# CAN IMF LENDING PROMOTE CORRUPTION?

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### Executive Summary

Evidence of widespread corruption in several countries receiving IMF assistance raises questions about the relationship between such assistance and corruption. While some degree of corruption is present in all countries and is often "home-grown," there are a number of reasons to believe that under certain conditions, government-to-government assistance can actually promote corruption.

Research suggests that the more pervasive is the public sector's role in the economy, the more likely is corruption to flourish. Foreign assistance, however well-intentioned, can promote the very conditions fostering corruption. Such aid can strengthen existing public sector bureaucracy, result in larger government spending and a larger public sector (relative to the private sector), entrench a corrupt status quo elite, and foster delay in reforming existing corruption.

All of this is directly relevant to current IMF operations. IMF funds currently can be distributed to corrupt public bureaucracies and elites and are often (unwittingly) used to promote those conditions fostering additional corruption. Despite widespread evidence of corruption, IMF lending generally has not been associated with adequate safeguards, controls, or pre-conditions to prevent corrupt misuse of borrowed funds. This lapse suggests IMF lending may work to foster corruption. Reducing or reforming IMF lending, imposing strict conditionalities, and/or establishing reliable monitoring methods appear to be alternative remedies available at this time.

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## Introduction

Emerging evidence of widespread corruption in several countries receiving substantial IMF assistance has raised questions related to a number of issues. For example, do corrupt governments tend to receive government-to-government assistance? What is the relationship between such assistance and corruption? Does financial assistance reduce such corruption? Or, could government assistance actually foster corruption?

The emerging evidence about corruption also raises questions about the policies underlying IMF procedures surrounding such assistance. Analysts, for example, have questioned how borrowed monies are monitored or tracked to ensure they are used for the purposes intended by the donors. Others question the anti-corruption conditionalities attached to lending agreements.

While most analysts agree some corruption is present in all countries and is often "home-grown," there are a number of reasons to believe that under certain conditions, government-to-government assistance and lending can actually promote corruption. This paper explores these corruption-promoting circumstances. The relevant foreign aid literature is reviewed and then related to IMF lending before remedies are prescribed.

## Can Foreign Assistance Promote Corruption?

Recent research tentatively identifies certain conditions that tend to promote corruption. Leite and Weidmann (1999), for example, argue that among other things, corruption depends on governmental policies and the concentration of bureaucratic power.[1] Tanzi (1998) suggests that factors tending to promote corruption over time include government regulations and authorizations, certain characteristics of tax and government spending systems, government provision of goods and services at below market prices, and bureaucratic traditions.[2] In an earlier paper, Tanzi (1994) argued that opportunities for corruption increase with a larger role of the state in the economy. In his own words, "The more pervasive is the role of the public sector (through regulations, taxes, etc.)… the greater will be the scope for corruption."[3] Lane and Tornell (1996) suggest that corrupt activity can operate in economies with powerful interest groups and weak institutions.[4] Further, it is now widely recognized that centrally planned economies were closely associated both with many of these characteristics and a significant degree of corruption.

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[1] Leite, Carlos and Jens Weidmann, "Does Mother Nature Corrupt? Natural Resources, Corruption and Economic Growth." IMF Working Paper, WP/99/85, July 1999.
[2] Tanzi, Vito. "Corruption Around the World: Causes, Consequences, Scope, and Cures." IMF Working Paper WP/98/63, May 1998, pp.3, 6, 10-16.
[3] Tanzi, Vito, "Corruption, Government Activities, and Markets," IMF working paper No. 94/99, August 1994, p. iii.
[4] Lane, Philip R., and Aaron Tornell, "Power, Growth, and the Voracity Effect," Journal of Economic Growth, Volume 1: 213-241 (June, 1996).

Literature dealing with foreign economic aid recognizes that government-to-government foreign economic assistance often can (inadvertently) promote those conditions that foster corruption. This is especially the case when a significant degree of corruption is already present in recipient countries.

Foreign assistance and lending, for example, is sometimes conditioned on budget deficit reduction, i.e., on proposals that can effectively increase a country's tax burden. Such assistance has also been identified with strengthening the public-sector bureaucracy which directly receives the aid, thereby promoting this bureaucracy's concentration of power. It is also known that the availability of foreign assistance encourages rent-seeking behavior and that government-to-government transfers often result in increased government spending on the part of aid recipients.[5] While this literature pertains to the effects of foreign economic aid, it readily applies to the type of longer-term subsidized IMF lending that has occurred in recent years.

On the whole, this research suggests that while the objectives of foreign economic assistance are commendable, foreign aid and lending can have important (unintended) corruption-promoting effects on recipient economics for a number of reasons:

- **Foreign aid strengthens the government sector relative to the private sector.**

Foreign aid is usually provided from centralized government sources to centralized government recipients. More specifically, such aid is financed by taxing the private sector of donor countries and subsequently transferring the resulting resources, via centralized government-to-government means to recipient governments. This process works to subsidize and strengthen the public sector of the recipient country. Part of the explanation relates to the incentives of recipients.

As Bauer emphasized:

> Unlike manna from heaven, official aid does not descend indiscriminately on the population of the recipient country; it accrues to specific groups of people in positions of power and sets up repercussions often damaging to development, notably by contributing to the politicisation of economic life.[6]

Specific recipients of aid monies have economic incentives that may differ or conflict with the intentions of donors. They have incentives, for example, to reward their friends, supporters, and special interest constituents. Because of these realities, foreign aid can in practice work to strengthen the role of the recipient countries' public sector relative to its private sector.[7] Aid has tended to promote centralized economic control and fostered a concentration of bureaucratic power in recipient governments.[8] This is corroborated by the fact that government-to-

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[5] See, for example, World Bank, Assessing Aid: What Works, What Doesn't and Why, World Bank and Oxford University Press, 1998, pp.64-66.
[6] Bauer, P.T., Dissent on Development, Harvard University Press, Cambridge, Mass., 1976, p.21.
[7] See Milton Friedman, "Foreign Economic Aid: Means and Objectives," The Yale Review, vol. XLVII, June 1958 No. 4, p.503.
[8] See Bauer, *op. cit.*, p.128.

government transfers often lead to increases in government spending.[9] And, as one researcher concluded, "Aid… does increase the size of government."[10]

- **Foreign aid can perpetuate or strengthen existing corruption.**

Research relating to foreign aid shows that such aid is dispersed not on the basis of need, but on the basis of strategic and geo-political considerations.[11] That is, aid tends to support existing recipients who generally are supportive of existing donors. Donors, after all, have incentives to provide aid to those forces, supporters, and organizations that will help them remain in power. In practice, these characteristics are more important to donors than forces of change. A World Bank survey of research on foreign aid, for example, indicates that "there is little relationship between changes in aid and policy reform."[12] Foreign aid, then, often has not worked to promote reform. Consequently, aid tends to subsidize -- and thereby strengthen -- existing government connections and structures since aid recipients also will distribute this aid so as to preserve their political positions. In short, political elites can benefit from aid. In practice, aid subsidizes and strengthens existing regimes so they become solidified and entrenched. When existing regimes are corrupt, such regimes can be strengthened by foreign aid. It has been shown, for example, that foreign aid seldom includes meaningful incentives to alter governmental behavior with regard to corruption. In sum, when existing regimes are corrupt, the result is that these corrupt political regimes can benefit from foreign aid and become more firmly entrenched.[13]

Recent research by Alesina and Weder (1999) corroborates this view. They find that foreign economic aid actually is directly associated with corruption.[14] More specifically, Alesina and Weder contend that: "…our results …suggest that foreign aid may increase, or at best, has no effect on corruption."[15] Their research shows that there is no evidence whatsoever that less corrupt governments receive more aid, or that aid donors discriminate against corruption.[16] Their research indicates that foreign aid appears to go to more corrupt governments.[17] According to the authors, "there is some evidence that more corrupt governments receive more" aid.[18] Alesina and Weder go on to say that multilateral aid seems to pay no attention to the level of corruption and there is some evidence that "multilateral aid is positively correlated to corruption."[19]

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[9] World Bank, *op. cit*., p.64.
[10] Boone, Peter. "Politics and Effectiveness of Foreign Aid," NBER Working Paper #5308, October 1995 (Abstract).
[11] Alesina, Alberto and David Dollar (1998), "Who Gives Foreign Aid and Why?" NBER Working Paper, No. 6612. See also Alesina, Aleberto and Beatrice Weder, "Do Corrupt Governments Receive Less Foreign Aid?" NBER Working Paper No. 7108, May 1999, p.5.
[12] World Bank, *op. cit*., p.49 (see also p.3).
[13] The World Bank survey finds that governments in power a long time are less likely to implement reforms. World Bank, *op. cit*., p.52.
[14] Alesina and Weder, *op. cit*., p.13.
[15] *Ibid*., p.5.
[16] *Ibid*., p. 13.
[17] *Ibid*., p. 5.
[18] *Ibid*., p. 13.
[19] *Ibid*., p.16. (Note that the later evidence, however, is not statistically significant.) See also, p. 4.

Other researchers as well as Alesina and Weder also find support for what they call a "voracity effect" of foreign aid. This "voracity effect" indicates that when a recipient country obtains a foreign aid windfall, lobbying and redistribution efforts are heightened and corruption worsens. As a result, the windfall is turned into a social loss.[20] Because of this effect, more foreign aid tends to produce more corruption; that is, "countries that receive more (foreign) aid tend to have higher corruption."[21]

In sum, there appear to be logical reasons and empirical evidence that foreign aid can, and in fact does, foster corruption.

- **Foreign aid can delay pressures for reform and efforts to reduce corruption.**

Similarly, foreign aid can create incentives to maintain existing institutions and inhibit reform; foreign aid can work to further entrench the status quo. Foreign aid, for example, may inhibit efforts to reform for several reasons. As countries come to expect economic aid from external sources, the impetus to develop the necessary preconditions for advancement may dissipate. Necessary efforts to reform attitudes, institutions, and incentive structures, and to minimize corruption may become subordinate to efforts to obtain such aid. The availability of foreign aid therefore may spawn efforts to obtain this external aid instead of efforts to develop the necessary, essential ingredients for corruption-free internally driven growth. In short, foreign aid may redirect attention away from necessary governmental policy reforms that weed out corruption, and toward aid procurement.[22] In this way such aid may inhibit the commitment to reform and to reduce corruption.

In cases where significant corruption already exists, foreign aid typically has not worked to alleviate it. Recent research indicates that "there is little relationship between changes in aid and policy reform."[23]

Occasionally, conditionalities on aid are prescribed as methods to counter corruption. But, as recent research suggests, such conditionality is unlikely to work for a number of reasons. Conditionality, for example, is inherently difficult to monitor, is typically in force for limited time frames, and is administered under the strong pro-disbursing incentives of donor agencies. This research generally remains skeptical "about the ability of conditionality to promote reform in countries where there is no strong local movement in that direction."[24]

In sum, the foreign aid literature clearly makes the case that however commendable the objectives of foreign economic aid, such aid can promote (1) conditions fostering corruption, (2) the public sector relative to the private sector, (3) the status quo and existing corruption, and (4) delays in reform efforts to reduce corruption.

[20] *Ibid*., p. 12. See also Lane and Tornell, op. cit.
[21] Alesina and Weder, *op. cit*., p.20 (parenthesis added).
[22] See Bauer, *op. cit*., pp.100-3.
[23] See World Bank, *op. cit*., p.49.
[24] World Bank, *Ibid*., p.51.

## Relevance to IMF Lending

Most of the above remarks pertaining to foreign aid are directly applicable to IMF lending. IMF assistance loans, after all, are heavily subsidized and increasingly longer-term in nature.[25] These loans are dispersed from a highly centralized (multilateral) government agency to centralized government recipients. The loans, therefore, go to those in power, supporting existing established elites. Furthermore, many of these loans recently have been made to lower-rated developing countries with especially high degrees of corruption as calibrated by various measures of corruption. In fact, many of these countries were identified as highly corrupt by the IMF's own research staff.[26] All of this suggests that IMF lending may subsidize and foster corruption.

Furthermore, the conditions placed on IMF loans to these countries often may (perhaps unwittingly) foster circumstances spawning further corruption. Conditions promoting increases in taxation, government spending, and subsidies to the bureaucracy, for example, may be counterproductive. IMF lending may also more directly promote corruption through the "voracity effect:" i.e., by increasing the conflict among powerful special interest groups and factions, their power and influence is strengthened and corruption thereby promoted. The fact that many countries receiving IMF loans have remained dependent on IMF assistance for extended time periods with little evidence of genuine reform suggests that the entrenchment of the (sometimes corrupt) status quo may be related to IMF lending.[27]

Despite widespread evidence of corruption in recipient countries, IMF lending has seldom, if ever, been associated with controls, safeguards, monitoring procedures, earmarking, or tracking systems to ensure such funds are used consistent with the wishes of donors.[28] Corruption-preventing conditionalities also have seldom been associated with IMF lending; such lending is not contingent on a lack of corruption. Further, there is little evidence that corrupt governments get less IMF support or that IMF lending reduces corruption.

In short, the evidence suggests the IMF knowingly makes loans to corrupt governments while recognizing that some of its loan conditions and procedures can create circumstances promoting additional corruption. Yet no important safeguards or preventive conditionalities have been attached to these loans. Thus, IMF lending operations may be consistent with subsidizing corruption.

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[25] See Robert Keleher and Christopher Frenze, "JEC Findings Regarding IMF Financial Structure and Cost of U.S. Participation in the IMF." Joint Economic Committee study, October 1999.

[26] See, for example, Tanzi (1998) *op. cit.*, Table 1 (pp.23-4) where Russia, Indonesia, Philippines, Brazil, Mexico, Thailand, and South Korea are all identified as being relatively corrupt. See also the data presented in Pranabe Bardhan, "Corruption and Development: A Review of Issues," Journal of Economic Literature, Sept. 1997, pp.1343-6.

[27] See, for example, Doug Bandow, "The IMF: A Record of Addiction and Failure," in Perpetuating Poverty, edited by Doug Bandow and Ian Vasquez, Cato Institute, Washington D.C., 1994, p.19.

[28] Since the IMF does not lend money for specific purposes and money is fungible, as long as macro conditions are satisfied, there is normally no strict monitoring of funds associated with IMF lending.

## Remedies

Current forms of IMF assistance can foster or perpetuate corruption. To minimize the possibility of this occurring, several types of IMF reforms or procedural changes have been proposed. These proposals take the following forms:

- **Reduce and reform IMF lending:** Minimizing IMF lending is one obvious way to prevent IMF assistance from promoting corruption. But refocusing such lending away from longer-term structural lending and toward the type of temporary, shorter-term balance-of-payment lending that earlier characterized the IMF also would work in this way. Adopting prudent lending limits and thereby embracing smaller-scale lending is consistent with such an approach. Elimination of pervasive IMF interest subsidies would also work to reduce the potential for corruption.

- **Impose strong conditionalities:** Another proposal to minimize the corruption-promoting effects of IMF assistance is to impose strong conditionalities on such lending. Pre-screening countries by requiring certain legal standards, anti-corruption codes, and accounting practices be established prior to obtaining IMF funds could work to minimize corruption.

- **Establish monitoring procedures:** A third approach to minimize the possibility of enhanced corruption is to establish monitoring or earmarking systems to reliably track IMF funds. These procedures would presumably ensure these funds are utilized in ways consistent with the wishes of donors. This might involve the establishment of separate accounts or accounting practices used exclusively for IMF funds.

While these proposals seem reasonable, few, if any of such proposals have been taken seriously or successfully implemented. Nonetheless, such changes appear to offer viable options at this time.

## Summary and Conclusions

Evidence of widespread corruption in several countries receiving IMF assistance has raised questions about the relationship between such assistance and corruption. Research pertaining to corruption indicates that the more pervasive the public sector's role in the economy, the more likely is corruption to flourish.[29]

However commendable the objectives of foreign aid, such assistance often can create the very conditions that foster corruption. Such aid can strengthen existing public sector bureaucracy, result in larger government spending and a larger public sector (relative to the private sector), promote more rent seeking activity, entrench a corrupt status quo elite, and foster delays in reforming existing corruption.

[29] See Tanzi, 1994, *op. cit*., p.iii.

All of this is directly relevant to current IMF operations. IMF funds currently can be distributed to corrupt public bureaucracies and elites and are often (unwittingly) used to promote those conditions fostering additional corruption. Despite widespread evidence of corruption, IMF lending has been associated with neither safeguards or controls, nor contingencies related to the absence of corruption. This suggests IMF lending may work to foster corruption. Reducing or reforming IMF lending, imposing strict conditionalities, and/or establishing reliable monitoring methods appear to be alternative remedies available at this time.

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