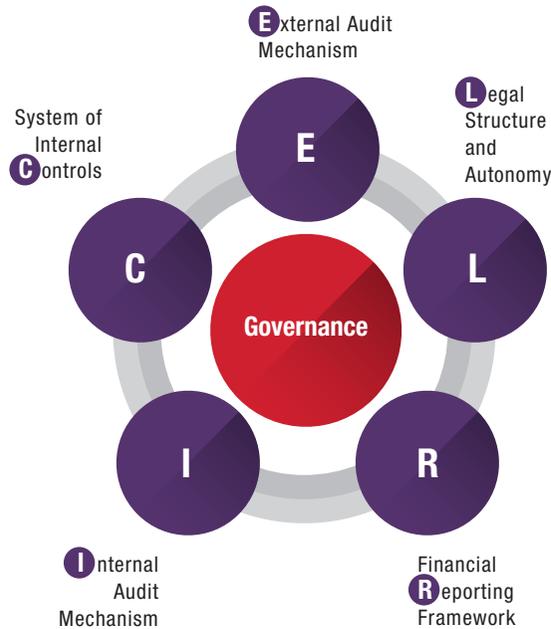
Under the IMF Articles of Agreement, “adequate safeguards” must be established for the use of its resources (International Monetary Fund (IMF) 2020, p. 2). This is to ensure that loans to member countries are repaid as they fall due so those resources will become available to other members in need. Safeguards include limits on how much can be borrowed, conditions on the loans, measures to deal with misreporting or arrears, and “safeguards assessments” of central banks.¹ The latter, specifically, are public institutions that require autonomy and proper governance to function optimally. Thus, the IMF’s safeguards assessment of central banks of member countries has governance as an overarching aspect of the framework used to engage in this work.

The IMF Safeguards Assessments Policy was introduced in 2000. Safeguards assessments are diagnostic evaluations of central banks’ governance and control frameworks, and involve an assessment of five areas: the external audit mechanism, the legal structure and autonomy, the financial reporting framework, the internal audit mechanism, and the system of internal controls (see Figure 13.1, which shows these five components of the safeguards framework, or ELRIC). As of the end of April 2021, 345 assessments have been conducted across the IMF’s membership, covering nearly 100 central banks. The sub-Saharan Africa region accounts for 116 of these assessments and 25 of these central banks. Central banks are subject to safeguards monitoring for as long as IMF credit remains outstanding. Currently, there are 84 central banks in the safeguards portfolio (about one-third in sub-Saharan Africa). The IMF Executive Board reviews the safeguards assessment policy every five years. In its 2010 and 2015 policy reviews, the Board endorsed a sharper focus on governance as an overarching principle of the safeguards framework (IMF 2010 and 2015).

The remainder of this chapter covers the various aspects of governance through its linkages to the ELRIC framework. The first section discusses the role of central bank law in supporting governance arrangements (the legal structure and autonomy pillar). The second section takes stock of trends in safeguards work, including the safeguards’ findings, lessons learned, and remaining challenges. This section covers two pillars, the internal audit mechanism and system of internal controls. The third section discusses the leading practices observed in terms of accountability and transparency of central banks. It draws specifically on the role of the external audit mechanism and financial reporting framework. Finally, the fourth section outlines the safeguards’ findings and recommendations offered in the assessments conducted during the COVID-19 pandemic.

¹ See IMF (2020) for further details on the components of the framework and process.

**Figure 13.1. Safeguards Analytical Framework:
A Clear Focus on Governance**



Source: IMF Finance Department.

THE ROLE OF CENTRAL BANK LAW IN SUPPORTING GOVERNANCE

Central bank autonomy is important in preserving monetary policy independence, which in turn helps to foster desirable macroeconomic outcomes and financial stability. The central bank law is the authoritative guidance that directs central banks, and safeguards assessments include a close review of this legal framework. The central bank law provides the basis for governance structures and mandates for decision-making (governance) bodies. Since 2010, safeguards work has been adapted to more closely review key governance bodies such as the board, audit committee and the interaction between the senior executive management team (the governor and deputy governors) and the board to assess checks and balances. Safeguards assessments review the central bank law to ensure that the four dimensions of autonomy—functional, institutional, financial, and personal—have strong legal provisions.²

² See Bossu and Rossi (2019). Paragraph 17 describes the four aspects of autonomy.

Figure 13.2. Status of Central Bank Legal Amendments

Source: IMF safeguards database.

Sub-Saharan Africa, along with other regions, has seen increased attention on legislation to improve governance. Between 2015, after the last policy review, and the end of 2019, 37 out of 43 central banks assessed, that is, 5 out of every 6, made recommendations to reform the central bank legislation. Of these 37 central banks, 28 had vulnerabilities that were deemed sufficiently significant that they were included as part of reform measures under IMF-supported programs. Progress is being made, as in 14 of these cases new central bank laws have been enacted, and, as of April 2021, 9 other draft amendments have been submitted to the cabinet or parliament (see Figure 13.2). Sub-Saharan Africa fares well with respect to legislative reforms to improve central bank governance, accounting for 50 percent of the central banks that have enacted new laws and one-third of central banks that are advancing draft amendments through submissions to the cabinet or parliament.

The quality of governance at central banks relies extensively on how effective the central bank board, audit committee, and management team are in fulfilling their roles and responsibilities. While governance structures such as audit committees have increasingly been established over the last decade or so in the safeguards portfolio, there continues to be a substance-over-form issue that needs to be resolved. It is one thing to have a board or audit committee in place, and another to assure that it is functioning as intended. Key governance attributes that foster good practices, and remain a challenge in many jurisdictions, include the following:

- *Independence and experience:* A majority nonexecutive board with strong requirements for professional experience, incompatibility criteria to avoid

potential conflicts of interest, and diverse backgrounds to help support the executive team on strategic direction. This board should also provide independent oversight of the executive team's execution of day-to-day operations.

- *Relevant professional backgrounds:* An audit committee should typically be composed exclusively of nonexecutive board members. At least one member should have deep accounting or audit experience in order to provide sufficient value-adding independent oversight of the external and internal auditors' performance, the system of internal controls, and risk management.
- *Collegial approach:* A governor, supported by a professional team of deputy governors, should facilitate close collaboration through collegial decision-making in management practices. Collegial teams should embrace wide deliberation and solicit input from senior staff with appropriate expertise to help ensure that decisions have taken account of relevant factors and alternative considerations.

The role of nonexecutive board members is to bring their diverse professional experience in order to facilitate decisions in a consultative manner on issues brought by the executive central bank team and ensure the compliance of these decisions with internal policies and the strategic direction of the whole board. Good central bank laws clearly delineate the responsibilities of the board and the governor and provide audit committees with a strong mandate and authority to exercise effective independent oversight. Empirical data from over 100 safeguards assessments conducted between 2010 and 2017 showed that audit committees can be key enablers of a strong governance environment at central banks. The common characteristics of an effective committee are (1) broad-based composition—it should include independent members with strong knowledge and expertise; (2) diligence and availability—its members should devote sufficient time to fulfill their role; and (3) close oversight—its members should closely monitor both external and internal auditors, who should be separate independent assurance providers (Chamoun and van Greuning 2018).

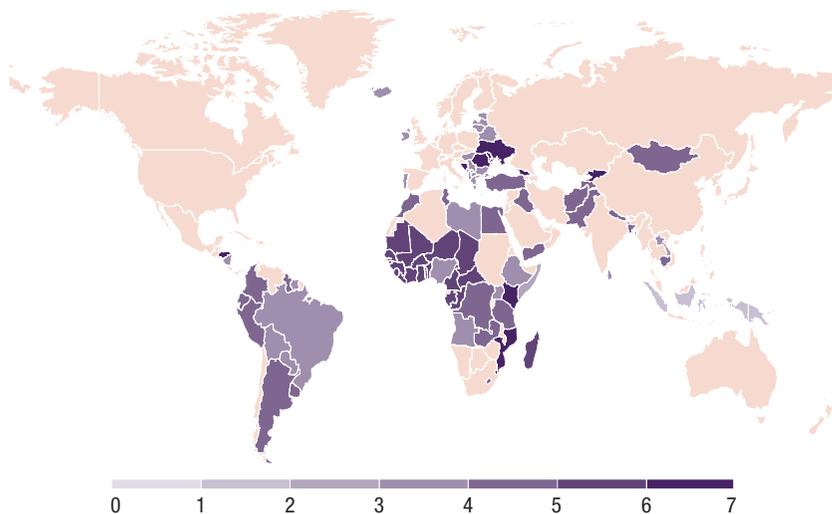
Challenges encountered in the review of the legal structure and autonomy of central banks include four broad underlying factors: (1) central bank laws that are outdated and have not been reviewed for prolonged periods; (2) a lack of compliance where strong *de jure* provisions are not followed in practice; (3) scarcity of suitably qualified independent individuals to fill board and audit committee positions; and (4) concentration of powers in the governor or executive team without an independent oversight board to provide checks and balances. The aforementioned strong focus on governance is beginning to foster an encouraging shift to modernize central bank legislation, as highlighted at the beginning of this section. In addition, some jurisdictions have looked beyond their national borders to seek suitable individuals to fill nonexecutive

board positions, which is possible as long as the regulatory framework permits it.

TRENDS IN SAFEGUARDS ASSESSMENTS

Safeguards assessments are diagnostic evaluations of central banks' governance and control frameworks and involve an assessment of five areas (see Figure 13.1). Safeguards assessments assign a risk rating to each ELRIC category: the four internal and confidential risk ratings are low, medium-low, medium-high, and high. The assessments are conducted for member countries that seek lending arrangements from the IMF, and as can be seen in the map in Figure 13.3, the more than 330 assessments that have been completed thus far have an extensive global reach.

Figure 13.3. Safeguards Assessments Completed Globally

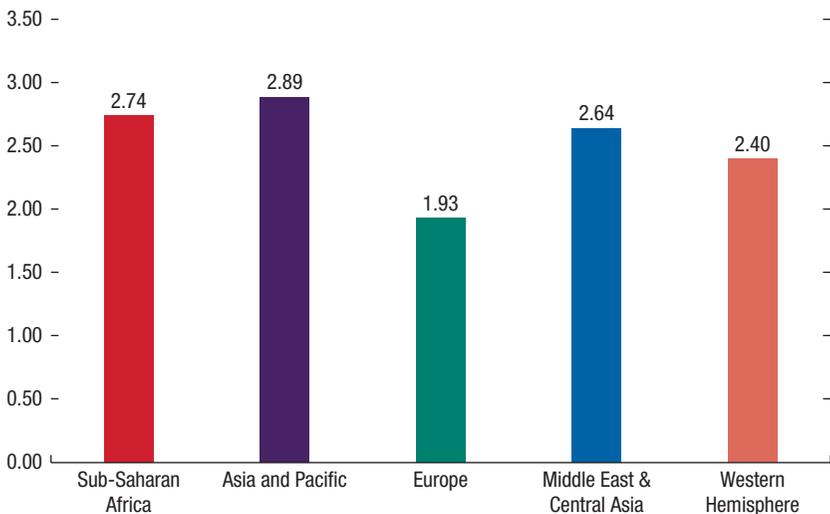


Source: IMF safeguards database.

An aggregated analysis of the risk ratings of all assessments conducted globally reveals that all regions, except for Europe, have average risk ratings that fall between medium-high and medium-low, or scores of 3 and 2, respectively (see Figure 13.4). Considering that a medium-low rating indicates that no serious vulnerabilities have been identified, these are arguably favorable results that are consistent with the general observations highlighted as part of the 2015 safeguards policy review, that central banks have improved their control, audit,

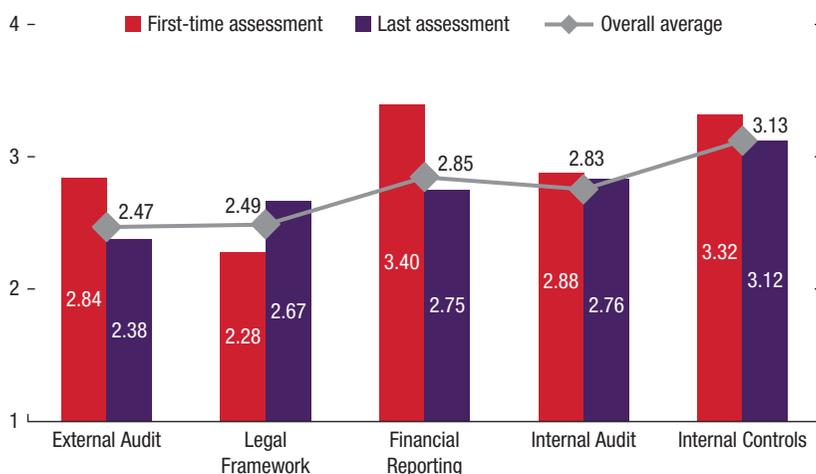
and financial reporting practices. The following section, on accountability and transparency, which covers the external audit and financial reporting pillars, further affirms that the majority of central banks are adhering to internationally accepted standards in these areas. The broad challenges experienced regarding the legal structure and independence of central banks were explained earlier, in the section on the role of central bank law. This pillar—legal structure and autonomy—and the pillars of the internal audit mechanism and the system of internal controls, prove to be the ones that provide the most challenges not just for the sub-Saharan Africa region, but across the safeguards portfolio.

Figure 13.4. Average Risk Ratings by Region (1 = low; 4 = high)



Source: IMF safeguards database.

A deeper dive into the sub-Saharan Africa region (see Figure 13.5) confirms that over time the external audit mechanism and the financial reporting frameworks of central banks have significantly improved. On the other hand, it also reveals that the legal structure and autonomy of central banks continue to face challenges, which is partly a result of an evolving assessment of this pillar that has emphasized more scrutiny on governance since the 2010 safeguards policy review. Central banks are taking steps to address these shortcomings by making amendments to their legal frameworks in order to align them with leading practices. Internal audit and internal controls pillars have seen only a marginal improvement, owing in part to the capacity challenges and exogenous risks faced by institutions in today's world.

Figure 13.5. Safeguards Risk Ratings by ELRIC Pillar for Sub-Saharan Africa

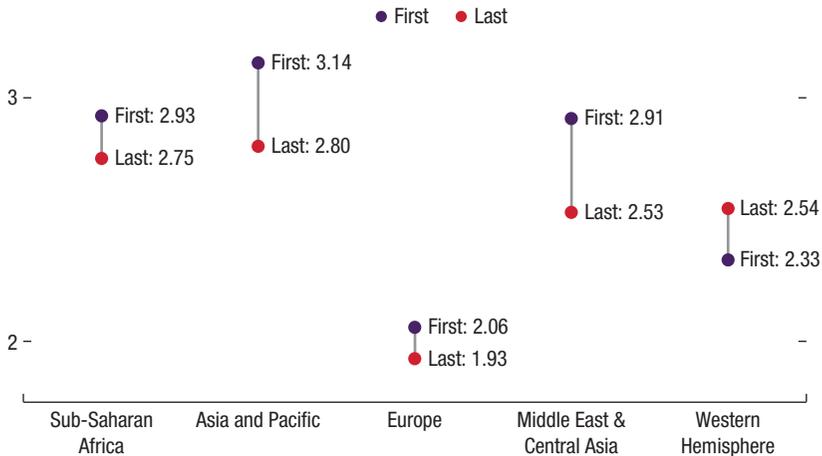
Source: IMF safeguards database.

The main drivers for the remaining high-risk ratings in the internal audit and internal controls pillars are as follows:

- Internal controls:* The effectiveness of governance bodies remains a key source of high risk in this pillar. This is the case for those central banks that have had prolonged vacancies on their boards. It also is the case for central banks that have experienced weak oversight, due either to board members not having sufficient requisite expertise or to provisions in the central bank law related to independent oversight that need to be strengthened. For instance, within sub-Saharan Africa, the Lusophone countries (for example, Angola, Mozambique, and São Tomé and Príncipe) tend to face more challenges related to their governance structures, which traditionally have not included an independent oversight body, that is, a majority nonexecutive board. Other factors include weak controls in foreign reserves management, compilation of program monetary data, and operations related to emergency liquidity assistance.
- Internal audit:* Internal audit functions continue to face exogenous challenges such as increased risks related to IT, cybersecurity, and SWIFT compliance. It is often difficult for audit functions to acquire talent with the requisite background and experience to keep up with these developments, and in some cases to retain such talent. A more fundamental issue seen in some jurisdictions is the difficulty of obtaining internal audit professional certifications that can help modernize the activity by moving it from a compliance-based function to a risk-based approach. These capacity issues tend to require an investment of time and sponsorship from senior management to achieve the desired results. Notwithstanding these challenges, on an

aggregated basis, central banks have improved their controls and processes between their first-ever and most recent assessments (see Figure 13.6). A subsequent lower score signifies a shift toward the risk ratings of low or medium-low, that is, scores of 1 and 2, respectively. The average risk rating (from 2.93 to 2.75) has overall improved in sub-Saharan African countries, in line with the trend for all regions since their first-time assessments, except for the Western Hemisphere region. The deterioration in the Western Hemisphere can be partly explained by the fact that IMF credit is of a revolving nature and lending to Latin America has not been active since the early 2000s, and has just resumed. First-time assessments and assessments after a long lapse of time tend to identify significant vulnerabilities. In contrast, the Middle East and Central Asia region has seen the biggest improvement thus far, followed by the Asia-Pacific region.

Figure 13.6. Evolution of Safeguards Risk Ratings by Region



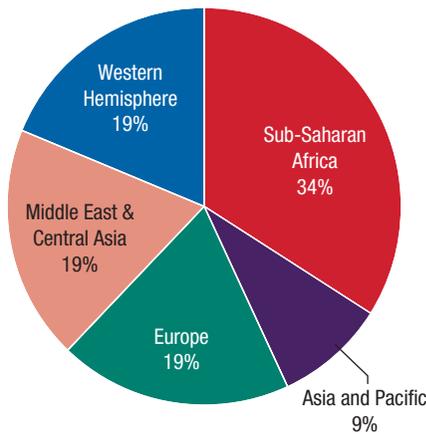
Source: IMF safeguards database.

Sub-Saharan Africa accounts for about a third of safeguards assessments conducted (see Figure 13.7), while other regions account for almost one-fifth, except for Asia and Pacific with 9 percent of the total. That said, enhanced and more engaged safeguards monitoring strategies have also contributed to many of these improvements.³ Monitoring activity, in many instances, has involved following through on safeguards-related reforms, such as legal amendments or the transition

³ Experience in cases in which an update assessment is conducted in a country where the IMF has had no financing arrangements, and thus no safeguards assessment interactions over the last decade, indicates that risk ratings are typically higher owing to limited exposure to leading practices.

to International Financial Reporting Standards (IFRS), as well as reviving the authorities' commitment to address long-outstanding recommendations. Specifically, monitoring visits have been conducted for six sub-Saharan African countries during 2017–2020, and on average, approximately 4.5 repeat assessments have been conducted in the region. This signals that a more interactive approach to following up can help in addressing some of the challenges observed and consequently improving the risk ratings of the region.

Figure 13.7. Safeguards Assessments by Region



Source: IMF safeguards database.

ACCOUNTABILITY AND TRANSPARENCY: ROLE OF EXTERNAL AUDITORS AND FINANCIAL REPORTING

Autonomy is important in order for a central bank to achieve its mandate, and the counterweight to autonomy is accountability and transparency. An independent, high-quality external audit of the central bank's published financial statements, in line with the International Standards on Auditing (ISA), provides accountability to stakeholders on the use of funds.⁴ The robust nature of these standards assures stakeholders of the rigor and high quality of the audits. Equally important is the basis for financial reporting, which enables a sufficiently transparent and widely understood set of standards upon which the auditors must opine. Given the complexities of a central bank audit, an audit firm with

⁴ ISA are the benchmark standards for the performance of audits of financial statements, issued by the International Auditing and Assurance Standards Board. The ISA and IFRS are the benchmarks used in safeguards assessments for external audits and financial reporting, respectively.

international affiliation provides certain benefits that support audit quality, including access to a wide network of expertise and quality-control procedures that align with ISA. For financial statements to be useful, they must be relevant, reliable, consistent in presentation over time, and based upon recognized standards, such as IFRS. This section covers these aspects in further detail based on 31 central banks of IMF member countries in sub-Saharan Africa and the two regional central banks of the CFA zone, representing 14 countries that do not have their own central bank.^{5,6}

Accountability

As public institutions, central banks should be held accountable for the use of their resources. Under the IMF safeguards assessment policy, an independent and high-quality external audit of a central bank's financial statements is an important accountability requirement. An audit provides assurance as to the reliability and accuracy of the information contained in the financial statements. When assessing the external audit arrangements, ISA are the benchmark.

Nearly all central bank (94 percent) audit reports in sub-Saharan Africa state use of ISA.⁷ In comparison, Arda and others (2018) found that out of 170 central banks studied around the world only about 64 percent used ISA. The sub-Saharan Africa region, and the broader safeguards population (84 central banks), of which 95 percent state use of ISA, generally fare well on this aspect of accountability.

The majority of central banks—94 percent—in sub-Saharan Africa are audited by reputable international audit firms, that is, either by the four large international audit firms (Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers) or the second-tier international firms (BDO, Mazars, and Grant Thornton) (see Figure 13.8). This compares favorably with the global practices noted by Arda and others (2018), who found that 70 percent of worldwide audits had been conducted by these large international firms. The internationally audited sub-Saharan banks (the 94 percent, or 30 central banks), include 10 central banks that are subject to joint audits, where two or more auditors are appointed to share responsibility for conducting the audit. There are two primary reasons for joint

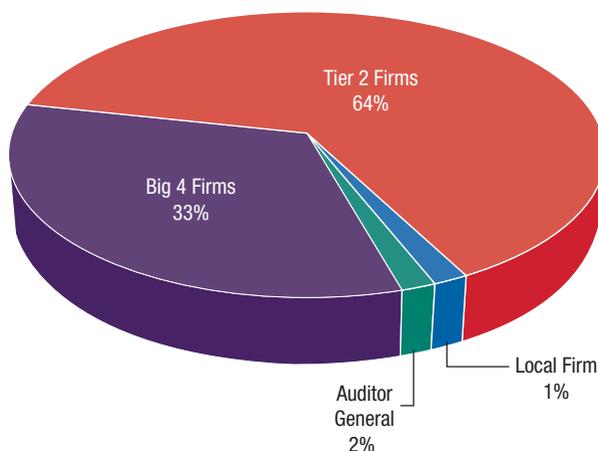
⁵ The CFA franc zone consists of 14 countries in sub-Saharan Africa, each affiliated with one of two monetary unions. Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo comprise the *West African Economic and Monetary Union*. The remaining six countries—Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, and Gabon—comprise the *Central African Economic and Monetary Union*.

⁶ Data presented are based on publicly available information, primarily from central banks' audited financial statements. Information was available for all but one central bank in sub-Saharan Africa.

⁷ In one case, the central bank is audited by the auditor-general under International Standards of Supreme Audit Institutions (ISSAI), as issued by the International Organization of Supreme Audit Institutions. Since 2010, these standards have been reviewed annually to ensure consistency with ISA. This does not mean, however, that safeguards assessments did not identify shortcomings in the application of ISA.

audits: (1) legal provisions in the central bank law (the case for four central banks); or (2) a requirement under an IMF program due to low audit capacity in the country that necessitates an international firm with requisite experience to work with a local firm (the case for six central banks).

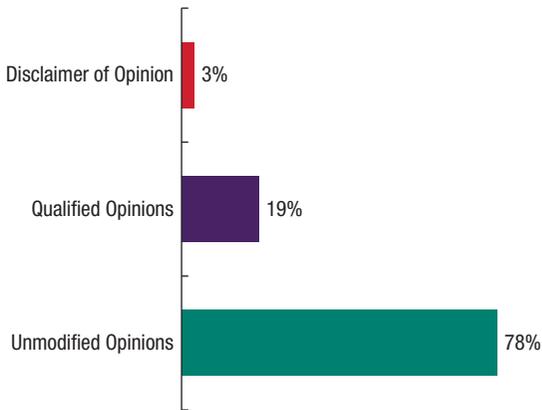
Figure 13.8. Central Banks' External Audit Arrangements in Sub-Saharan Africa



Source: IMF safeguards database.

At the conclusion of its work, an external auditor issues an opinion on the financial statements based on their evaluation of the audit evidence obtained. Nearly 80 percent of central banks in sub-Saharan Africa had unmodified (clean or without qualification) audit opinions on their latest published financial statements (see Figure 13.9).⁸ This is slightly lower than the 87 percent of clean audit opinions in the 84 central banks in the safeguards portfolio. The nature of qualifications related, among other things, to (1) foreign exchange differences recorded directly in equity; (2) auditor scope limitations; (3) non-consolidation of a subsidiary; and (4) recoverability of loans and advances. In one case, the auditor was unable to obtain sufficient appropriate audit evidence on which to base their opinion, and therefore concluded that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. Safeguards assessments often recommend that central banks work to remedy the factors that lead to modified opinions.

⁸ An unmodified audit opinion refers to audits for which the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Figure 13.9. Central Banks' Audit Opinions in Sub-Saharan Africa

Source: IMF safeguards database.

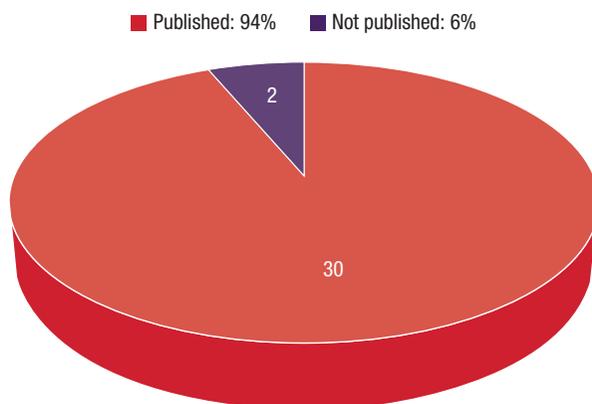
A strong accountability mechanism should also feature an effective oversight body, such as an audit committee, with primary responsibility for overseeing the efficacy of audit, financial reporting, and control processes in a central bank. The importance of such oversight is evidenced by remarkable improvements in the safeguards risk profiles of central banks (see Chamoun and van Greuning 2018).

Transparency

Transparency of central bank operations, an important component of the IMF *Code of Good Practices in Monetary and Financial Policies* (1999), promotes accountability and good governance. The publication of audited financial statements is a key requirement of the IMF safeguards assessment policy. Likewise, the timeliness of publication is essential, as outdated information loses its relevance. Application of a robust and generally accepted accounting framework assures stakeholders of the reliability and comparability of reported results. Use of alternate accounting practices not only hampers transparency, but can allow central banks to make exceptions in the recording, measurement, and reporting of transactions (see IMF 2002). The application of a widely recognized accounting framework, such as IFRS, provides additional assurance that financial information is presented on a transparent and widely recognized basis.⁹

⁹ IFRS were developed and are maintained by the IASB, an independent accounting standard-setting body. The IASB's objective is that the standards be applied on a globally consistent basis. According to the IASB website, IFRS are now used by more than 140 countries, including three-quarters of the G20.

Figure 13.10. Publication of Central Banks' Financial Statements in Sub-Saharan Africa



Source: IMF safeguards database.

There has also been a positive trend toward greater transparency in financial reporting since the inception of the IMF safeguards assessment policy in 2000. Currently, 30 central banks (94 percent) in sub-Saharan Africa publish their full financial statements (Figure 13.10), which compares favorably with the findings by Arda and others (2018) that only around 83 percent of central banks do so globally.¹⁰ Notwithstanding this, there are two central banks in sub-Saharan Africa that do not publish their annual financial statements on a consistent basis. In one case it was due to the absence of procedures, and in the other case it was due to the lack of a legal requirement for such publication, though neither of these constitutes acceptable grounds for nonpublication.

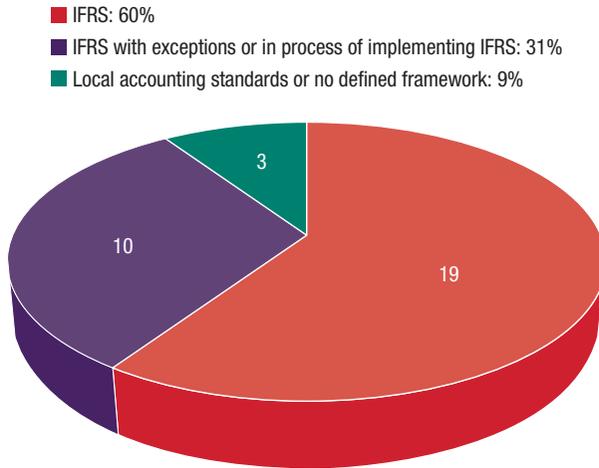
Central banks are making progress toward implementing IFRS, but challenges remain. Around 60 percent of central banks in sub-Saharan Africa have fully adopted IFRS, with a further 31 percent either in the process of implementing IFRS (five banks) or have legal provisions that limit full implementation (five banks) (see Figure 13.11). The latter relates to two main issues, the most noteworthy being the treatment of unrealized foreign exchange gains as stipulated in International Accounting Standard (IAS) 21, *The Effects of Changes in Foreign Exchange Rates*.^{11,12} The second issue is the result of deviations from the recognition and

¹⁰ The number is coincidental; these 30 central banks are not the same ones that were audited by international firms shown in Figure 13.8.

¹¹ *IAS 21 The Effects of Changes in Foreign Exchange Rates*, <https://www.ifrs.org/issued-standards/list-of-standards/ias-21-the-effects-of-changes-in-foreign-exchange-rates/>.

¹² Most central bank laws have provisions that prohibit the distribution of unrealized gains, which is why central banks are able to apply IFRS. However, there are some central banks that record unrealized gains directly in equity with an equivalent receivable recorded on the balance sheet due to the fact that the government retains the foreign exchange risk.

Figure 13.11. Central Banks' Accounting Frameworks in Sub-Saharan Africa



Source: IMF safeguards database.

measurement of financial instruments (that is, IFRS 9, Financial Instruments), in particular the recording of legacy government debt.¹³ The remaining central banks (three) follow local accounting standards or have a defined framework that tends to fall short of international standards. Specifically, these shortfalls relate to (1) insufficient disclosures in the financial statements; (2) the lack of fair-value measurement for certain financial instruments and impairment of assets; and (3) the use of discretionary accounting policies that may not reflect the true financial position of the central bank.

IFRS is permitted in the majority of sub-Saharan African countries. Legal impediments are often cited in some countries as obstacles to adopting IFRS; however, according to the IASB, the application of IFRS is required or permitted in 23 countries (that is, 70 percent) in the region.

OBSERVATIONS DRAWN FROM THE COVID-19 PANDEMIC

The COVID-19 pandemic has caused financial strain in many countries, due to the urgent financial needs faced by authorities at the onset of the health crisis. As of the end of March 2021, some 85 IMF member countries have received approvals from the IMF Board for emergency financing (IMF 2021). While a majority of this financing has gone to treasuries, in the form of budget support, this has

¹³ In these cases, legacy debt is recorded at historical cost instead of fair value. Applying the fair-value methodology could result in the recording of significant losses on the central bank's income statement, which would result in the erosion of the bank's capital, and could trigger recapitalization.

nevertheless resulted in a sharp increase in the volume of safeguards assessments to be conducted. Most countries are expected to require more financial assistance to deal with the macroeconomic effects brought about by this health pandemic. IMF financing is typically directed to central banks, and the safeguards policy requires that the assessments be completed before receiving IMF Board approval for these subsequent additional lending arrangements. During the period between May 2020 and April 2021, fieldwork for some 23 virtual assessments has been completed.

The central banks assessed during the pandemic have broadly been resilient in their business continuity processes. That said, some central banks have limitations in the ability to have their staff fully telework and thus have had to rely on skeletal staff deemed essential for core operations to be present in person on a sustained or rotational basis.

The assessments have also seen an emergence of quasi-fiscal operations and direct financing of the government as central banks and national authorities attempted to respond and support the economy. Of the 23 assessments conducted, 10 central banks (43 percent) had adopted some form of these operations. These included preferential (subsidized) loans to sectors of the economy to provide liquidity support, and emergency decisions to extend further credit to the government beyond limits in the central bank law. Such quasi-fiscal activities could undermine central bank autonomy, and therefore should be mitigated through sound accountability and transparency mechanisms. In light of the challenging and unprecedented nature of the current circumstances, advice in such cases has been to ring-fence these activities by limiting their scale and establishing clear and transparent time-bound exit strategies that transition to normal lending operations.

In a number of cases, central banks had already gone into such unconventional activities with clear caps on the resources approved for such new operations and with near-term transition provisions for governments to take on the fiscal responsibility of providing subsidies or additional lending to select critical sectors of the economy that have seen disruption in the pandemic. In some other cases, the pandemic has provided an opportunity to revisit central bank laws and ensure that provisions include force majeure clauses that ex ante provide a clear and time-bound set of conditions that would allow the central bank to take exceptional measures to support the economy, without resorting to ad hoc decisions that could jeopardize the central bank's institutional and financial autonomy.

CONCLUSION

Sub-Saharan Africa has a broadly well-developed audit industry with a strong presence of large international firms that help ensure that audits are conducted in compliance with international standards on auditing. This is accompanied by a growing use of international financial reporting standards in the region, which, coupled with rigorous audits, provide stakeholders with a reliable independent source of assurance on the transparency of the use of public resources.

These factors and achievements go a long way in establishing the accountability of central banks to their stakeholders. That said, the audit industry has been facing calls for reform in the face of recent scandals in which clean audit reports did not, in fact, identify misappropriation of funds.¹⁴ These incidents indicate that clean audit opinions are not a panacea, even if they are, arguably, exceptions and certainly not a new phenomenon in the history of audits. On one end of the spectrum, it is true that an audit does not certify against fraudulent activity, but there is scope to narrow on the red flags that should serve as alerts.

Another area that continues to present challenges is the governance of institutions. Most central banks have established governance bodies—oversight boards and audit committees—to oversee the executive team that is responsible for day-to-day operations. The challenge in most countries, including those in sub-Saharan Africa, is to have proper composition in these bodies: majority nonexecutive (independent) boards and exclusively nonexecutive board members on audit committees in order to assure good independent oversight of the executive team, professionalism and experience of the nonexecutives so they provide true discipline and relevant expertise in carrying out their responsibilities, and strong institutional support so that the strategic decisions and direction provided by these bodies are well executed and complied with.

The above aspects need to be enshrined in a well-designed central bank legal framework. Safeguards experience shows encouraging shifts, with more central banks amending, or in the process of amending, their legal frameworks. The change in the law needs to be coupled with strong ownership to ensure that the human side—implementation of the legal framework—is robust and sustained.

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¹⁴ Recent scandals include those in South Africa on KPMG’s audits of VBS Mutual Bank and tax services provided to the Gupta family; in the United Kingdom on Deloitte and KPMG’s audit of Carillion; Ernst & Young’s European audit of the German firm Wirecard; and PricewaterhouseCooper’s audits in the United Kingdom of Redcentric and BHS, to name a few.

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The Dividends of Digitalization and Big Data to Institutional Quality and the Macroeconomy

Abdoul Aziz Wane and Jing Xie

ABSTRACT

This chapter analyzes interactions between digitalization and big data innovations and institutional quality, and how these interactions influence economic outcomes. It discusses the increasingly important role of e-government in the provision of online public services, the importance of expanding the existing telecommunication infrastructure, and the necessity of enhancing the ability of populations to use e-government services (the “human capital” dimension). The empirical analysis uses data from 132 countries and confirms the potential of these innovations to improve government effectiveness and to reduce corruption through transparency, checks on government officials’ discretionary powers, accurate policymaking, and trust in government. Good sequencing of these innovations can maximize their potential to strengthen government effectiveness. The chapter provides preliminary indications that e-government can boost government revenue mobilization through lower corruption and enhance public spending effectiveness, especially during crises.

INTRODUCTION AND CONTEXT

Many governments are harnessing digitalization and big data analytics,¹ boosted by the acceleration in the use of electronic devices and the ensuing densification of social networks. They aim to leverage these innovations to improve the living conditions of their populations, including through the impact of the innovations on the quality of public institutions—the rules of the game in a society (North 1990). Indeed, economists concur about the positive relationship between the quality of institutions and macroeconomic outcomes (Acemoglu and others 2002; Djankov and others 2003; Glaeser and others 2004). Some estimates put

¹ “Big data” refers to the large volume of data now available, its variety, and the speed at which it can be processed. “Analytics” is the means for extracting value in the form of actionable insights from this data (EY Americas 2019).

the cost of corruption, a key indicator of the quality of institutions, at more than 5 percent of world GDP (World Economic Forum 2020). Estimates in Chapter 1 and Chapter 2 suggest that bringing sub-Saharan Africa's institutional quality to the world average would increase annual GDP per capita growth by 1–2 percentage points. Studies have also shown a positive relationship between institutional quality and the adoption of digitalization and data analytics in government operations (for example, CEBR 2016; Krishnan, Teo, and Lim 2013). The causality between these variables and the direction of the causality are, however, a matter for debate, which is relevant to the sequencing of reforms. Further, the literature has devoted little attention to the extent to which the innovation content of change in institutional quality affects macroeconomic outcomes. Experience suggests that e-government² supports good governance and is essential for effective, accountable, and inclusive institutions (Haldenwang 2004). Available estimates of annual savings from the use of big data analytics range from \$20 to \$41 billion for the United Kingdom and \$223 to \$446 billion for the European Union (World Bank 2017). These studies base their figures on efficiency gains, reduced fraud and error, and improved tax collection, all of which reflect institutional quality changes supposedly caused by e-government innovations. Thus, e-government endows governments with better information and analytical capabilities to improve the accuracy of their policymaking and the effectiveness of their policies; it also reduces corruption by enhancing transparency and limiting executive power's discretion (Bruinshoofd 2016). Recently, amid the COVID-19 pandemic, many countries used big data and information and communication technologies (ICT) to save lives and protect livelihoods (Wu and others 2020). As discussed in Chapter 12, real-time audits of emergency spending enabled by these innovations can curb corruption and save resources, and thus contribute to fighting the COVID-19 pandemic, as they did during the 2014 West Africa Ebola outbreak.

Reducing the knowledge problem³ through more systematic use of data for decision-making enhances government effectiveness and institutional quality, but trust in government, participation, and compliance with rules and regulations—critical to institutions' sound functioning—require transparency. Indeed, institutional transparency is the basis of sound economic governance and arguably the first step in improving accountability and integrity. Digitizing public services and increasing government's use and publication of data can help achieve transparency. Countries with better institutions, ones that embrace transparency and accountability, would thus be more inclined to adopt integrity-friendly innovations despite the reduction in the government powers such innovations entail. Following

² The term “e-government” was introduced to describe the use of ICT and big data innovations to promote citizen empowerment, improve service delivery, strengthen accountability, increase transparency, or improve government efficiency (European Union, n.d.; World Bank 2015).

³ The knowledge problem highlights the paradox of not having the knowledge to make a decision but pretending to have it and act. Such an approach calls into question the legitimacy of governmental decision-making and its impact on the economy (Erkut 2020).

this line of reasoning, good institutions are a precondition for e-government, including data-based public policymaking processes.

This chapter offers an overview of digitalization and big data analytics innovations and how their interplay with the quality of institutions influences macroeconomic outcomes. Following the two initial schools of thought of the new institutional economics (NIEs),⁴ the chapter assumes that institutional quality encompasses firm-level property rights and contracts and the broader institutional environment.⁵ After a structured analysis of recent developments in institutional quality and e-government, the chapter examines their relationship. It then discusses how this relationship affects revenue and spending, two key variables for macroeconomic stability.⁶ The results presented in the chapter should be interpreted with caution, given the limited data available and the limitations of the econometric techniques used. These techniques cannot fully address methodological challenges such as reverse causality, endogeneity, and omitted variables. The analysis is, however, helpful in charting new directions for research.

ICT, DATA INNOVATIONS, AND INSTITUTIONAL QUALITY

In its October 2020 report, the International Telecommunication Union (ITU 2020) estimated that 60 percent of the world's population is connected to the internet. However, the patterns of internet usage vary widely by age, location, and income, and during good and bad times. First, young people tend to use the internet more than their older peers. Almost 70 percent of young people aged 15 to 24 use the internet, while the average across all age groups is just over 50 percent. Second, sub-Saharan Africa lags all other regions, with only 29 percent of its population using the internet, compared to 83 percent in Europe at the other end of the spectrum. Third, skills and education levels continue to explain the persistence of gaps in internet access. The coverage in rural areas is just half that of the coverage in cities. Finally, preliminary data and anecdotal evidence suggest internet usage increased significantly during the COVID-19 pandemic (Rahul 2020).

Buoyed by its fast-growing usage, the internet is generating previously inconceivable volumes of data with enormous knowledge-enhancing potential, if combined with the right tools to extract information. Against this backdrop, governments are investing large resources in internet-based innovations and data analytics, including machine learning and other artificial intelligence innovations. For instance, in fiscal year 2021, the United States government spent \$90.9 billion

⁴ Coase and Williamson, on the one hand, and Douglas North on the other hand.

⁵ A broader institutional environment includes regulatory, social, and infrastructure services.

⁶ The chapter does not discuss the opportunities technological innovations and big data offer private business, even though more transparent private sector operations can reduce the supply of corruption significantly. See World Economic Forum (2020) for some private sector applications.

on information technology, amounting to 1.1 percent of the budget (IT Dashboard 2020; OMB 2020). In China, spending on research and development climbed to \$378 billion in 2020 (2.4 percent of GDP) from \$322 billion in 2019.⁷ These investments aim, among other things, to collect data and find patterns and statistical relationships between variables, predict socioeconomic trends, support early warning systems, and ultimately fine-tune policy formulation and monitoring. While the internet facilitates transparency and participation,⁸ big data analytics improves the ability of governments to make short-term predictions (including nowcasting) and allows reducing public officials' discretion in policy-making and hence corruption vulnerabilities.

Recent Trends in E-government

The United Nations E-Government Development Index (EGDI), compiled since 2001, helps track the adoption by governments of internet-based innovations in their interventions. EGDI is a normalized (0 to 1 scale) composite index with three components: (1) the Online Services Index (OSI), which measures governments' capability and willingness to adopt the internet in the delivery of public services to its citizens and the extent to which these services are accessible and integrated; (2) the Telecommunication Infrastructure Index (TII), which measures the quality of the existing infrastructure to deliver e-services to the population; and (3) the Human Capital Index (HCI), which measures the intrinsic ability of populations to use e-government services. The EGDI is available for 193 countries as the arithmetic average of the three-component indices.

Over the past twenty years, governments worldwide have consistently intensified the use of internet-based innovations in their operations, with the global average of the E-Government Index increasing from 0.35 in the early 2000s to 0.61 in 2020. Most of the advances have happened during the last 10 years with the acceleration in the provision of digital government services, such as business registrations and applications for business licenses and birth certificates. In 2020 the average world citizen used 14 different online transactional public services, and around six out of every seven countries in the world offered at least one digital government transaction. At the regional level⁹, all country groups

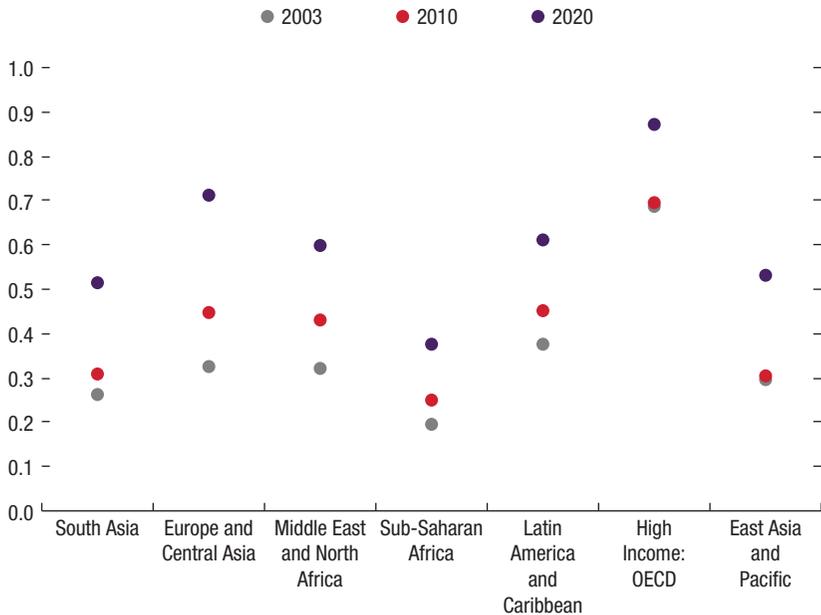
⁷ National Bureau of Statistics of China, "Communiqué on National Expenditures on Science and Technology in 2019," news release, August 28, 2020, http://www.stats.gov.cn/english/PressRelease/202008/t20200828_1786511.html; National Bureau of Statistics of China, "Statistical Communiqué of the People's Republic of China on the 2020 National Economic and Social Development," February 28, 2021, http://www.stats.gov.cn/english/PressRelease/202102/t20210228_1814177.html.

⁸ The terms "e-governance," "e-democracy," and "digital governance" reflect the efforts of governments to go beyond e-government by building stronger partnerships with civil society and citizens through support of participation, accountability, and democracy.

⁹ Regional Grouping based on list provided by International Monetary Fund, World Economic Outlook (Annex 14.8.1) (IMF 2021b)

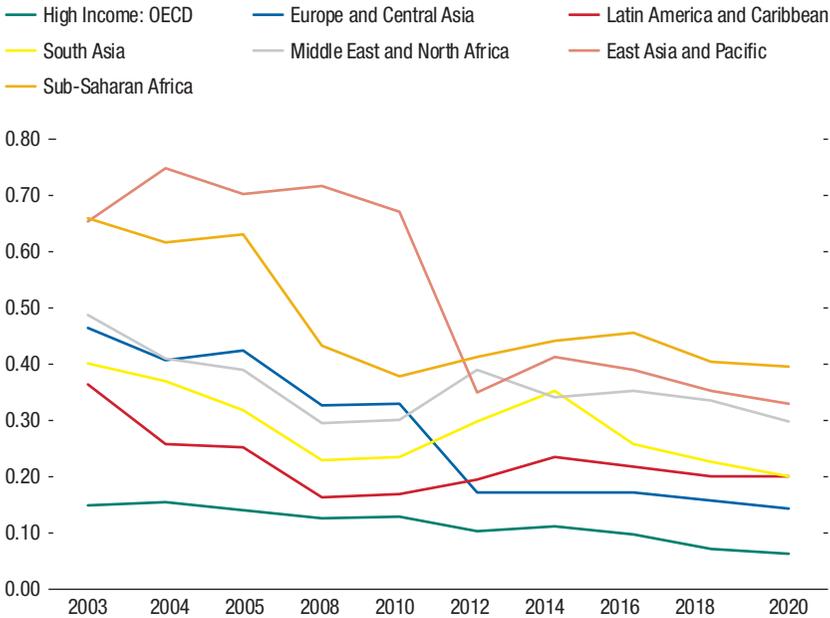
improved their e-government intake over the last two decades (Figure 14.1). OECD countries remain in the lead (0.87), followed by Europe and central Asia (0.72), Latin America and the Caribbean (0.61), the Middle East and North Africa (0.60), East Asia and the Pacific (0.53), South Asia (0.52), and sub-Saharan Africa (0.38). Unlike other regions, sub-Saharan Africa has not reduced its e-government gap with OECD countries. The average difference in the E-Government Index of other regions with the OECD's declined by 9½ points, while sub-Saharan Africa remained about 50 points below the OECD throughout the period.

Figure 14.1. E-Government Index
(By region)



Source: United Nations E-Government Development Index.

Of course, average regional scores mask high variation of the level of e-government within each region. This within-region volatility is negatively correlated with the region's average performance. For instance, sub-Saharan Africa's top performer (Mauritius) is far more advanced than the country with the lowest score (South Sudan), while the difference between the top and bottom performers in the OECD is much lower (Figure 14.2).

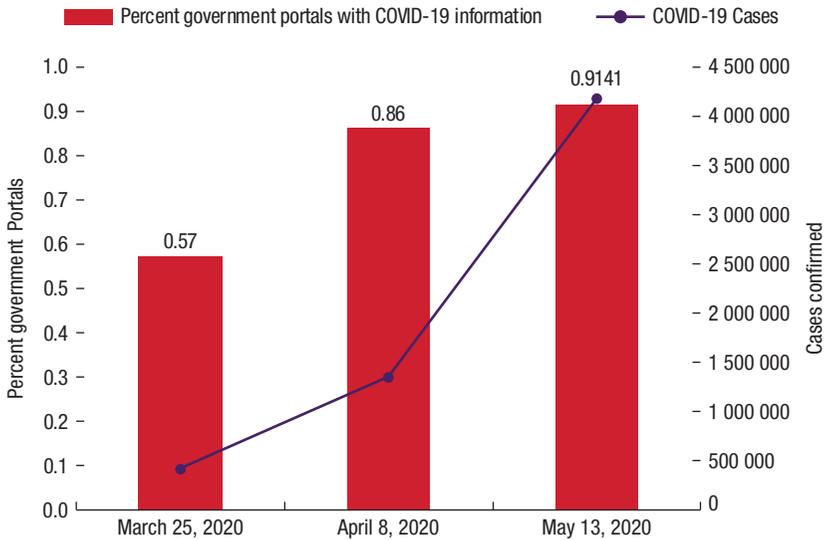
Figure 14.2. E-Government Index Volatility*(By region; 2003–20)*

Source: United Nations E-Government Development Index.

Note: Coefficient of variation = standard deviation / mean. Coefficient of variation is presented.

During the COVID-19 pandemic, digital government services played a critical role in accelerating policy responses to save lives and livelihoods. For example, these technologies helped keep people connected through hackathons, enabled work continuity and online service delivery, and facilitated the enforcement of stay-at-home measures through text messaging. To support vulnerable households, many governments used direct cash transfers. In countries with a large informal sector, where these transfers are difficult to administer, digital solutions helped deliver the support securely and in a cost-effective manner by identifying and validating recipients. The use of digital solutions was effective in countries where the authorities were able to adapt quickly by streamlining public financial management procedures (IMF 2020a). In many countries, local governments supported the response by establishing portals with information on the disease's local prevalence, regular policy updates, and guidance on receiving government assistance. Successful local e-government initiatives included (1) Vancouver's online dashboards to enable citizens to track the city's emergency response; (2) the Western Cape's online platform for remote teaching; (3) Sichuan's use of chatbots to assess patients' infection risks and use of 5G+ telemedicine to improve health care outcomes; and (4) London's use of smart city technology to control social distance through traffic control cameras, sensors, and algorithm-based control devices (Hong and others 2020; United Nations 2020).

Figure 14.3. Government Portals with COVID-19 Information and World Total Confirmed Cases



Sources: UN DESA (2020) and World Health Organization.

Countries that were hit hardest by the pandemic in 2020 were, luckily, already enjoying a high utilization of e-government. As the number of COVID-19 cases increased, their governments leveraged the existing IT infrastructure to devote more online resources to the fight against the pandemic (Figure 14.3). The percentage of government portals with COVID-19 information increased by more than 60 percent between March and May 2020. Notwithstanding the head start of more advanced countries, Africa hosted 12.8 percent of technologies developed to respond to the pandemic, of which 58 percent were ICT-driven, according to the WHO (Anderson 2020). These innovations included (1) online applications launched in Sierra Leone to improve the government’s ability to track quarantine periods and other services like food delivery, (2) robots and drones deployed in Rwanda to reduce health workers’ contacts with potential positive COVID-19 patients and thus contamination risks, and (3) South Africa’s chatbots to reduce the spread of false information on the disease.

Recent Trends in Institutional Quality

As in Bruinshoofd (2016), institutional quality or the quality of governance¹⁰ can be measured with the six Worldwide Governance Indicators complemented by the Ease of Doing Business Index: (1) “voice and accountability” measures the extent to which citizens can select and challenge the government; (2) “political stability

¹⁰ These two terms are used interchangeably in the chapter.

and absence of violence” accounts for how much citizens are incentivized to invest in their future; (3) “government effectiveness” stands for the quality of public services and the administration’s degree of independence from political pressures; (4) “regulatory quality” measures the ability of the government to formulate and implement sound policies and level-playing-field regulations; (5) “rule of law” captures the enforcement quality of society’s rules (contract, property rights, police, courts, and so on); (6) “control of corruption” links economic success to effort and competence, rather than connections and bribery; and (7) “ease of doing business” measures the extent to which the regulatory environment is conducive to business operation.¹¹ While this composite indicator of institutional quality can help track progress over time and across regions, it has serious limitations, including recent irregularities in reporting the doing business indicators.¹²

Worldwide, progress on institutional quality has been less impressive than on e-government; notably, there were even relapses on institutional quality during the 2000s. This degradation reflects setbacks in the Middle East and North Africa and in Latin America and the Caribbean. South Asia and sub-Saharan African countries also saw their overall index of governance slip, albeit less drastically. Throughout the last 20 years, the high-income OECD group has enjoyed by far the best overall governance, while sub-Saharan Africa has remained the region with the worst overall governance indicators (Figure 14.4). All the other five regions recorded changes in their governance standing relative to peers. East Asia and the Pacific, with the second-best overall indicator, overtook Latin America and the Caribbean. Each of these three regions—East Asia and the Pacific, Latin America and the Caribbean, OECD—enjoyed above-average governance status throughout the period. The other four regions, which remained below the world average, were led in 2020 by Europe and Central Asia (ECA). In turn, the indicators for ECA rapidly approached those of regions with higher governance indicators, followed by South Asia, whose scores converged with those of the higher-scoring regions, albeit at a slower pace. The Middle East and North Africa and sub-Saharan Africa’s indicators slipped deeper into negative territory.

The main drag on world governance performance stems from political stability and absence of violence/terrorism, the only indicator showing a worldwide decline between 2000 and 2019. Most of the worsening security and attendant political instability reflects the 9/11 terrorist attacks on the United States and

¹¹ Use of these indicators should be considered carefully, as they are derived from perceptions-based data. The CPI uses a scale of 0 (highly corrupt) to 100 (very clean). The WGI give scores on aggregate indicators, in units of a standard normal distribution (ranging from -2.5 to 2.5).

¹² See World Bank, “Doing Business—Data Irregularities Statement,” news release, August 27, 2020, <https://www.worldbank.org/en/news/statement/2020/08/27/doing-business--data-irregularities-statement>; and Reuters, “World Bank Halts Country Business Climate Rankings to Probe Data Irregularities,” news release, August 27, 2020, <https://www.reuters.com/article/us-worldbank-data-review/world-bank-halts-country-business-climate-rankings-to-probe-data-irregularities-idUSKBN25N28J>, and “The World Bank’s Doing Business Report”, Congressional Research Services, October 29, 2021, <https://crsreports.congress.gov/product/pdf/IF/IF11959>.

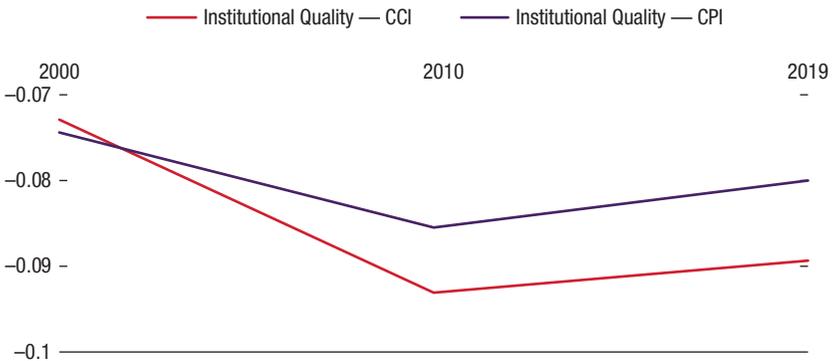
Figure 14.4. Governance on Institutional Quality

(By region; 2000–19)

1. Institutional Quality Average



2. Worldwide Governance



Sources: Doing Business Index; Transparency International; and Worldwide Governance Indicator.
 Note: CCI = World Bank Group, Control of Corruption Index; CPI = Transparency International, Corruption Perception Index.

their worldwide repercussions. The regions that experienced the most significant security issues are the Middle East, with the largest number of ongoing conflicts (International Crisis Group 2020). The Latin America and Caribbean region experienced massive antigovernment protests beginning in 2000, including the general oil strike in Venezuela (Murphy 2002), causing lasting economic and social damage. High-income OECD countries, especially those involved in the response to the 9/11 attacks, also saw an increase in the number of attacks in their territory. Sub-Saharan Africa started to experience an increase in terrorism-linked violence after 2010 in the aftermath of the conflict in Libya that led to the creation of the G5 Sahel (Burkina Faso, Chad, Mali, Mauritania, Niger) to manage the instability through international cooperation.

Significant progress on the rule of law was also elusive in the conflict regions and South Asia. The fastest progress was recorded for the following indicators: (1) doing business, with recent reforms (including to eliminate paid-in capital requirements and digitize filing and payment systems) in Europe and Central Asia; the upward trend was reinforced by progress in South Asia, which became the second business-friendly region, behind high-income OECD countries (World Bank 2020a); (2) voice and accountability, thanks to advances in South Asia and in Europe and Central Asia; and (3) control of corruption, buoyed by reforms in the Europe and Central Asia and the East Asia and Pacific regions. These two regions have also enjoyed significant gains in government effectiveness and regulatory quality. While data are not available to measure governance in 2020 and ascertain the impact of the COVID-19, the pandemic probably impacted governance adversely. Indeed, as can be seen during previous crises, fragility and crises tend to weaken governance as uncertainty and governments' openness to emergency solutions create conditions for rent-seeking behaviors.

As discussed, the security crisis in the Middle East and North Africa region underpinned the rapid worsening of governance indicators. Following the West Africa Ebola health crisis, there was a significant increase in governance issues in the management of emergency funds to finance mitigation, relief, and recovery efforts. During the COVID-19 pandemic, in some regions, lockdowns and other containment measures helped control the spread of the virus by restricting civil rights (such as mobility). The Oxford Stringency Index (Figure 14.5), which peaked around 80 for an index capped at 100, suggests significant impairments of voice and accountability, including from postponement of elections and the rule of law, as some of the containment measures were inconsistent with laws and regulations in normal times.

Figure 14.5. COVID-19 Worldwide Governance Stringency Index
(January 2020–March 2021)

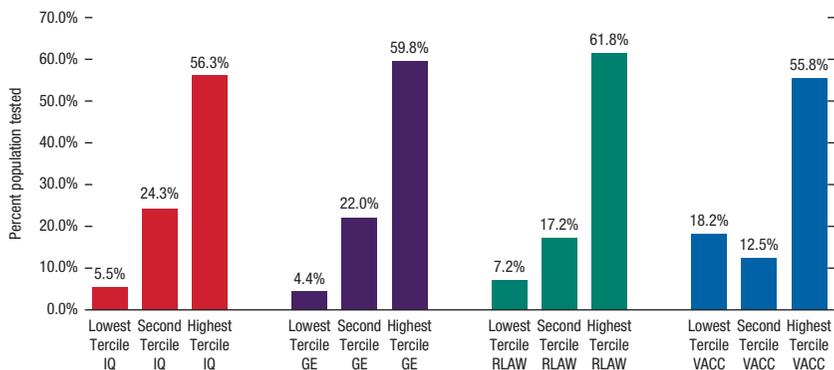


Source: Government Stringency Index, OxCGRT Project; and Hale and others (2020b).

Note: X-axis is the date; y-axis is the Stringency Index between 0 and 100 (100 = strictest response).

Regardless, governments with higher governance standards are exhibiting better responses in the control of the COVID-19 pandemic. In publishing its 2020 Corruption Perception Index (CPI), Transparency International argued, “COVID-19 is not just a health and economic crisis. It is a corruption crisis.” That is, because countries with lower perceived corruption invest more in health care, including testing; are better able to provide universal health coverage and to face the pandemic; and are less likely to violate democratic norms and institutions or the rule of law in combatting the pandemic. Figure 14.6 shows that good governance positively impacts the ability of countries to test for COVID-19 (Kaufmann 2020). Countries in the highest quantile of institutional quality (IQ), government effectiveness (GE), rule of law (RLAW), and voice and accountability (VACC) indicators tend to have higher COVID-19 testing ability and lower positive cases rate as a share of tests.¹³ Among countries with the highest institutional quality ranking in 2019, many have addressed the pandemic well. For instance, New Zealand, ranked first in the 2019 institutional quality indicator, has excelled in controlling the pandemic. The seven-day rolling average of confirmed cases saw a decreasing trend only one month after the outbreak of March 2020, and there were fewer than 20 cases confirmed each day as of the beginning of 2021. Singapore, ranked sixth in the 2019 institutional quality indicator, has the world’s lowest COVID-19 death rate, and is among the countries with the lowest number of daily confirmed cases (Geddie 2020). On the contrary, many countries in the bottom of the Governance Index, are among largest contributors to the world COVID-19 caseload (Our World Data 2021).

Figure 14.6. Percent of Population Tested for COVID-19
(By quality of governance)



Sources: Kaufmann (2020); Worldometers (2021) and World Governance Indicator.

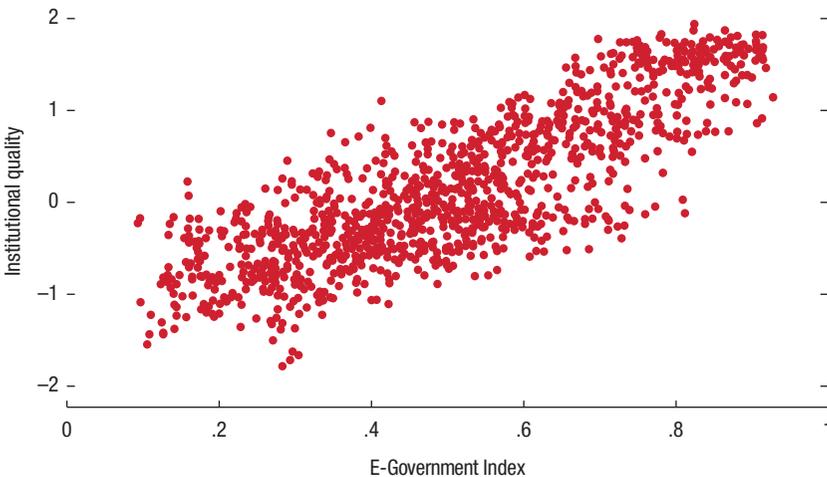
Notes: IQ = Institutional quality; GE = Government effectiveness; RLAW = Rule of law; VACC = Voice and accountability.

¹³ Based on COVID-19 total cases divided by total tests population.

Leveraging Technology and Human Capital to Enhance Governance

Adoption of e-government can play a crucial role in the improvement of the quality of institutions. Indeed, the scatter plot in Figure 14.7 shows strong and positive comovements between e-government and institutional quality. Regressing institutional quality against the E-Government Index (EGI) and the Human Development Index (HDI)—to capture the level of development—indicates that e-government is significantly and positively correlated with institutional quality. The regressions of institutional quality on e-government sub-components, controlling for the level of development, suggest that changes in institutional quality are closely associated with variations in the quality of telecommunications infrastructure and in human capital (Annex 14.1). Online services are not significantly correlated with institutional quality, though it is generally admitted that publicly accessible, good-quality information on government services is critical for transparency and reduces transactions between public service users and government officials and corruption vulnerabilities.

Figure 14.7. Comovements between Institutional quality and E-Government



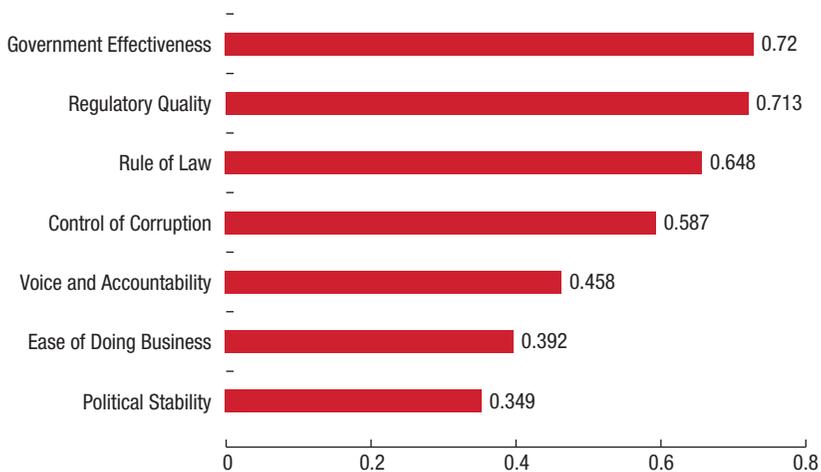
Sources: World Bank Group; World Governance Indicator; and UN E-Government databases.

Note: The institutional quality composite score is calculated using the average of subindicator. Doing Business Index was normalized using the z-score method.

The counterintuitive result that changes in online services are not associated with institutional quality variability in the regressions could be because telecommunication infrastructure and human capital capture the relevant variability of online services for governance. In other words, online services can affect institutional quality only in the presence of good telecommunications infrastructure and

adequate education level, which enable users to extract benefits from online services (threshold effects). West (2015) identified poverty, high charges (for device, data, and telecommunications), poor infrastructure, digital illiteracy, and policy and operational obstacles as significant barriers to internet access in low-income countries. In these countries, investments in top-notch online services will not bear fruit fully if the population does not possess adequate education and skills to search for the relevant services or if telecommunication infrastructure is too poor to sustain demands at affordable prices. The regression of each of the seven components of the institutional quality indicator on the E-Government Index gives insights on how e-government covaries with governance (Figure 14.8). The results suggest a more than 50 percent conditional correlation of e-government with government effectiveness, regulatory quality, the rule of law, and control of corruption. Changes in e-government are correlated with more than 40 percent of the variability in voice and accountability, and more than 30 percent of the variability in the Ease of Doing Business Index and political stability.

Figure 14.8. Predictive Power of E-Government on Governance Component
(Adjusted *r*-squared)



Sources: Transparency International, Corruption Perception Index; World Bank Group, Global Governance Indicator, Doing Business Index; and United Nations Development Program.

Note: The regressions include the Human Development Index to control for the level of development.

The regressions of each of the subcomponents of institutional quality on the e-government subindices provide additional guidance on how e-government influences institutional quality. The results (Annex 14.2) indicate the following:

- Telecommunication infrastructure and human capital have a consistent positive and highly significant association with all the dimensions of institutional quality.

- Telecommunication infrastructure displays the highest marginal association with each of the governance subcomponents, except for the ease of doing business indicator, which is linked primarily to human capital. This suggests that e-government strategies that aim to enhance governance should prioritize investments in telecommunication infrastructure. Further, the results provide preliminary indications that the impact of investments in telecommunication infrastructure is larger for control of corruption.
- Human capital's association with governance, in order of importance, goes through voice and accountability, ease of doing business, government effectiveness, and regulatory quality. Control of corruption, the rule of law, and political stability are also positively and significantly associated with human capital, albeit with less strength.
- Finally, online services' covariance with governance is more nuanced. The online service variable is positively associated only with ease of doing business, regulatory quality, and government effectiveness. It does not have a significant association with rule of law, control of corruption, and voice and accountability. The online service variable is negatively and significantly associated with political stability and the absence of violence and terrorism. This latter result suggests that online services can even provide potent support for organizations promoting violence. Indeed, proponents of violence can take advantage of the right to freedom of expression in national and international laws to share content in support of their causes (UNODC 2012).

Panel data techniques allow further analysis of the impact of e-governance on corruption and government effectiveness. By leveraging the additional information and variability from the combination of pure time series and cross-sectional data, panel data analysis can detect and measure statistical effects that escape unidimensional analyses. Additionally, panel data can eliminate or reduce the impact of omitted variables using the intertemporal dynamics of the data (for a detailed presentation of the advantages of panel data techniques, see Hsiao 2005). The fixed effects models assume that the impact estimates are identical, whereas the random effects models assume these estimates vary, which makes the random models more easily justified (Borenstein and others 2009).

The focus on corruption reflects the existence of theoretical models of corruption, which allows the identification of estimates from statistical models and a rationalization of investments in e-government. Tirole (1986) offers a concise framework for corruption modeled as collusion between an agent (a public official) and firms or individuals (a third party) supervised by the agent on behalf of the principal (government), who has an information disadvantage regarding the actions of the third party.¹⁴ In this framework, when markets are competitive, the probability of collu-

¹⁴ Klitgaard (2015) offers an even more straightforward characterization in a formula equating corruption to a combination of monopoly, discretion, and lack of accountability: $\text{Corruption} = \text{Monopoly} + \text{Discretion} - \text{Accountability}$.

sion increases with the information gap between the principal and the agent, and with the agent's discretion to decide on behalf of the principal. Investments in e-government represent the principals' cost to reduce their information disadvantage through more transparency and reduce the agent's discretion by mandating the systematic use of big data and data analytics in policymaking.

The results of the panel regressions confirm the positive and significant relationship between e-government and control of corruption and government effectiveness (Annex 14.3).¹⁵ Countries that fare better on the different dimensions of e-government enjoy more effective government and less corruption. The results are also comparable with the findings of Shim and Eom (2008) and Zhao and Xu (2015), who showed the critical role of e-government in lowering corruption. As shown in previous results, human capital and telecommunication infrastructure are the most important pillars for reducing corruption and enhancing government effectiveness. Online services positively and significantly affect control of corruption and government effectiveness.

These results are in line with recent empirical studies that provide evidence of how e-government contributes to fighting corruption (Owusu-Oware, Effah, and Boateng 2018; Zhao and Xu 2015). However, based on the research conducted for this chapter, no empirical study has established a causal relationship and the direction of causation between e-government and the quality of governance. While Granger causality tests cannot fill this gap, they can help establish statistical precedence between institutional quality and e-government. The analysis documents conditional correlations that could offer insights to policymakers and stakeholders of governance reforms on the dividends of digitalization. The results (Figure 14.9) show that e-government Granger causes institutional quality, but institutional quality does not Granger cause e-government (in the sense of temporal precedence). This direction of Granger causality means that policymakers should prioritize robust e-governance strategies to improve the population's living conditions through improvements in the overall quality of institutions. The results also show no causal relationship (in the sense of Granger) between online services and overall institutional quality. Human capital and telecommunication infrastructure Granger cause institutional quality but are not caused by institutional quality. Also, there is no governance subcomponent that is not Granger caused by at least one of the e-government variables, and all dimensions of e-government cause control of corruption. This last result gives support to the proponents of investments in e-government to curb corruption. Further, Figure 14.9 shows the following¹⁶

¹⁵ The Random Effect Model is preferred to assess the relationship because of its better fit indicators. In addition, the use of robust standard errors complicates the implementation of the Hausman test, which is assessed to overreject the null hypothesis (Sheytanova 2014).

¹⁶ The Granger causality test is based on the null hypothesis that x does not Granger cause y . The alternative hypothesis is x does Granger cause y for at least one panelvar (countrynum). At a 90 percent confidence level, the null hypothesis is rejected if p -value < 0.05 .

Figure 14.9. Assessing Precedence between E-Government and Institutional Quality

		EGDI Components			
		E-Government Index	Telecommunication Infrastructure	Human Capital	Online Services
Institutional Quality Components	Z: WGI				
	Institutional Quality				X
	Voice and Accountability			X	X
	Rule of Law	X	✓	✓	X
	Regulatory Quality	X		✓	X
	Political Stability	X	✓		X
	Government Effectiveness	X	✓	✓	X
Control of Corruption	X		✓		
Legend:		Y causes Z	Y does not cause Z		
Z causes Y	✓				
Z does not cause Y		X			

Source: Authors' estimations and calculations.

Note: EGDI = E-Government Development Index; WGI = World Governance Index. Details of the Granger causality tests are in Annex 14.4.

- Telecommunication infrastructure Granger causes all governance dimensions but is not Granger caused by voice and accountability, rule of law, regulatory quality, or control of corruption. Telecommunication infrastructure is Granger caused only by political stability and government effectiveness, which can thus be viewed as important pillars to boost investment in telecommunication infrastructure.
- Human capital Granger causes all Institutional Quality components, except voice and accountability. Human capital has bidirectional causal relationships with rule of law, regulatory quality, government effectiveness, and control of corruption.
- Online services Granger cause corruption but are not Granger caused by corruption. There is no Granger causality relationship between online services and any other governance variable.

PROMOTE MACROECONOMIC STABILITY THROUGH INTEGRITY-FRIENDLY TECHNOLOGY

The view in Acemoglu and others (2002), that poor macroeconomic policies are symptoms of underlying institutional problems rather than the main causes of economic volatility, suggests that sustained growth and stability require good governance. The results discussed in the previous section are in line with studies that have established the positive impact of e-government on institutional quality and the powerful relationship between the introduction of ICT and data innovations and control of corruption, which also trigger changes in human capital. Olken and Pande (2012) provide a simple framework to show that corruption can be fought by increasing the expected cost of crime, which in turn is achieved by

increasing the probability of catching offenders. This result holds in a highly corrupt environment where high-level officials supposed to organize the monitoring of economic activities are themselves corruptible. Monitoring can be provided through audits or through transparency. Both provide information about government actions to citizens who can better monitor government officials and enforce greater accountability.¹⁷ ICT and data innovations provide tools that can safeguard the integrity of established processes (Duflo, Hanna, and Ryan 2012) and facilitate monitoring, including through audits and transparency. Mechanisms through which technology can stem corruption vulnerabilities include putting checks on public officials' discretion and gathering enough data on them to prevent and uncover corruption.¹⁸ Typical areas for such mechanisms are revenue mobilization and spending efficiency, given their importance for macroeconomic stability, especially during crises such as the COVID-19 pandemic.

E-Government to Mobilize Revenue through Less Corruption

IMF studies suggest that highly corrupt countries lose up to 4 percent of GDP in revenue to corrupt activities; furthermore, if all countries were to reduce corruption in a similar way, they could gain \$1 trillion in lost tax revenues, or 1.25 percent of global GDP (IMF 2019a; 2019b). Countries in which the government is representative and can be challenged by citizens experience less political interference related to favoring supporters or harassing opponents and less nepotism in the appointment, selection, transfer, and promotion of tax officials. Control of corruption mechanisms, including more frequent investigations, can reduce the likelihood of tax officials either being bribed or embezzling funds by increasing the probability of detection and punishment (Fossat and Bua 2013). Effective governments can better deter smuggling and undervaluation of turnovers by taxpayers (Martini 2014). To illustrate the importance of government effectiveness, Yang (2008) finds that through transmission of information, preshipment import inspection programs increased import duty collection by 15 to 30 percentage points by improving the monitoring ability and reducing the bargaining power of corrupt customs officials. Kleven and others (2010) find that the tax evasion rate in Denmark on self-reported income is substantially larger than for income subject to double reporting, which, however, requires skilled tax officials and effective revenue agencies.

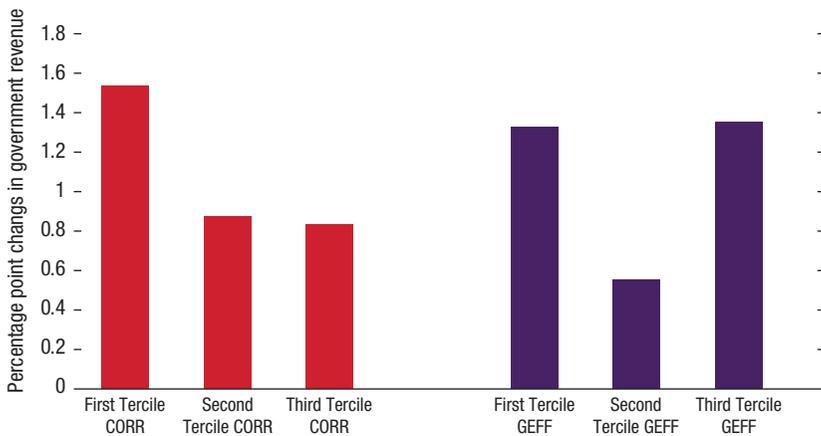
Measures to reform tax administration have been successful in raising revenue by acting on several of the levers discussed in this chapter (especially capacity of tax administrations) but increases in revenue have not necessarily come from lower

¹⁷ Djankov and others (2010) find that public disclosure of politicians' assets, liabilities, income sources, and potential conflicts, as opposed to simply income and wealth levels, is more consistently associated with better government and lower perceived corruption.

¹⁸ Such data include public officials' income and assets, their roles in awarding contracts, their company board memberships, their holdings of stocks and shares included in financial disclosures, company registry data, tax declarations, taxpayer IDs of firms and public officials, tax activity of firms (shell companies), and financial intelligence data such as suspicious transactions abroad.

corruption. Figure 14.10 shows that countries that made the least progress on corruption (first tercile) are those that recorded the fastest gains in revenue. Over the last two decades, sub-Saharan Africa recorded significant gains in revenue collection (1.2 percentage points of GDP), while its control of corruption index worsened slightly. These facts suggest sub-Saharan Africa still enjoys significant potential for raising more revenue through reducing corruption. Against this backdrop and amid increasing demands for tax transparency, recent reforms emphasize reducing corruption in the process of collecting revenue (Moore 2013) by (1) limiting tax officials' discretionary powers; (2) increasing the autonomy of tax administrations and introducing measures to heighten their resistance to political interference; and (3) strengthening monitoring and oversight of the ethics and integrity of all mid- to senior-level tax officials, including mandating asset declarations for all such officials. E-government can facilitate the achievement of these objectives, and modern revenue agencies can systematically use data analytics to develop a picture of companies' tax profiles and decide on tax and audit assessments; data analytics can also help identify patterns and irregularities in tax officials' asset declarations or appearances in property registries. In other words, ICT and data innovations can improve government revenue through lower corruption, contrary to the previous generation of reforms. These reforms are also more equitable and more sustainable.

Figure 14.10. Revenue Enhancement amid Corruption (2010–2019)



Sources: World Bank Group, World Governance Indicator; and authors' calculations.

Note: CORR = Control of Corruption; GEF = Government Effectiveness Index. Tercile groups were ranked based on absolute changes in CORR and GEF. There are a total of 160 countries: First is the lowest and Third is the highest.

The extent to which e-government increases the association between corruption and revenue collection can be assessed through transformations and tests to a baseline regression of revenue on indicators of institutional quality, controlling

for income level. Results from this baseline regression (Annex 14.5) are in line with the positive and significant impact of control of corruption, voice and accountability, and government effectiveness on revenue performance found by other studies.¹⁹ While these results provide hints on the relationships between these variables, they are fraught with statistical problems and biases, including ones from omitted variables and endogeneity:

- The omitted variable bias can be assessed by sequentially adding e-government variables individually and jointly to the regression of government revenue on institutional quality. The results show that the added e-government variables are relevant in the statistical relationship between governance and government revenue, because their coefficient estimate is significant (Annex Table 14.5.1), and their introduction reduces the bias in the original coefficient estimate of corruption, which converges toward the true value of the correlation between corruption and government revenue (Annex Figure 14.5.1). These results lend credit to the important role played by e-government in the explanation of changes in government revenue.
- Interacting the variables suggests that, overall, the Human Capital and Telecommunication Infrastructure Index boosts the correlation of corruption and revenue (Annex Table 14.6.1). Thus, these two variables should be considered together to arrive at positive outcomes (Fjeldstad 2003; 2006; Fossat and Bua 2013; Moore 2013). Regressions by region (Annex Table 14.6.2) suggest that the interaction of control of corruption with e-government variables has the largest effect (1) in the Middle East and North Africa, where all three e-government variables interact positively with corruption to enhance government revenue; and (2) in sub-Saharan Africa, where the correlation of corruption and revenue is boosted by human capital and telecommunication infrastructure. This shows that the impact of e-government reforms to boost revenue collection by reducing corruption is even larger in poor countries with low-paid civil services and in countries where gift giving is a dominant cultural trait (Graycar and Jancsics 2016).
- The endogeneity bias is addressed by using instrumental variables (Annex 14.7) with a two-stage least-squares estimation method. The coefficient estimate of control of corruption in the baseline regression of government revenue is positive and significant. The point estimate of 0.0157 suggests that an improvement from the lowest quintile of control of corruption to

¹⁹ The results also suggest that regulatory quality and rule of law are negatively associated with revenue. While this latter finding is counterintuitive, it is conceivable that complex laws can facilitate extortion of taxpayers when taxpayers have weak capacity and understanding of tax laws, especially when there is a lack of adequate monitoring and supervision of tax officials (Puhorit 2007; Rahman 2009). Likewise, sound regulatory quality can hinder the collection of tax revenue when tax laws and regulations are sponsored and captured by well-connected companies, and when revolving doors allow the use by former tax officials of insider knowledge for private gain.

the median performer²⁰ would be associated with an increase in government revenue by 1.46 percentage points of GDP. The point estimate turns negative and loses its significance with a two-stage least-squares regression with human capital and telecommunication infrastructure as instrumental variables.²¹ This means that the impact of corruption on government revenue goes through these two dimensions of e-government, which are endogenous in the explanation of revenue by corruption.

Promoting Value for Money through E-Government

Poor governance in public financial management exposes massive amount of public wealth and income to corruption. Procurement is often presented as one of the most corruption-prone government activities, in view of the amounts at stake and the complexity and frequency of interactions between public officials and private businesses.²² In response, governments are moving to online procurement platforms to prevent corruption and to promote better service delivery by increasing access to information and making their procurement systems more transparent.²³ IMF's Expenditure Assessment Tool has also identified inefficiencies, including from corrupt practices, in other areas of public spending, such as the wage bill and subsidies and transfers. An IMF study (IMF 2020d) also shows that an average country loses about 30 percent of the returns on its investment to inefficiencies, including corruption in the appraisal, design, and implementation of projects. Government spending is even more vulnerable during emergencies such as the COVID-19 pandemic or the 2014 Ebola outbreak, given the need to execute the spending speedily.²⁴ This explains the emphasis civil society organizations put on transparency during crises to stem corruption and ensure the relief reaches its intended purpose (TI, HRW, and GW 2020). In the April 2020 *Fiscal Monitor*, the IMF called on government "to do what it takes, but to keep the receipts," highlighting the importance of ensuring fiscal transparency, public accountability, and institutional legitimacy (IMF 2020b).

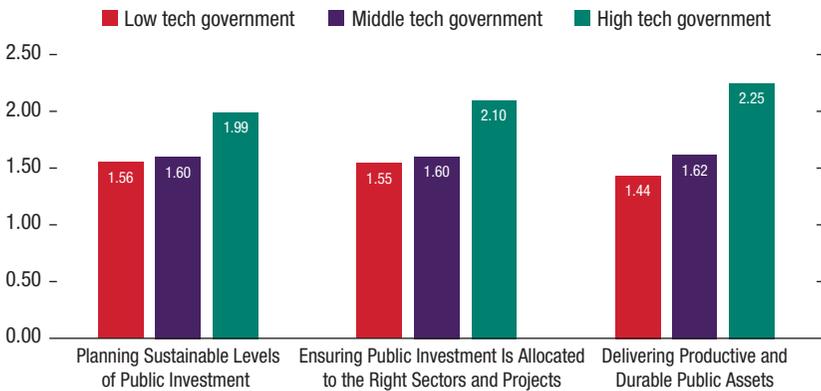
²⁰ The difference between the midpoint of the first quintile (-1.16) to the index of the median performer (-0.23) is 0.93.

²¹ The choice of instrumental variables was made by regressing corruption on the three e-government variables. Online services is not significant and thus not a good instrument.

²² According to OECD (2017a), 57 per cent of foreign bribery cases are due to procurement corruption.

²³ Lewis-Faupel and others (2016) find that electronic procurement leads to higher quality of roads, as measured by independent central government audits, though not to lower costs. The evidence suggests that the quality improvement comes from higher-quality contractors being more likely to win contracts.

²⁴ The IMF estimated COVID-19-related spending at about \$9 trillion six months into the crisis. Most of the spending was carried through extrabudgetary funds (EBFs) to hasten the delivery of relief by streamlining budgeting, spending, and procurement processes (see Chapter 11). The spending covered the promotion of research on the disease and vaccine, face masks, social distancing, testing, and tracing and isolation of suspected cases; the enforcement of lockdowns; the distribution of aid to households and firms to protect countries' human and social capital; and the provision of health care for sick people.

Figure 14.11. Public Investment Management Assessment and E-Government

Sources: IMF's Fiscal Affairs Department and UN e-government data.

Several databases provide useful insights into the quality of public spending processes and how the outcomes of public spending are linked to their costs. These databases include the IMF's Public Investment Management Assessment (PIMA)²⁵ and Expenditure Assessment Tool, and the World Economic Forum's Expenditure Wastefulness Index.^{26,27} Figure 14.11 indicates that low-tech countries lag countries with higher e-government intake on the planning and allocation of public investment, and importantly are less productive and have less durable public assets. Regression analysis suggests e-government accounts for 53 percent of the volatility in delivering productive and durable assets, 40 percent of the volatility of the quality of public investment allocation, and 31 percent of the volatility of the quality of investment planning. These results are confirmed by crossing data from WEF's Spending Wastefulness Index and E-Government Index: on average, the most advanced fifth in terms of e-government has a spending effectiveness perception 30 percent better than that of the least advanced fifth.

During the COVID-19 pandemic, e-government helped bolster the governance of public resources through (1) the establishment of dedicated portals to publish information on the execution of COVID-19 spending (Côte d'Ivoire, Gabon, Honduras, etc.); (2) the exclusive use of e-transactions and e-procurement to simplify the maintenance of transaction records; (3) granting access to other relevant databases—such as those maintained by the national revenue authority or social services—to

²⁵ PIMA is a comprehensive framework that evaluates countries' infrastructure governance practices through 15 institutions involved in planning, allocation, and implementation of public investment.

²⁶ The index is not based on any objective economic or accounting measure, but rather by the perceptions of the population. The countries are ranked from 1 (least wasteful) to 140 (most wasteful).

²⁷ Use of these indicators should be considered carefully, as they are derived from perceptions-based data.

identify and pay eligible beneficiaries (Mauritius); (4) the disclosure of the existence of COVID-19 funds on government websites and descriptions of their key characteristics, including their legal mandate, objectives and policy rationale, sources of revenue, governance and management arrangements, and operating rules and procedures; (5) reporting on the revenue and expenditures of the funds monthly or quarterly on a gross basis; (6) conducting interim audits and concurrent controls using information posted on government websites (Honduras, Sierra Leone). These interim audits and real-time audits were instrumental in safeguarding public resources in Sierra Leone during the 2014 Ebola crisis (Chapter 12, this volume; IMF 2021a).

CONCLUSION

This chapter provided illustrations that internet- and data-based innovations can act as powerful enablers of good governance by improving the accuracy of policy-making and by reducing corruption. They promote a culture of transparency and trust in government by limiting officials' discretion in policymaking and conflicts of interest. The chapter's empirical results suggest that policymakers should consider prioritizing e-government to improve the quality of institutions. In addition, the results indicate that e-government strategies that successfully impact governance should be well sequenced, with investments in human capital, institutional capacities, and telecommunication infrastructure taking precedence on the development of a sophisticated offering of government online services. These services should remain in line with the level of education of the population and the ability of the telecommunication infrastructure to deliver them. The results call for further research to understand the low predictive power of online services on governance.

The chapter provided indications that e-government can enhance government revenue mobilization by reducing corruption, in contrast to reforms that enhance revenue collection amid higher corruption. This result suggests that innovation-based revenue reforms are more sustainable and bolsters the case for reforms of revenue-collection agencies that focus on improving governance and reducing corruption through e-government. Such reforms are even more critical in poor countries with a culture of gift giving, given the potential of e-government to reduce human interaction and anonymize public services. The reforms will also help shield revenue agencies from political pressure and support the view that internal decisions on tax assessments and audits are fair and a reflection of tax profiles and risks. In reforming these agencies, policymakers should recognize the critical role good-quality information and a robust telecommunication infrastructure play in preventing corruption and increasing revenue. Preliminary evidence presented in this chapter suggests also that policymakers should consider extending modernization programs to the spending side to improve public investment (including through more transparent public procurement), especially during emergencies. Future work could build on these preliminary findings and address more systematically causality between e-government and institutional quality and the direction of this causality. This could be achieved by exploring additional variables such as random changes in internet access due to external infrastructure changes, among other variables that provide exogenous variation to e-government.

Capacity development will be critical in helping countries improve governance by adopting and absorbing internet- and data-based innovations. The IMF framework for enhanced engagement on governance and corruption issues offers a platform for a discussion with member countries of their governance weaknesses and the identification of capacity development needs to address them. It is important that these discussions cover e-government initiatives, in collaboration with specialized agencies.

ANNEX 14.1.

How E-government Covariate with Governance?

The table below shows the result of the regressions of institutional quality indicators on subcomponents of the E-Government Index (HCI, OSI, and TII), controlling for the level of development with the HDI. Variables from 131 countries in 2003, 2004, 2005, 2008, 2010, 2012, 2014, 2016, and 2018 were used (years for which both E-Government Index and World Governance Indicators are available).

ANNEX TABLE 14.1.1.

E-Government Indicators as Potential Determinants of Institutional Quality		
Variables	(1)	(2)
	Institutional Quality with Corruption Perception Index	Institutional Quality
Human Capital Index	1.085*** (0.110)	1.245*** (0.113)
Online Service Index	0.0274 (0.0756)	0.0468 (0.0777)
Telecommunication Infrastructure Index	2.054*** (0.103)	2.123*** (0.105)
Human Development Index	-0.129 (0.200)	-0.131 (0.205)
Constant	-1.220*** (0.0748)	-1.382*** (0.0768)
Observations	1,157	1,156
R-squared	0.717	0.732

Sources: World Bank Group, Worldwide Governance Indicator; United Nations Development Program, Human Development Index; and United Nations e-government databases.

Note: Standard errors in parentheses, *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

ANNEX 14.2.

How E-Government Affects Governance (Sub-components)

The table below shows the regression results of subcomponents of institutional quality on sub-components of the EGDI, controlling for income level with the HDI. The data cover 131 countries in 2003, 2004, 2005, 2008, 2010, 2012, 2014, 2016, and 2018.

ANNEX TABLE 14.2.1.

E-Government Indicators as Potential Determinants of Select Dimensions of Institutional Quality							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variables	Government Effectiveness	Control of Corruption	Ease of Doing Business Index	Political Stability	Regulatory Quality	Rule of Law	Voice and Accountability
Human Capital Index	1.349*** (0.127)	1.238*** (0.164)	1.526*** (0.206)	0.876*** (0.182)	1.225*** (0.123)	1.119*** (0.141)	1.568*** (0.174)
Online Service Index	0.255*** (0.0870)	-0.00552 (0.112)	0.626*** (0.135)	-0.962*** (0.125)	0.354*** (0.0845)	-0.00527 (0.0968)	0.0381 (0.119)
Telecommunication Infrastructure Index	2.311*** (0.118)	2.971*** (0.152)	0.997*** (0.192)	2.247*** (0.169)	1.829*** (0.115)	2.678*** (0.131)	1.939*** (0.161)
Human Development Index	-0.0107 (0.230)	-0.659** (0.296)	-0.350 (0.395)	0.494 (0.329)	0.346 (0.224)	-0.157 (0.256)	-0.578* (0.314)
Constant	-1.648*** (0.0860)	-1.266*** (0.111)	-1.281*** (0.143)	-1.274*** (0.123)	-1.668*** (0.0836)	-1.433*** (0.0957)	-1.255*** (0.118)
Observations	1,157	1,157	1,040	1,157	1,157	1,157	1,157
R-squared	0.751	0.643	0.401	0.432	0.732	0.699	0.492

Sources: United Nations Development Program, Human Development Index; UN e-government databases; and World Bank Group, Worldwide Governance Indicator.

Note: Standard errors in parentheses, *** p < 0.01, ** p < 0.05, * p < 0.1

ANNEX 14.3.

Panel Data Estimation of the Correlations of E-Government and Governance

The table below shows the panel regression of control of corruption and government effectiveness on subcomponents of the EGDI and the HDI to capture the level of economic development.²⁸

ANNEX TABLE 14.3.1.

Variables	Fixed Effect		Random Effect	
	Control of Corruption	Government Effectiveness	Control of Corruption	Government Effectiveness
	Telecommunication Infrastructure Index	-0.193 (0.124)	0.229 (0.133)	0.221*** (0.0515)
Human Capital Index	-0.0674 (0.202)	0.166 (0.167)	0.812** (0.386)	1.194*** (0.343)
Online Service Index	0.159 (0.0974)	0.0553 (0.101)	0.150 (0.115)	0.0645 (0.137)
Human Development Index	0.0573 (0.307)	-0.0453 (0.181)	0.603 (0.690)	0.614 (0.654)
Constant	0.129 (0.0879)	0.0122 (0.0942)	-1.051*** (0.339)	-1.385*** (0.407)
Observations	1,157	1,157	1,157	1,157
R-squared	0.199	0.748	0.528	0.701
Number of Country	130	130	130	130

Sources: World Bank Group, Worldwide Governance Indicator; United Nations Development Program, Human Development Index; and United Nations e-government databases.

Note: Robust standard errors in parentheses, with cluster of income groups; *** p<0.01, ** p<0.05, * p<0.1.

ANNEX 14.4.

Granger Causality Results

The table below presents the underlying results for Figure 14.9, the Granger causality matrix. Please note that the subtable on the top shows the result of whether the variable WGI Granger causes the variable E-Government Index (EGOV), whereas the bottom subtable shows the result of whether the variable EGDI Granger causes the variable WGI. If “Yes” is shown in the last row, the Granger cause relationship exists between the two variables for at least one country.

²⁸ Obviously, beyond e-government, other factors influence governance. The economic literature has categorized corruption factors into four groups: economic factors, political and governmental factors, demographic factors, and cultural factors. The effects of all these factors, which should be used for a more comprehensive governance model, are assumed to be in the residual of the regression as omitted variables. This also represents a source of bias for the estimates.

ANNEX TABLE 14.4.1.

Granger Causality Test Result (Institutional Quality to E-Government)														
WGI => EGDI	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variables	E-Government Development Index							Telecommunication Infrastructure Index						
Institutional Quality	0.306 (0.278)							0.580* (0.243)						
Voice and Accountability		0.211 (0.186)							0.389* (0.177)					
Rule of Law			0.0605 (0.196)							0.188 (0.214)				
Regulatory Quality				0.240 (0.320)							0.0332 (0.412)			
Political Stability					-0.0415 (0.194)							0.0388 (0.209)		
Government Effectiveness						0.145 (0.197)							0.273 (0.206)	
Control of Corruption							0.141 (0.129)							0.267* (0.104)
zbart_pv	0.763	0.826	0.4	0.0621	0.152	0.504	0.893	0.341	0.542	0.247	0.0749	0.00179	0.0165	0.22
	No	No	No	No	No	No	No	No	No	No	No	Yes	Yes	No

WGI => EGDI	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variables	Human Capital Index							Online Service Index						
Institutional Quality	-0.356*							0.778						
	(0.146)							(0.679)						
Voice and Accountability		-0.185							0.453					
		(0.141)							(0.495)					
Rule of Law			-0.161							0.162				
			(0.155)							(0.536)				
Regulatory Quality				-0.418*							1.110			
				(0.165)							(0.653)			
Political Stability					0.00202							-0.0203		
					(0.165)							(0.560)		
Government Effectiveness						-0.0931							0.231	
						(0.182)							(0.571)	
Control of Corruption							-0.146							0.339
							(0.0832)							(0.342)
zbart_pv	0.377	0.501	0.0000602	0.00177	0.35	0.00358	6.38E-09	0.921	0.894	0.108	0.0575	0.122	0.892	0.751
	No	No	Yes	Yes	No	Yes	Yes	No	No	No	No	No	No	No

ANNEX TABLE 14.4.2.

Granger Causality Test Result (E-Government to Institutional Quality)														
EGDI => WGI	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variables	Institutional Quality	Voice and Accountability	Rule of Law	Regulatory Quality	Political Stability	Government Effectiveness	Control of Corruption	Institutional Quality	Voice and Accountability	Rule of Law	Regulatory Quality	Political Stability	Government Effectiveness	Control of Corruption
E-Government Development Index	0.429 (0.489)	0.853 (0.551)	0.432 (0.527)	1.446** (0.539)	2.038** (0.643)	0.621 (0.411)	-0.0494 (0.820)							
Telecommunication Infrastructure Index								0.113 (0.287)	0.361 (0.351)	0.178 (0.305)	0.847** (0.322)	0.908* (0.416)	0.241 (0.255)	-0.144 (0.431)
Human Capital Index														
Online Service Index														
Constant	0.235 (0.221)	0.193 (0.320)	0.341 (0.321)	-0.279 (0.201)	-0.180 (0.239)	0.211 (0.278)	0.463 (0.403)	0.344 (0.275)	0.498 (0.410)	0.520* (0.258)	0.328** (0.113)	0.565* (0.254)	0.490* (0.214)	0.403 (0.396)
zbart_pv	0.00186	0.00276	0.282	0.607	0.557	0.0652	0.0913	6E-08	4E-02	5E-11	6E-04	1E-02	2E-03	2E-04
	Yes	Yes	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes

EGDI => WGI	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variables	Institutional Quality	Voice and Accountability	Rule of Law	Regulatory Quality	Political Stability	Government Effectiveness	Control of Corruption	Institutional Quality	Voice and Accountability	Rule of Law	Regulatory Quality	Political Stability	Government Effectiveness	Control of Corruption
E-Government Development Index														
Telecommunication Infrastructure Index														
Human Capital Index	-0.0104 (0.537)	-0.578 (0.724)	-0.0516 (0.708)	-0.604 (0.868)	-1.779 (1.129)	-0.530 (0.607)	0.591 (0.841)							
Online Service Index								0.186 (0.219)	0.412 (0.251)	0.188 (0.265)	0.472 (0.304)	1.058** (0.337)	0.359 (0.193)	-0.0317 (0.386)
Constant	0.295 (0.656)	0.956 (0.926)	0.559 (0.761)	0.845 (0.952)	2.368 (1.331)	1.018 (0.613)	-0.183 (0.972)	0.333 (0.223)	0.389 (0.317)	0.466 (0.259)	0.164 (0.128)	0.474* (0.190)	0.367 (0.195)	0.449 (0.373)
zbart_pv	4E-05	9E-01	2E-03	3E-02	3E-04	2E-07	3E-04	0.351	0.0917	0.487	0.629	0.903	0.553	0.0228
	Yes	No	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	Yes

Sources: Luciano and Sylvain (2017); United Nations E-Government Development Index; United Nations Development Program, Human Development Index; and World Bank Group, Worldwide Governance Indicator.

Note: Standard errors in parentheses; *** p < 0.01, ** p < 0.05, * p < 0.1.

ANNEX 14.5.

Innovation, Governance, and Revenue

Annex Table 14.5.1 shows the regression results between government revenue (in percent of GDP) and institutional quality and e-government, controlling for the level of development via HDI. Annex Figure 14.5.2 shows the changes in the control of corruption coefficient in the regression as we add subcomponents of e-government to look at the reduction in bias in the original coefficient estimate.

ANNEX TABLE 14.5.1.

ANNEX FIGURE 14.5.1.

Potential impact of institutional quality and e-government on government revenue		Changes in Control of Corruption Coefficient under Different Scenarios	
Variables			
Government Effectiveness	0.0293** (0.0119)		
Control of Corruption	0.0542*** (0.00962)		
Ease of Doing Business Index	0.00358 (0.00392)		
Political Stability	-0.000291 (0.00473)		
Regulatory Quality	-0.0353*** (0.00941)		
Rule of Law	-0.0711*** (0.0128)		
Voice and Accountability	0.0480*** (0.00472)		
Human Development Index	-0.00163 (0.0479)		
Telecommunication Infrastructure Index	0.0719*** (0.0263)		
Human Capital Index	0.0698*** (0.0262)		
Online Service Index	-0.0404** (0.0171)		
Constant	0.116*** (0.0208)		
Observations	1,032		
R-squared	0.281		

Sources: United Nations Development Program, Human Development Index; United Nations E-Government Development Index; and World Bank Group, Worldwide Governance Indicator.

Note: Robust standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. The benchmark coefficient is generated from regression with only the subcomponents of government revenue and institutional quality. The other scenarios are generated to compare the addition effects of e-government components to the effect of control of corruption in government revenue.

ANNEX 14.6.

Interaction Effects

Annex Table 14.6.1 adds the interaction effect between control of corruption and the e-government subindicators (HCI, OST, and TII) to the model.

ANNEX TABLE 14.6.1.

Interacting e-government and control of corruption (Percent of GDP)		
Variables	(1)	(2)
	Government Revenue	Government Revenue
Control of Corruption	-0.0138 (0.0147)	-0.0196 (0.0155)
Rule of Law	-0.0297*** (0.00954)	-0.0290*** (0.00950)
Voice and Accountability	0.00901 (0.00565)	0.00910 (0.00576)
Regulatory Quality	0.00936 (0.00896)	0.00913 (0.00885)
Political Stability	0.00553 (0.00365)	0.00600 (0.00372)
Human Development Index	0.0913** (0.0409)	0.0828** (0.0337)
Control of Corruption * Human Capital Index	0.0448** (0.0181)	0.0520*** (0.0194)
Control of Corruption * Telecommunication Infrastructure Index	0.0487 (0.0449)	0.0773* (0.0413)
Control of Corruption * Telecommunication Infrastructure Index * Human Capital Index	-0.0876* (0.0524)	-0.106** (0.0518)
Control of Corruption * Telecommunication Infrastructure Index * Online Service Index	0.0165* (0.00984)	
Constant	0.105*** (0.0289)	0.111*** (0.0238)
Observations	1,157	1,166
R-squared	0.072	0.068
Number of Country	130	130
R-squared	0.166	0.168

Sources: United Nations Development Program, Human Development Index; United Nations E-Government Development Index; and World Bank Group, Worldwide Governance Indicator.

Note: Robust standard error; *** p<0.01, ** p<0.05, * p<0.1.

ANNEX TABLE 14.6.2.

Interaction Effects, By Region (Percent of GDP)							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Government Revenue						
East Asia and Pacific							
Control of Corruption * Human Capital Index	0.0665			0.0780	0.0341		-0.136
Control of Corruption * Online Service Index		-0.0411		-0.0313		-0.0220	-0.0666
Control of Corruption * Telecommunication Infrastructure Index			-0.0529*		-0.0430	-0.0328	-0.0133
Europe and Central Asia							
Control of Corruption * Human Capital Index	-0.0322			-0.0135	0.0578		0.0296
Control of Corruption * Online Service Index		0.0352*		0.0327		0.0155	0.0159
Control of Corruption * Telecommunication Infrastructure Index			0.0506		0.0720*	0.0393	0.0499
Sub-Saharan Africa							
Control of Corruption * Human Capital Index	0.0437			0.0423	0.0713***		0.0652***
Control of Corruption * Online Service Index		0.00209		0.0107		-0.0175	-0.0137
Control of Corruption * Telecommunication Infrastructure Index			0.0368		0.0826	0.0608	0.0903

Middle East and North Africa

Control of Corruption * Human Capital Index	0.0640		0.174*	0.148*	0.277***
Control of Corruption * Online Service Index		0.0824***	0.0941***		0.0706**
Control of Corruption * Telecommunication Infrastructure Index			0.0417	0.0738***	0.0774

Latin America and Caribbean

Control of Corruption * Human Capital Index	0.0670***		0.0314	0.0219	0.0107
Control of Corruption * Online Service Index		-0.0193**	-0.0132		0.00819
Control of Corruption * Telecommunication Infrastructure Index			-0.0563***	-0.0503***	-0.0493**

High Income: OECD

Control of Corruption * Human Capital Index	-0.00830		-0.00569	-0.0109	-0.00845
Control of Corruption * Online Service Index		0.00296	0.00246		0.00346
Control of Corruption * Telecommunication Infrastructure Index			-0.00123	-0.00335	-0.00317

South Asia

Control of Corruption * Human Capital Index	0.212***		0.211***	0.200***	0.203***
Control of Corruption * Online Service Index		-0.0589	-0.0583*		-0.0257
Control of Corruption * Telecommunication Infrastructure Index			-0.138*	-0.128	-0.105

Sources: United Nations Development Program, Human Development Index; United Nations E-Government Development Index; and World Bank Group, Worldwide Governance Indicator.

Note: Robust standard error; *** p<0.01, ** p<0.05, * p<0.1.

ANNEX 14.7.

Transmission Effect with Instrumental Variables

The instrumental variables—the e-government subindicators (HCI, TII, and OSI)—are used as additional variables to estimate the causal effect of corruption on revenue. These variables qualify as instrumental (relative to the pair consisting of control of corruption and revenue) because (1) they are independent of all variables (including error terms) that have an influence on revenue that is not mediated by corruption (exclusion restriction), (2) they are not independent of corruption, and (3) there is no confounding for the effect of e-government on revenue. Therefore, these e-government instrumental variables affect revenue only through their effects on corruption. Consequently, the e-government indicators are unrelated to revenue but are related to the predictor of revenue (corruption) and are not causally affected (directly or indirectly) by corruption, revenue, or the error term from the regression of revenue on corruption.

In Annex Table 14.7.1, a baseline regression of revenue on corruption and other institutional quality variables is run before adding the three e-government subindicators as the instrumental variables. The purpose is to see how the coefficient of control of corruption would change when different instrumental variables are added to the model.

ANNEX TABLE 14.7.1.

Transmission Effects with Instrumental Variables
(Percent of GDP)

Variables	(0)	(1)	(2)	(3)	(4)
	Baseline	Instrumental Variable: HCI	Instrumental Variable: TII	Instrumental Variable: HCI TII	Instrumental Variable: HCI TII OSI
	Government Revenue	Government Revenue	Government Revenue	Government Revenue	Government Revenue
Control of Corruption	0.0157** (0.00643)	-0.451 (0.586)	-0.312 (0.406)	-0.368 (0.420)	0.0484 (0.0713)
Rule of Law	-0.0279*** (0.00983)	0.133 (0.196)	0.0849 (0.137)	0.104 (0.140)	-0.0403 (0.0283)
Voice and Accountability	0.0108* (0.00571)	0.114 (0.134)	0.0829 (0.0910)	0.0954 (0.0962)	0.00180 (0.0170)
Regulatory Quality	0.0108 (0.00883)	0.138 (0.160)	0.101 (0.110)	0.115 (0.114)	0.00168 (0.0190)
Political Stability	0.00631* (0.00377)	-0.00471 (0.0166)	-0.00110 (0.0112)	-0.00291 (0.0123)	0.00597 (0.00422)
Human Development Index	0.0857** (0.0348)	-0.0270 (0.149)	0.00694 (0.107)	-0.00761 (0.110)	0.104** (0.0482)
Constant	0.108*** (0.0244)	0.182* (0.100)	0.159** (0.0717)	0.169** (0.0745)	0.0966*** (0.0336)
Observations	1,170	1,167	1,169	1,166	1,158
Number of country	130	130	130	130	130
R-squared	0.204	0.0675	0.0580	0.0639	0.0961

Sources: United Nations Development Program, Human Development Index; United Nations E-Government Development Index; and World Bank Group, Worldwide Governance Indicator.

Note: HCI = Human Capital Index; OSI = Online Service Index; TII = Telecommunication Infrastructure Index.

Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1.

ANNEX 14.8.

Regional Groupings

ANNEX TABLE 14.8.1.

Regional Groupings, Countries List						
South Asia	Europe and Central Asia	Middle East and North Africa	Sub-Saharan Africa	Latin America and Caribbean	High Income: OECD	East Asia and Pacific
Afghanistan	Albania	Algeria	Angola	Antigua and Barbuda	Australia	Brunei Darussalam
Bangladesh	Armenia	Bahrain	Benin	Argentina	Austria	Cambodia
Bangladesh Chittagong	Azerbaijan	Djibouti	Botswana	Bahamas, The	Belgium	China
Bangladesh Dhaka	Belarus	Egypt, Arab Rep.	Burkina Faso	Barbados	Canada	China Beijing
Bhutan	Bosnia and Herzegovina	Iran, Islamic Rep.	Burundi	Belize	Chile	China Shanghai
India	Bulgaria	Iraq	Cabo Verde	Bolivia	Czech Republic	Fiji
India Delhi	Croatia	Jordan	Cameroon	Brazil	Denmark	Hong Kong SAR, China
India Mumbai	Cyprus	Kuwait	Central African Republic	Brazil Rio de Janeiro	Estonia	Indonesia
Maldives	Georgia	Lebanon	Chad	Brazil São Paulo	Finland	Indonesia Jakarta
Nepal	Kazakhstan	Libya	Comoros	Colombia	France	Indonesia Surabaya
Pakistan	Kosovo	Malta	Congo, Dem. Rep.	Costa Rica	Germany	Kiribati
Pakistan Karachi	Kyrgyz Republic	Morocco	Congo, Rep.	Dominica	Greece	Lao PDR
Pakistan Lahore	Liechtenstein	Oman	Côte d'Ivoire	Dominican Republic	Hungary	Malaysia
Sri Lanka	Moldova	Qatar	Equatorial Guinea	Ecuador	Iceland	Marshall Islands

Montenegro	Saudi Arabia	Eritrea	El Salvador	Ireland	Micronesia, Fed. Sts.
North Macedonia	Syrian Arab Republic	Eswatini	Grenada	Israel	Mongolia
Romania	Tunisia	Ethiopia	Guatemala	Italy	Myanmar
Russian Federation	United Arab Emirates	Gabon	Guyana	Japan	Palau
Russian Federation Moscow	West Bank and Gaza	Gambia, The	Haiti	Japan Osaka	Papua New Guinea
Russian Federation Saint Petersburg	Yemen, Rep.	Ghana	Honduras	Japan Tokyo	Philippines
San Marino	Iran	Guinea	Jamaica	Korea, Rep.	Samoa
Serbia	Palestine	Guinea-Bissau	Mexico	Latvia	Singapore
Tajikistan		Kenya	Mexico Mexico City	Lithuania	Solomon Islands
Turkey		Lesotho	Mexico Monterrey	Luxembourg	Taiwan, China
Ukraine		Liberia	Nicaragua	Netherlands	Thailand
Uzbekistan		Madagascar	Panama	New Zealand	Timor-Leste
Andorra		Malawi	Paraguay	Norway	Tonga
Kyrgyzstan		Mali	Peru	Poland	Vanuatu
Monaco		Mauritania	Puerto Rico	Portugal	Vietnam
Turkmenistan		Mauritius	St. Kitts and Nevis	Slovak Republic	Korea, Dem. People's Rep.
Greenland		Mozambique	St. Lucia	Slovenia	Nauru
Jersey, Channel Islands		Namibia	St. Vincent and the Grenadines	Spain	Tuvalu
Gibraltar		Niger	Suriname	Sweden	American Samoa
Isle of Man		Nigeria	Trinidad and Tobago	Switzerland	Cook Islands
Serbia and Montenegro		Nigeria Kano	Uruguay	United Kingdom	Guam
Yugoslavia		Nigeria Lagos	Venezuela, RB	United States	Macao SAR, China

(continued)

ANNEX TABLE 14.8.1. (CONTINUED)

South Asia	Europe and Central Asia	Middle East and North Africa	Sub-Saharan Africa	Latin America and Caribbean	High Income: OECD	East Asia and Pacific
	Faroe Islands		Rwanda	Cuba	United States Los Angeles	Niue
			São Tomé and Príncipe	Anguilla	United States New York City	Taiwan Province of China
			Senegal	Aruba		French Polynesia
			Seychelles	Bermuda		New Caledonia
			Sierra Leone	Cayman Islands		Northern Mariana Islands
			Somalia	French Guiana		Kiribati
			South Africa	Martinique		
			South Sudan	Netherlands Antilles		
			Sudan	Virgin Islands (U.S.)		
			Tanzania	Curacao		
			Togo	Sint Maarten (Dutch part)		
			Uganda	St. Martin (French part)		
			Zambia	Turks and Caicos Islands		
			Zimbabwe			
			Sao Tome and Principe			
			Reunion			
			Swaziland			
			Congo-Brazzaville			

Source: International Monetary Fund, World Economic Outlook.

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Digitalization, Corruption, and Trust in Tax Officials in Africa

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ABSTRACT

This chapter explores the impact of digitalization on corruption perception and trust in tax officials in Africa. The findings are threefold. First, a higher level of digital adoption is negatively associated with the perception of corruption of tax officials. The chapter shows that, on average, the adoption of digital tools is correlated with a reduction of perception of corruption in the tax administration by around 4.3 percentage points. Second, the chapter demonstrates that trust in tax officials is significantly higher in countries with a higher level of digital adoption. Third, the alleviating effect of digitalization on corruption perception is reduced when the government intentionally shuts down the internet, while a successful promotion of Information and Communications Technology (ICT) by the government amplifies the dampening effect of digitalization on corruption perception. The findings of the chapter suggest that African countries should step up digitalization to combat corruption on the continent, while managing the associated risks and challenges. They should avoid intentionally shutting down the internet and instead establish policies to promote the development of ICT.

INTRODUCTION

With the outbreak of the COVID-19 pandemic, the importance of digitalization has never been clearer. In the race to contain the spread of a highly transmissible virus, countries have quickly deployed digital technologies to facilitate planning, surveillance, testing, contact-tracing, and quarantine. Governments around the world have used digital tools to raise public awareness, safeguard citizens' health, operate essential public services, and provide targeted support to vulnerable populations and companies to cushion the impact of the crisis (IMF 2020). In the area of public finance, depending on the prevailing social and economic circumstances, several tax agencies have focused on maintaining the operation of essential business processes, including taxpayer registration, taxpayer services, tax return, and payment-processing through online platforms. One would also hope

that digitalization could help to strengthen the governance of the use of funds allocated to combat the COVID-19 pandemic.

In recent years, many sub-Saharan African countries have adopted new digital tools in their tax administrations to reduce bureaucracy and combat corruption of tax officials. Digitalization is increasingly transforming how tax administrations operate, helping to improve process efficiency and service delivery and reduce the scope for corruption (Gupta and others 2017). For countries that already have a high level of corruption, digitalization is associated with better control of corruption, as it reduces human interactions (IMF 2019). In principle, digitalization can help promote transparency, accountability, and citizen participation, facilitate advocacy, and allow for closer interaction between government and citizens (IMF 2018; IMF 2019). In an environment characterized by imperfect information, high transaction costs, and discretionary rent-seeking tasks, digitalization can help reduce search costs, disseminate information in a cost-effective way, and reduce the moral hazard problem attached to monitoring public sector agents. Digital technology can also improve or provide educational services for public servants and the broader population at a lower cost.

However, digitalization can also create new opportunities for corruption. These opportunities are mostly related to cybercrime or simply through the misuse of well-intended technologies such as digital public services. Digital records and public service systems can be manipulated by corrupt officials with high IT skills. Digital systems are also vulnerable to cyberattacks, which can disrupt government functions and jeopardize citizens' digitally stored private information, particularly in countries with limited administrative capacity and underfunded security systems (IMF 2018; World Bank 2016). Therefore, the impact of digitalization on corruption is unclear. There is a paucity of empirical studies on the potential effect of digitalization on the perception of corruption in Africa.

This chapter fills in this gap in the literature by estimating the effect of digitalization on the perception of corruption of tax officials in Africa. Individual-level data from the sixth wave of the Afrobarometer survey and various indicators of digitalization are used. Moreover, the chapter explores whether digitalization could affect citizens' trust in tax officials by introducing transparency and reducing the opportunities for bribes and influence. The chapter estimates nonlinearity effects by exploring whether intentional internet shutdowns, as well as government success in promoting ICT matter. Partial or total intentional outage of the internet prevents free access to online information, intrudes on the rights of citizens to get accurate information and undertake fact-checking, and interrupts the ability of businesses to conduct transactions. Internet blackouts can undermine the trust of citizens in the internet and government actions and raise the perception that the government is corrupt and has something to hide. Regarding the promotion of ICT, government policies are very important, not only in terms of regulations but also in terms of the education in and availability of tools related to ICT.

The findings of this chapter are threefold: First, a higher level of digital adoption is negatively associated with perception of corruption of tax officials. The chapter shows that, on average, the adoption of digital tools is correlated with a

reduction of corruption perception in the tax administration by about 4.3 percentage points. Second, the chapter demonstrates that trust in tax officials is significantly higher in countries with a higher level of digital adoption. Third, the alleviating effect of digitalization on corruption perception is reduced when the government intentionally shuts down the internet, while a successful promotion of ICT by the government amplifies the dampening effect of digitalization on corruption perception. The findings of the chapter imply that African countries should step up digitalization to combat corruption on the continent, while managing the associated risks and challenges. They should avoid intentionally shutting down the internet and instead establish policies to promote the development of ICT.

The rest of the chapter is organized as follows: The following section describes the data sources and the empirical methodology and provides some stylized facts. The next section presents the results from the empirical analysis. Next, the chapter focuses on nonlinearity effects by exploring whether the effect of digitalization on corruption depends on the outcome of the government promotion of ICT and of the intentional internet outages. Finally, some concluding remarks are provided.

DATA SOURCES, EMPIRICAL METHODOLOGY, AND STYLIZED FACTS

This section describes the data sources and the empirical methodology used to explore the effects of digitalization on corruption perception.

Data Sources and Empirical Methodology

The data presented in this chapter are from the sixth round of Afrobarometer surveys conducted in 2014 and 2015. As an independent, nonpartisan research project that measures the social, political, and economic conditions in Africa, Afrobarometer represents a strong, reliable source of public opinion data within African states (Isaksson and Kotsadam 2018; Konte 2016). Nationally representative samples of individuals who are more than 18 years old were selected from both rural and urban areas of the different countries. The sample used in this chapter covers more than 23,000 individuals from 26 African countries.

To capture the perception of corruption of tax officials, the responses to Afrobarometer's question Q53F were examined. This question asks, "How many of the following people (Tax Officials, like Secretary of Treasury, Internal Revenue Service or State and Local tax administration) do you think are involved in corruption?" Possible responses include "None," "Some of them," "Most of them," and "All of them." For the purposes of the research conducted for the present chapter, the responses were coded as follows: 0 if the response was "None," 1 if the response was "Some of them," 2 if it was "Most of them," and 3 if the answer was "All of them."

To capture the perception of trust in tax officials, the responses to question Q52D were examined. Q52D asks, "How much do you trust each of the following Tax Officials (including Secretary of Treasury, Internal Revenue Service or

State and Local tax administration)?” Possible answers include “Not at all,” “Just a little,” “Somewhat,” and “A lot.” Again for the purposes of the present chapter, the responses have been coded as follows: 0 if the answer is “Not at all,” 1 if the answer is “Just a little,” 2 if the response is “Somewhat,” and 3 if it is “A lot.”

To examine digitalization, the World Bank’s Government Digital Adoption Index (DAI), year 2014, is used. The DAI is the simple average of three indicators: core administrative systems, online public services, and digital identification. The International Budget Partnership’s Open Budget Index and the World Bank’s E-Filing Index were also used. The Open Budget Index measures the extent to which government budget data are made accessible to the public (online) in an editable (machine-readable) and reusable format, without any restrictions (free and legally open). The E-Filing Index is a binary variable taking the value of 1 if the government provides online tax-filing services and 0 otherwise. The United Nations data on e-government and e-participation are also used. The E-Government Index measures the scope and quality of online services, including each country’s national website and the websites of the key ministries, and, in particular, the ministries of finance. The E-Participation Index is similar to the E-Government Index but focuses on the use of online services to facilitate the provision of information by governments to citizens, interactions with stakeholders, and engagement in decision-making processes.

Given that this chapter estimates the effect of digitalization—measured at the country level—on individuals’ perception of the corruption of tax officials, it is important to account for the hierarchical structure of the data. For the research presented in this chapter, a multilevel (hierarchical) model was used; this model is specific to hierarchical data and accounts for the clustering of data upon different categories (levels). The model allows for the estimation of how two factors—(1) the perception of corruption in tax officials, as reported by individuals, and (2) individuals’ trust in the tax officials—relate to digitalization, while accounting for the sociodemographic conditions of respondents, country specifics, and religious and ethnic effects (Box 15.1).

Stylized Facts

Figure 15.1 highlights the perception of corruption of tax officials (Figure 15.1.1) and the relationship between the Government DAI and the perception of corruption of tax officials (Figure 15.1.2). There is a very high perception of corruption of tax officials in Africa, as around 9 out of 10 people surveyed responded that tax officials are corrupt in some way (Figure 15.1.1). Among them, 44 percent of respondents think that some tax officials are corrupt, 30 percent argue that most are corrupt, and 16 percent believe that all tax officials are corrupt. Only 11 percent of individuals think that none of tax officials are corrupt. Figure 15.1.2 shows that in countries with higher government digital adoption indices, the perception of corruption of tax officials is lower, and vice versa.

Figure 15.2 presents the descriptive statistics for the variable trust in tax officials and the relationship between the Government DAI and trust in tax officials.

Box 15.1. Estimating the Impact of Digitalization on Corruption and Trust

This box explains in more detail the empirical approach—the use of a multilevel (hierarchical) model—employed in this chapter.

According to several studies (Luke 2004; Moerbeek 2004; Van den Noortgate, Opendakker, and Onghena 2005), ignoring the hierarchical structure of data, as well as ignoring the higher clustering of data, could lead to misattributed response variation within the already included levels, biased standard errors of the estimates, and wrong conclusions about the covariates' effects.

The observed outcomes (corruption of tax officials and trust in tax officials) are ordinal variables, with values ranging from 0 to 3. A multilevel ordered probit model with two levels (the individual level and the country level) was used to estimate the effect of digitalization on the perception of corruption of tax officials and trust in tax officials.

The advantage of multilevel over the traditional ordinary least squares (OLS) method is that it allows for correctly modeling hierarchical data that do not satisfy the basic assumption of independence of observations. The following equation was separately modeled:

$$\text{Corruption}_{ic} = \pi \text{Digitalization}_c + \beta X_{ic} + \mu_c + \varepsilon_{ic} \quad (1)$$

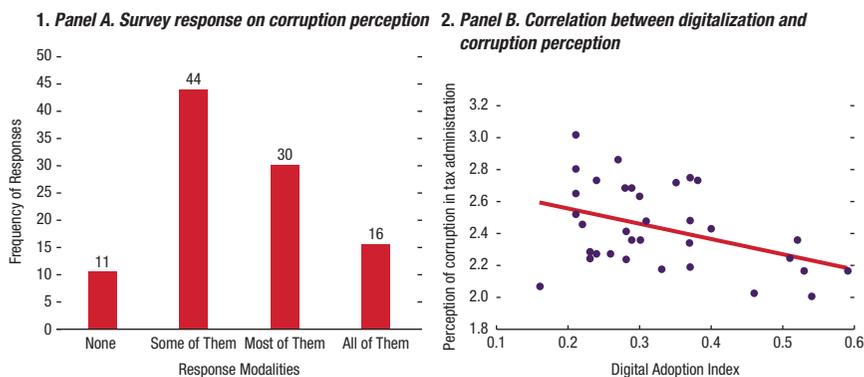
$$\text{Trust}_{ic} = \theta \text{Digitalization}_c + \tau_{ic} + \sigma_c + \delta_{ic} \quad (2)$$

where Corruption_{ic} represents the level of perception of corruption in tax officials reported by individual i in country c . Trust_{ic} is trust in the tax officials. Digitalization_c is the independent variable of interest, which is the level of adoption of digitalization of country c . X_{ic} and Y_{ic} stand for the individual-level characteristics controlled for in the regressions. ε_{ic} , σ_c , δ_{ic} , and μ_c represent the unobserved individual and country effects, each assumed to be normally distributed. In addition, religious and ethnic effects were controlled for in the estimates. The coefficients π and θ are the parameters of interest and measure the impact of digitalization on corruption perception and trust in tax officials, respectively.

Several control variables from the sixth wave of Afrobarometer surveys are included, namely, the sociodemographic conditions of respondents (age, education, employment status, gender, living area, wealth); the respondents' assessments of the difficulty of finding which taxes to pay; and the handling by government of various public services (those related to health and education services, living standards, infrastructure, fighting crime). Also taken into account were the respondents' perception of democracy and treatment of their own ethnic group compared to the other ethnic groups in the country, and their perceived satisfaction of politicians. Finally, the quality of the business environment was accounted for by using the World Bank's Doing Business database.

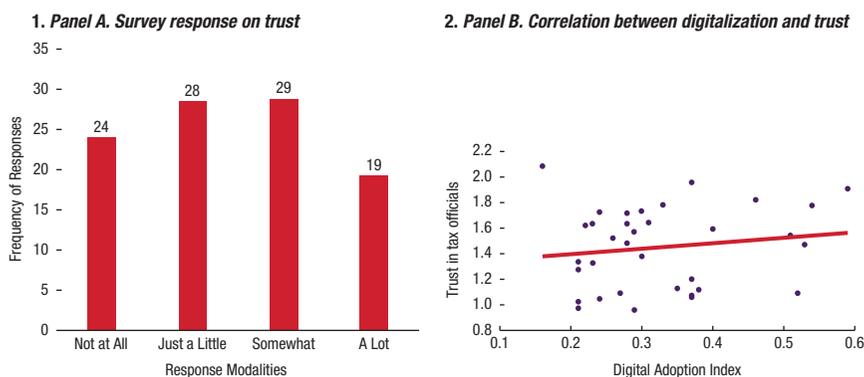
Only 1 out of 5 individuals surveyed have full trust in tax officials, which suggests that mistrust in tax departments seems to be common in Africa (Figure 15.2.1). Nearly one-quarter of individuals do not trust tax officials at all, while around one-third either trust tax officials a little or somewhat. Figure 15.2.2 shows the relationship between the Government DAI and trust in tax officials: in countries where digitalization is higher, so is trust in tax officials. On the contrary, trust in tax officials seems to be lower in countries with a low digital adoption rate.

Figure 15.1. Relationship between Digital Adoption and Corruption of Tax Officials



Sources: Afrobarometer; and authors' calculations.

Figure 15.2. Relationship between Trust in Tax Official and Digitalization



Sources: Afrobarometer; and authors' calculations.

RESULTS

Impact of Digitalization on Corruption of Tax Officials

The results of the estimates are reported in Table 15.1. Column (1) provides an estimate of how closely the perception of tax officials is associated with the Government DAI as an indicator of digitalization. The coefficient associated with this index is negative and significant at the 1 percent level, suggesting that digitalization is negatively correlated with the level of perception of corruption of tax officials. Quantitatively, Table 15.1 shows that an increase in the index of

government digital adoption from the first quartile to the third quartile is associated with a decline in the probability that respondents answer that all tax officials are corrupt from 14.9 to 12.5 percentage points,¹ while the probability that respondents answer that no tax officials are corrupt increases from 8.8 to 10.7 percentage points.

TABLE 15.1.

Impact of Digitalization on Corruption Perception					
Variables	(1)	(2)	(3)	(4)	(5)
Government DAI	-0.5142*** (0.191)				
E-Government Index		-1.4582*** (0.357)			
E-Participation Index			-0.5912*** (0.150)		
Open Budget Index				-0.8162*** (0.154)	
E-Filing					-0.3867*** (0.047)
Number of Observations	23,343	25,356	25,356	24,491	25,356
Number of Regions	301	334	334	310	334
Number of Countries	26	26	26	26	26
Region Fixed Effects	Yes	Yes	Yes	Yes	Yes
Ethnicity Fixed Effects	Yes	Yes	Yes	Yes	Yes
Religion Fixed Effects	Yes	Yes	Yes	Yes	Yes
Control Variables	Yes	Yes	Yes	Yes	Yes

Source: Authors' estimates.

Note: Standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

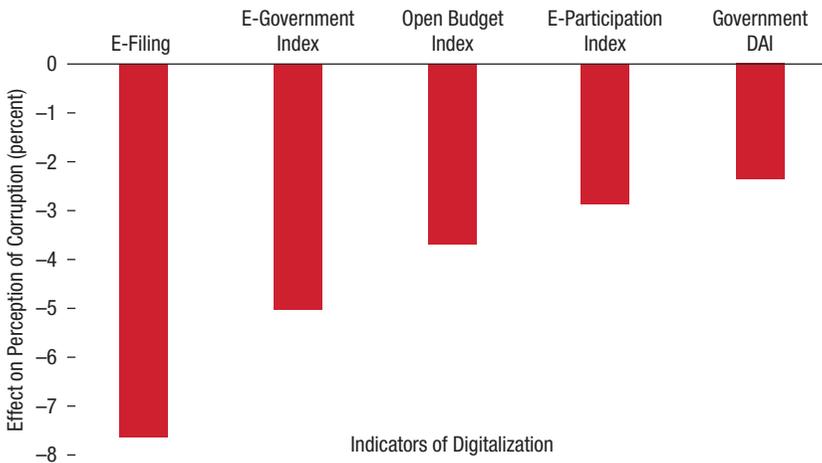
In columns (2) and (3), the E-Government and E-Participation indices are used, respectively. Notably, the coefficients associated with the two variables are still negative and statistically significant at the 1 percent level. This finding highlights the conclusion that publication of data and information online, as well as citizens' interactions with stakeholders and engagement in decision-making processes, are correlated with a lower perception of corruption of tax officials. Finally, the specific use of digital tools in public finances is considered through the use of the Open Budget Index and the e-filing indicator. The results are reported in columns (4) and (5). They suggest that there is a negative correlation among the online openness of the budget process to the public, the deployment of e-filing services in public finance, and the perception of corruption of tax officials. In other words, the higher the online transparency of the budget process, the lower the level of perception of corruption of tax officials. Similarly, the level of the perception of corruption of tax officials is lower in countries that provide e-filing

¹ These are estimated marginal effects at the mean values.

services. Quantitatively, the provision of e-filing services could lower the perception of corruption by up to 7.6 percentage points.

Figure 15.3 provides the quantified effects of the different indicators of digitalization on the perception of corruption. These quantified effects are calculated based on the movement from the first quartile to the third quartile of the digitalization indicator, except in the e-filing indicator, where the comparison is made between countries with and without e-filing services. The impact varies according to the indicator used to capture digitalization. E-filing appears to have the biggest impact in dampening the perception of corruption of tax officials.

Figure 15.3. Estimated Impact of Digitalization on Corruption Perception



Source: Authors' calculations.

Impact of Digitalization on Trust in Tax Officials

This section explores whether digitalization improves trust in tax officials. The use of digital tools helps to create more direct channels of feedback and communication between citizens and government, reducing the opacity of government transactions and promoting trust. To test this assumption, the effect of digitalization on the level of trust in tax officials was estimated, using the same specifications as in Table 15.1. The results are reported in Table 15.2. The coefficients associated with the different indicators of digital adoption are positive and highly significant at the 1 percent level in all columns. This finding suggests that trust in tax officials appears to be higher in countries with a high level of digital adoption. Considering column (1), where the Government DAI is used, an increase in the index from the first quartile to the third quartile is associated with an increase in the trust in all tax officials from 15.2 to 16.8 percentage points. At the same time, the probability that none of the tax officials is trusted declines from 21.9 to 20 percentage points.

TABLE 15.2.

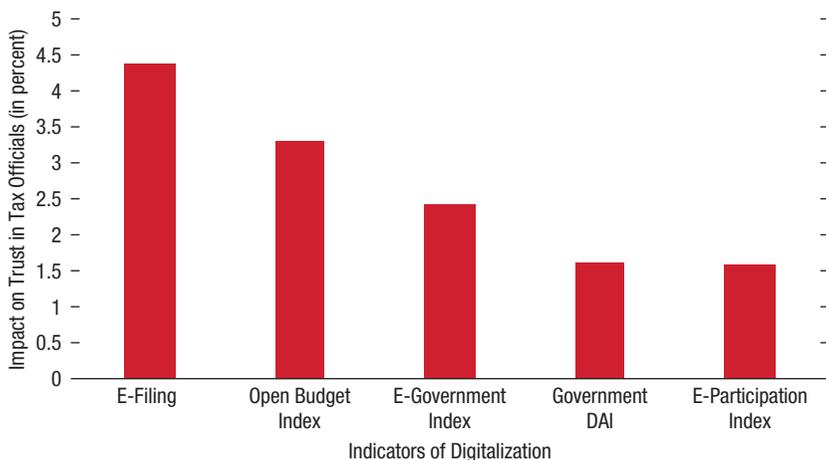
Impact of Digitalization on Trust in Tax Officials					
Variables	(1)	(2)	(3)	(4)	(5)
Government DAI	0.3084** (0.121)				
E-Government Index		0.6189** (0.308)			
E-Participation Index			0.2929** (0.129)		
Open Budget Index				0.5851*** (0.122)	
E-Filing					0.1882*** (0.042)
Number of Observations	23,752	25,808	25,808	24,950	25,808
Number of Regions	301	334	334	310	334
Number of Countries	26	26	26	26	26
Region Fixed Effects	Yes	Yes	Yes	Yes	Yes
Ethnicity Fixed Effects	Yes	Yes	Yes	Yes	Yes
Religion Fixed Effects	Yes	Yes	Yes	Yes	Yes
Control Variables	Yes	Yes	Yes	Yes	Yes

Source: Authors' estimates.

Note: Standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Figure 15.4 shows the estimated impact of the different indicators of digitalization on trust in tax officials. As in Figure 15.3, the estimation is based on the move from the 25th percentile to the 75th percentile of each indicator, except for e-filing, where the comparison is made between countries with and without e-filing services. Figure 15.4 shows that provision of e-filing services has the biggest impact in boosting trust in tax officials, while e-participation has the lowest impact.

Figure 15.4. Estimated Impact of Digitalization on Trust in Tax Officials



Source: Authors' calculations.

INTERNET SHUTDOWNS AND GOVERNMENT SUCCESS IN THE PROMOTION OF ICT

This section explores whether the effects of digitalization on corruption perception depends on Internet shutdowns and the successful promotion of ICT by the government.

Internet Shutdowns

An internet shutdown is an intentional disruption of internet-based communications, rendering them inaccessible or effectively unavailable, for a specific population, location, or mode of access, often to exert control over the flow of information. The intentional use of internet blackouts as a method of controlling the information landscape can have economic and human rights impacts and breach the trust of citizens in government actions. In fact, internet shutdowns undermine users' trust in the internet and the reliability of critical online government services, and raise the perception that the government has something to hide. Internet shutdowns can deprive people of vital information and restrict the ability of citizens to hold government or public officials to account. To explore whether the blackout of the internet can alter the relationship between digitalization and the perception of corruption, data on the number of internet shutdowns were extracted from the Internet Society and NetBlocks.² The number of internet shutdowns was then interacted with the different indicators of digitalization, and equation (1) was then estimated. The coefficient associated with the interactive variables between digitalization and the number of internet shutdowns is positive and significant in all columns (Table 15.3). This implies that the dampening effect of digitalization on the perception of corruption of tax officials is reduced in countries with a high number of internet blackouts.

Government Success in Promoting ICT

A successful implementation of ICT has proven to be an effective instrument for connecting not only citizens and public officials but also disparate government communication networks at every level. To achieve this, several countries have implemented initiatives to significantly increase the participation of citizens in public decision-making and providing citizens with a central window to government services, while other countries have introduced policies aiming at making ICT tools accessible to the public. To explore whether a successful promotion of ICT tools matters, an interactive variable was created between the different indicators of digitalization and the index of government success in promoting ICT, which was extracted from the World Economic

² NetBlocks, accessed in December 2019, <https://netblocks.org/projects/cost>.

Forum. This index was constructed based on survey responses from all countries, with respondents being asked, “In your country, how successful is the government in promoting the use of ICTs?” Possible answers ranged from “1 = not successful at all” to 7 = extremely successful.” The results reported in Table 15.4 show that the coefficients associated with the interactive variable between digitalization and the index of government success in promoting ICT are negative and strongly significant in all columns, except column (3). Therefore, a successful promotion of ICT could amplify the extent to which digitalization decreases the public perception of corruption among tax officials.

TABLE 15.3.

Digitalization, Corruption, and Internet Shutdowns					
Variables	(1)	(2)	(3)	(4)	(5)
Government DAI	-0.4718** (0.223)				
Government DAI*—Internet Shutdown	0.146** (0.063)				
E-Government Index		-1.5372*** (0.412)			
E-Government Index*—Internet shutdown		0.2409*** (0.019)			
E-Participation Index			-0.8980*** (0.221)		
E-Participation Index*—Internet shutdown			0.2448* (0.139)		
Open Budget Index				-0.9095*** (0.179)	
Open Budget Index*—Internet Shutdown				0.0048* (0.003)	
E-Filing					-0.4500*** (0.055)
E-Filing*—Internet Shutdown					0.0571** (0.021)
Internet Shutdown	0.1067 (0.116)	-0.0067 (0.108)	-0.0010 (0.048)	-0.1127 (0.128)	0.0891* (0.051)
Number of Observations	23,235	25,248	25,248	24,383	25,248
Number of Regions	296	329	329	305	329
Number of Countries	26	26	26	26	26
Region Fixed Effects	Yes	Yes	Yes	Yes	Yes
Ethnicity Fixed Effects	Yes	Yes	Yes	Yes	Yes
Religion Fixed Effects	Yes	Yes	Yes	Yes	Yes
Control Variables	Yes	Yes	Yes	Yes	Yes

Source: Authors' estimates.

Note: Standard errors in parentheses. *** p < 0.01, ** p < 0.05, * p < 0.1.

TABLE 15.4.

Digitalization, Corruption, and ICT Promotion					
Variables	(1)	(2)	(3)	(4)	(5)
Government DAI	-2.6842*** (0.674)				
Government DAI*—Government Success	-1.7249*** (0.515)				
E-Government Index		-2.0900*** (0.556)			
E-Government Index*—Government Success		-0.3408* (0.167)			
E-Participation Index			-0.6203** (0.307)		
E-Participation Index*—Government Success			-0.0083 (0.272)		
Open Budget Index				-0.2329 (1.478)	
Open Budget Index*—Government Success				-0.6278** (0.215)	
E-Filing					-0.3720*** (0.132)
E-Filing*—Government Success					-0.5897** (0.229)
Number of Observations	21,258	22,950	22,950	22,085	22,950
Number of Regions	284	315	315	291	315
Number of Countries	25	25	25	25	25
Region Fixed Effects	Yes	Yes	Yes	Yes	Yes
Ethnicity Fixed Effects	Yes	Yes	Yes	Yes	Yes
Religion Fixed Effects	Yes	Yes	Yes	Yes	Yes
Control Variables	Yes	Yes	Yes	Yes	Yes

Source: Authors' estimates.

Note: Standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

CONCLUSION

This chapter empirically tested the relationship between digitalization, the perception of corruption, and trust in tax officials in Africa. The findings can be summarized as follows:

- First, government digital adoption is associated with a lower perception of corruption and a higher trust in tax officials. On average, the adoption of digital tools is correlated with a reduction of corruption perception of tax officials by about 4.3 percentage points, while increasing trust in tax officials by 2.7 percentage points. By enabling transparency and reducing the opportunities for bribes and influence, digitalization can improve trust in government officials.

- Second, internet shutdowns by governments undermine the potential dampening effect of digitalization on the perception of corruption. In contrast, government policies to promote ICT strengthen the impact of digitalization in reducing the perception of corruption of tax officials.

African countries should step up the adoption of digital tools to combat corruption and improve trust in tax officials. Such policy will be key to improving tax compliance and helping African countries mobilize much-needed resources. Furthermore, African countries should refrain from intentionally shutting down the internet, which not only undermines private business but also limits the right of citizens to access public information. Instead, African countries should promote ICT to improve digital infrastructure and increase citizen access to digital tools. Going forward, more work is needed to understand the payoffs of different investments to spur digitalization on African economies, starting with providing basic infrastructure, such as electricity, to making available affordable and reliable internet services, to designing relevant applications and services. Managing risks, keeping digital systems up to date, and adapting to highly challenging and evolving digital environment will require boosting human capital and digital infrastructure.

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Abbreviations

ACA	Anti-Corruption Agency
AfDB	African Development Bank
AFROPAC	African Organisation of Public Accounts Committee
AFROSAI	African Organisation of Supreme Audit Institution
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
APD	Asia Pacific Department
ASSL	Audit Service Sierra Leone
AUCPAC	African Union Convention on Preventing and Combating Corruption
BCBS	Basel Committee on Banking Supervision
BCC	Banque Centrale du Congo
BEAC	Bank of Central African States (Banque des États de l'Afrique Centrale)
BIANCO	Bureau Indépendant Anti-Corruption
BIS	Bank for International Settlements
BNR	National Bank of Rwanda
BoB	Bank of Botswana
CABRI	Collaborative Africa Budget Reform Initiative
CAMA	Companies and Allied Matters Act
CBN	Central Bank of Nigeria
CBR	Correspondent Banking Relationship
CBS	Central Bank of Seychelles
CC	Customs Code
CCB	Code of Conduct Bureau
CCI	Control of Corruption Indicator
CD	Capacity Development
CEMAC	Central African Economic and Monetary Community
CENAREF	La Cellule Nationale des Renseignements Financiers
CFT	Combating the Financing of Terrorism
CIBN	Chartered Institute of Bankers of Nigeria
CNLCCF	Commission Nationale de Lutte Contre la Corruption
CNM	National Public Procurement Commission
COBAC	Central African Banking Commission
CORR	Control of Corruption
CPEAC	Chaîne Pénale Economique et Anti-Corruption
CPI	Corruption Perceptions Index
CPIA	Country Policy and Institutional Assessment
CSI	Comité pour la Sauvegarde de l'Intégrité

CSM	Supreme Council of Magistrate (Conseil Supérieur de la Magistrature)
CSO	Civil Society Organization
DAI	Digital Adoption Index
DCEC	Directorate on Corruption and Economic Crime
DEMPA	Debt Management Performance Assessment
DFID	Department for International Development
DGDA	Direction Générale des Douanes et Accises
DGI	Direction Générale des Impôts
DGRAD	Direction Générale des Recettes Administratives, Judiciaires, Domaniales et de Participations
DIGNAR	Debt Sustainability, Public Investment, and Natural Resources
DNFBP	Designated Nonfinancial Businesses and Profession
DPR	Department of Petroleum Resources
DRC	Democratic Republic of Congo
DSIB	Domestic Systematically Important Bank
EBE	Extrabudgetary Entity
EBF	Extrabudgetary Fund
ECA	Europe and Central Asia
EFCC	Economic and Financial Crimes Commission
EGDI	E-Government Development Index
EGI	E-Government Index
EITI	Extractive Industries Transparency Initiative
EM	Emerging Market
ERGP	Economic Recovery and Growth Plan
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group
FAD	Fiscal Affairs Department
FATF	Financial Action Task Force
FCPA	Foreign Corrupt Practices Act
FCS	Fragile and Conflict-affected States
FDI	Foreign Direct Investment
FG	Federal Government
FI	Financial Institution
FIU	Financial Intelligence Unit
FMIS	Financial Management Information System
GABAC	Groupe d'Action contre le Blanchiment d'Argent en Afrique Centrale / Task Force on Money Laundering in Central Africa
GAS	Ghana Audit Service
GE	Government Effectiveness
GEFF	Government Effectiveness Index
GFSM	Government Statistics Manual
GIABA	Intergovernmental Action Group against Money Laundering in West Africa
GIZ	Gesellschaft für Internationale Zusammenarbeit
GMM	Generalized Method of Moments

HCC	Constitutional High Court (Haute Cour Constitutionnelle)
HCI	Human Capital Index
HDI	Human Development Index
HIPC	Heavily Indebted Poor Countries
IAS	International Accounting Standard
IASB	International Accounting Standard Board
IBP	International Budget Partnership
ICA	Investment Climate Assessment
ICPC	Independent Corrupt Practices and Other Related Offenses Commission
ICRG	International Country Risk Guide
ICT	Information and Communications Technology
IDA	International Development Association
IDI	International Organization of Supreme Audit Institutions Development Initiative
IEO	Independent Evaluation Office
IFF	Illicit Financial Flows
IFI	International Financial Institution
IFMIS	Integrated Financial Management and Information System
IFRS	International Financial Reporting Standards
IGF	Inspector General of Finance
INTOSAI	International Organization of Supreme Audit Institutions
IPD	Institutional Profiles Database
IQ	Institutional Quality
ISA	International Standards on Auditing
ISSAI	International Standards of Supreme Audit Institutions
IT	Information Technology
JV	Joint Venture
LAC	Latin America and the Caribbean
LACC	Liberia Anti-Corruption Commission
LIC	Low-Income Country
LIDC	Low-Income Developing Country
MCD	Middle East and Central Asia Department
MENAAP	Middle East, North Africa, Afghanistan, and Pakistan
MFI	Microfinance Institution
ML	Money Laundering
MONA	Monitoring of Fund Arrangements
MPC	Monetary Policy Committee
MPR	Ministry of Petroleum Resources
NACS	National Anti-Corruption Strategy
NAPAMC	Nigeria Petroleum Assets Management Company
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NCPFC	National Commission of Prevention and Fight against Corruption

NDCPCPSD	National Directorate for Controlling Public Contracts and Public Service Delegation
NEITI	Nigerian Extractive Industries Transparency Initiative
NFA	Net Foreign Asset
NFIU	Nigerian Financial Intelligence Unit
NGO	Nongovernmental Organization
NIE	New Institutional Economics
NNPC	Nigeria National Petroleum Corporation
NPC	National Petroleum Company
NRGI	Natural Resource Governance Institute
OBS	Open Budget Survey
OCSIF	Organisme de Coordination et de Suivi des Investissements et de leurs Financements
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
OHADA	Organization for the Harmonization of Business Laws in Africa
OLS	Ordinary Least Squares
OSCEP	Observatory for Monitoring Corruption and Professional Ethics
OSI	Online Service Index
PAC	Public Accounts Committee
PCA	Post Clearance Audit
PEFA	Public Expenditure and Financial Accountability
PEP	Politically Exposed Person
PFM	Public Financial Management
PIB	Petroleum Industry Bill
PIMA	Public Investment Management Assessment
PMF	Performance Measurement Framework
PPP	Public-Private Partnership
PPRA	Public Procurement Regulatory Authority
PSA	Production-Sharing Agreement
PSC	Profit-Sharing Contract
RHS	Right Hand Side
RLAW	Rule of LAW
ROW	Rest of the World
SAI	Supreme Audit Institution
SAMIFIN	Sampandraharaha Malagasy Iadiana amin'ny Famotsiam-bola (Service de Renseignements Financiers)
SB	Structural Benchmark
SDG	Sustainable Development Goal
SGMM	System of Generalized Method of Moments
SNPC	Société Nationale Pétrolière du Congo
SOE	State-Owned Enterprise
SOP	Standards of Operational Practice

SRF	Financial Research Service
SSA	Sub-Saharan Africa
STR	Suspicious Transaction Reports
SWF	Sovereign Wealth Fund
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TADAT	Tax Administration Diagnostic Assessment Tool
TF	Terrorist Financing
TGA	Treasury General Account
TII	Telecommunication Infrastructure Index
TSA	Treasury Single Account
UNCAC	United Nations Convention Against Corruption
VACC	Voice and Accountability
WAEMU	West African Economic and Monetary Union
WBG	World Bank Group
WDI	World Development Indicator
WDR	World Development Report
WEF	World Economic Forum
WEO	World Economic Outlook
WGI	Worldwide Governance Indicator

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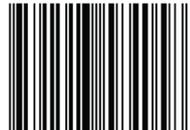
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