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Anti-Corruption Policy

Can International Actors Play a Constructive Role?

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Chapter 14

Securing Investor Confidence or Fighting Corruption? How Intergovernmental Organizations May Reconcile Two Opposing Goals

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Bribe paying companies are often betrayed. After receiving a payment, public servants and politicians may fail to deliver the promised service. Other bribers are extorted, threatened with criminal prosecution, or forced to pay another bribe. Businesspeople who engage in bribery face a multitude of such troubles and uncertainties. At the same time, recognizing these troubles has shed new light on the design of reform.

I officials are provided with an incentive to cheat bribers, the stability of corrupt transactions is undermined, and bribery itself is inhibited. Reform may encourage those who operate in the shadow of the law to betray each other. Those who give and take bribes would punish each other as a result of their own self-interested behavior. Temptations to give or take bribes may be resisted, not due to a moral concern or fear of punishment, but because of the inherent uncertainty that surrounds such deals (Lambsdorff, 2007; 2009).

In light of this uncertainty at the heart of many corrupt transactions, this chapter considers a recent dilemma faced by international organizations: Whom should they side with if bribery is detected in international business transactions? Should they defend investors whose transaction-specific investments might be endangered if their property rights are not well protected? Or should they support host governments in sanctioning corporate misbehaviour? As I will

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argue, recognizing the existence of corrupt reciprocity helps in designing a regime that reconciles anti-corruption with investor's confidence.

I. Fighting Corruption or Preserving Investor Confidence

Fighting corruption and cultivating the confidence of international investors commonly go hand in hand. If corruption is absent, countries can develop a trusted environment that protects investor property rights. Various studies have confirmed that incoming FDI increases with the quality of governance and decreases with corruption (Lambsdorff, 2007: 100–04). Other studies have observed that investors are deterred both by corruption itself and by the uncertainty that goes along with corruption (Campos et al., 1999). For example, Guasch et al. (2007) investigate more than 1000 water and transport projects in Latin American countries and observe that corruption increases the tendency among governments to opportunistically exploit foreign investors by unilaterally renegotiating contracts. Economist Roger B. Myerson (2008) devoted part of his Nobel-Prize lecture to a formal model where investor uncertainty and corruption (in the form of authoritarian self-seeking) go hand in hand. Myerson argues that investors can be assured of their rights if autocrats are short of capital and completely dependent on international capital or if they create domestic institutions that impose checks and balances on their power vis à vis foreign investors (Myerson, 2008). These checks and balances can help reduce corruption and improve investor confidence at the same time.

Investors seek safeguards against the uncertainties they face. They adjust their entry-mode, determine how much intellectual property to put at risk, or seek personal contacts that cultivate trust in host governments. But to a large extent, investors also rely on their home country's government which supports their efforts in various ways; for example, by offering export credit guarantees, communicating along diplomatic channels, and issuing notes of protest if a host country misbehaves. Home governments may also call in foreign ambassadors, humiliate host country's diplomats, or seek support from diplomatic partner countries in marginalizing the head of a badly behaving state. Furthermore, they can chose to pressurize the host country's government and attempt to destroy its reputation if the government renegotiates contracts, expropriates property, or fails to pay as agreed (Hall 1999).

Investors purchase many types of insurance from private companies to protect against business hazards. But private companies do not offer insurance against the risk of expropriation by foreign governments. This is a type of in-

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surance which is sometimes offered by an investor's home government. Before World War II, home governments occasionally even used force to help private companies recover losses when their foreign direct investments were expropriated (Tomz, 2007); however, this type of enforcement by 'gunboat diplomacy' has been largely abandoned since.

Today investors tend to trust the established diplomatic network, which has been strengthened by numerous international conventions and intergovernmental organizations. The World Bank, the IMF and others are part of this network, enhancing investors' protection against the hazards of expropriation, unfair price cuts and unilateral renegotiations by opportunistic governments (Ramamurti and Doh, 2004). For example, the Multilateral Investment Guarantee Agency belongs to the World Bank Group and insures against political risks in developing countries. The World Bank thus incurs losses if a government expropriates investors, aggravating the World Bank's concern for a secure investment environment. The World Bank and the IMF are assumed to have considerable influence on many developing countries, which provides private investors with an implicit guarantee against misbehaviour (Ramamurti, 2003).

On the downside, this established network that supports international business transactions—in which intergovernmental organizations play an important role—may easily be biased. If investors are in conflict with host governments, the first superficial notion might be that it is the investor who deserves protection. There are at least two reasons for such a bias. First, bias may arise due to the intergovernmental organization's private sector involvement; be it in the form of equity, loans, guarantees or insurance. The World Bank would incur losses if a host government expropriates property.

Second, certain welfare considerations support such a bias. If host governments are at risk of acting opportunistically, organizations that support the investor can help generate fairer contract terms. For example, Levine et al. (2005) suggest that regulatory agencies may cultivate a pro-industry bias in order to protect sunk-investments, and help the government commit to honoring future income streams. Less developed countries may not have independent regulatory agencies that are strong enough to direct government policies towards a fair treatment of investors. But, as a substitute, governments in less-developed countries may tie their own hands by using intergovernmental organizations as guarantors to prevent them from succumbing to opportunistic temptations. Thus, for example, World Bank loans or equity and link investment projects to an international network that takes a strong pro-investor position on contract enforcement. Being subject to this pressure can help to boost foreign direct investment.

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II. Some Case Studies

One concern is that the international system may be biased in contexts where host countries have good reason to renegotiate contracts.[1] When contracts were obtained through corruption, a major challenge is whether host countries should be allowed to renegotiate them. Civil law on this issue differs considerably around the world. Many developed countries claim discretionary powers to renegotiate such contracts (Schlüter, 2005; Nell, 2009); however, this discretion may be unavailable to less developed countries that are pressured by international investors and their supporters. During the 1993–96 tenure of Pakistan's Prime Minister Benazir Bhutto, many private power companies were awarded contracts to sell power to the state Water and Power Development Authority. But the government's main anti-corruption arm believed that, in exchange for these contracts, kickbacks had been paid to bureaucrats and politicians. After a round of elections, the new government sought to renegotiate the old contracts and cut the electricity rate by 30 percent; however, the IMF and World Bank (whose loans to private power companies would sour in case of a rate cut) warned the Pakistani government that unilaterally cutting electricity rates would seriously lower investors' confidence and threatened a postponement of the loan agreements.[2]

A similar example comes from Indonesia where, due to charges of corruption, the government's utility authority (PLN) cancelled its contracts to obtain power from large plants built through joint ventures with large foreign companies. In these cases, relatives of Suharto had been given shares of the operations, raising suspicions of kickbacks and inflated prices for electricity. But foreign delegations of export credit insurers pressured the Indonesian government to honor the old contracts. They argued that the "future investment climate will be shaped by a long-term resolution (…) that protects the fun-

1. Guasch and Straub (2006) observe that in the majority of cases renegotiation is initiated by the operator of an investment project rather than the government. These may be hit by a shock, such as devaluation or a recession that renders the investment project unprofitable. Operators, not only governments, may also be opportunistic, using their bargaining power, their expertise and capacity to cut off important supplies, to strike a better deal than the one initially agreed upon. Bribes to regulatory agencies or politicians may also be given in exchange for improved contracts. This is a behavior, certainly, that will find little support among intergovernmental organizations and a pro-industry bias is unlikely to expand to such practices.

2. See Financial Times, October 29, 1998, "Pakistan: Attempts to solve the power tariff dispute" and Reuters, April 26, 1998, "Pakistani power row seen scaring investors".

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damental rights of investors" and that, as a result, "(default) will impair Indonesia and our ability to work with you in the future" (Murphy, 1999, p. 63).[3]

A pro-investor bias may also induce home governments to turn a blind eye to malfeasance, rather than thoroughly investigating allegations. Take the case of the Aerospace Engineering Design Corporation (AEDC), registered in Panama, which was alleged to have arranged the sale of aircraft equipment worth 20 billion British pounds from Rolls-Royce to the Saudi Arabian Air Force. Rolls-Royce agreed to pay commissions of up to 15 percent to AEDC. In exchange, the Panamanian firm maintained "close relationships" with prominent Saudi Arabian nationals. It requires little imagination that this will have involved the payment of bribes. Allegedly Rolls-Royce did not pay the commissions as negotiated. AEDC brought the case to the high court in Great Britain. Following a High Court writ, Rolls-Royce feared for its reputation, XE "Reputation: for honesty" as did the British government, which had always denied any bribery payments in connection with the deal. This induced Rolls-Royce to settle the case out of court, causing AEDC to withdraw the case.[4] The British government, it seems, was unable to deliver on its promise of an honest deal. In order to avoid further investigation, it was forced to opt for the worst option: requesting the company to pay the dubious commission.

These cases expose a tension between fighting corruption and honoring contracts that may have been facilitated by major bribes to government leaders. Many similar and more recent cases are reported by Hall (1999; 2010). The pressure on new governments in host countries to honor past contracts—and thus to uphold past corrupt deals—arises also through more subtle channels. World Bank loans are almost exclusively granted to sovereign states. If governments declare contracts null due to bribery, the loan contract must be automatically terminated according to World Bank statues. However, termination of the loan agreement puts a hardship on the creditor government; in particular if the loan conditions were favorable or the country is short of foreign reserves. In such a circumstance it becomes unattractive to nullify contracts and thus unattractive to expose bribery and corruption.

Good governance and investor confidence can be in conflict with each other. Preserving investor confidence comes with a substantial risk. Intergovernmental organizations might unwillingly be complicit in helping the enforcement of corrupt transactions. They might prefer to turn a blind eye to corruption,

3. See also the Financial Times, March 10, 2000, "Interim deal in Indonesia power dispute".

4. See the Financial Times, December 20, 1997: "Rolls Royce: Silent on Saudi Talks".

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rather than risk their loans and equity if contracts are renegotiated. Is there a way to reconcile these two goals? To answer this question, let us return to the concept of reciprocity in corrupt transactions.

III. The Effects of Nullifying Corrupt Contracts

Courts commonly do not enforce bribe transactions. They follow the principle that those who operate outside the law cannot claim the law's protection. Bribe transactions are thus null and void. The nullity of the bribe transaction often entails a further legal consequence: bribes cannot be reclaimed, irrespective of whether or not the promised corrupt favor was delivered. Such a consequence presents a severe risk to bribe payers, evidenced in many cases of failed corrupt transactions (Lambsdorff, 2007). This legal judgment by courts is important for anti-corruption efforts because it helps to increase the risks of corruption, and thus serves to reduce its prevalence.

Some anti-corruption activists go further, arguing that both the bribe transaction and the main contract that was influenced by help of bribery should be nullified. Consider a contract for government construction that was induced by a bribe to a procurement official. Pope (2000) argues that governments should have the right to declare the construction contract void. Alternatively, the contract could automatically be declared null and void without any action by the host state.

Contracts induced by a bribe can be annulled either from the beginning (*recission ab initio*)—meaning that contract parties are brought back to the position in which they were before they entered into a contract—or from the future (*termination ex nunc*)—whereby any previous exchange under the contract remains valid (Nell 2009). Future profits from the contract are abolished in both types of nullity. The major difference between *recission ab initio* and *termination ex nunc* arises in case of transaction-specific investment—the resources invested into fulfilling a contract. For example, an investor may have tailored products to the specific needs of a customer, located his production to respond to local demand, or expanded his capacities in response to negotiated demand. If the contract is terminated ex nunc, the investor can reclaim these expenses as they were based in the past on a valid contract. To the contrary if the contract is rescinded, transaction-specific investments are lost, causing major losses to an investor. Thus the costs of *rescission ab initio* termination increase with the cost of transaction-specific resources dedicated by an investor to a particular contract.

Nullity is part of the debate over how to deal with contracts tainted by allegations of corruption. For example, Article 34 of the United Nations Con-

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vention against Corruption (UNCAC) states: "State Party shall take measures, in accordance with the fundamental principles of its domestic law, to address consequences of corruption. In this context, States Parties may consider corruption a relevant factor in legal proceedings to annul or rescind a contract, withdraw a concession or other similar instrument or take any other remedial action" (UN General Assembly, 2003, p. 18).

The risk of having contracts rescinded hurts companies that opt for bribery. This is the good side of nullity. It adds to the penalties and helps deter bribery. Contracts that were induced by unethical behavior can then be renegotiated and repaired. But there are various downside effects, many related to nullity in general, others in particular with respect to rescission.

First, nullity is a binary choice decision that cannot be linked to the gravity of the offense. If a small facilitation payment was instrumental to obtaining a contract, nullity may be regarded as an excessively harsh legal consequence. One cannot soften the consequences of nullity as it assigns legal rights to the contracting parties (sometimes also to competitors), which render the contract pending until mutual consent is achieved.

Second, the costs and delay of repeating a complete public tender are often avoided, and contracts renegotiated instead. However, renegotiation often falls short of the transparency and rigor otherwise exercised in public procurement, and is thus prone to corruption.

Third, companies that were honestly committed to avoiding bribery but chose the wrong intermediaries or joint-venture partners will suffer from the nullity of a contract. Given the uncertain validity of their contracts these companies will likely be reluctant to make future transaction-specific investments.

Fourth, managers who detect bribe-paying among their employees, face adverse incentives. If they investigate the case, some evidence may leak. This would endanger future profits and, if contracts are rescinded, transaction-specific investments.[5]

Fifth, and this relates to our focus on corrupt reciprocity, only companies that were successful in bribing are sanctioned by this type of penalty. Those who

5. The German company Siemens was investigated by prosecutors, the media, and internal and external investigators because of slush funds that were being amassed to bribe officials. Reacting ~~th~~ public pressure in 2006, a new leadership at Siemens introduced immense efforts to comply with anti-corruption standards. This openness in dealing with the problem, however, generated its own problems. Many contracts that were obtained previously by way of bribery were nullified and had to be renegotiated, often to less favorable conditions. Other German companies did not follow the good example set by Siemens, fearing also that their contracts would be nullified. This reveals how nullity may backfire and hinder self-reporting.

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paid bribes but were cheated by an opportunistic public servant are not penalized by the nullity of contracts. They failed to get the expected contract and the threat of nullity is immaterial, implying that the deterrent effect of nullity contains an unusual bias. Imagine for a moment that nullity would be the only official sanction faced by companies. This would be comparable to letting criminals get away with attempted murder and punishing them only if they succeeded in killing the victim. Such a sanction would fail to adequately deter criminal activities. Completed corrupt transactions go along with welfare losses, similar to murder. But already the payment of a bribe without a contract being returned may be bad, for example by destroying trust in politics and administration. Thus, even if contracts are not distorted in favor of the briber a sanction may have to be imposed, which would not be achieved by nullity.

Sixth, as a result of this bias a cheated briber retains the incentive to threaten self-reporting. As long as the briber did not obtain the contract he has less to lose and can credibly force the public servant to deliver the expected contract. Nullity thus operates in favor of corrupt reciprocity. It may stabilize corrupt transactions rather than inducing corrupt partners to cheat each other.

Finally, there are even some perverse incentives that originate from nullity. If the government is uncertain about the profitability of a contract, it may delegate negotiations to its most corrupt bureaucrats. Once these bureaucrats take bribes, rules on nullity provide the government with an unfair advantage. If the contract turns out to be unfavorable, the government can reveal the initial bribery and nullify the contract (Nell, 2009). By threatening nullity, the government can also blackmail the contractor and negotiate better conditions. As a result, the government loses the incentive to prevent its bureaucrats from taking bribes. Overall, these concerns explain why legal scholars (see reviews in: Raeschke-Kessler and Gottwald (2008) and Meyer (2011) advance arguments in favor of the validity—rather than nullity—of contracts obtained by help of bribery.

IV. Fighting Corruption and Preserving Investor Confidence

Should a different type of punishment be preferred to the nullity of contracts? There appears to be good reason to follow economists' oft-cited preference for monetary fines. Examples of such fines are manifold. The general terms and conditions of the purchase of the Deutsche Bahn AG (Allgemeine Einkaufsbedingungen AEB) set a fine of up to seven percent of the gross accounted sum to be paid by a contractor who paid a bribe. Similar provisions can be found

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in the US Sentencing Guidelines, and the 'integrity pacts' negotiated by Transparency International take similar types of fines into consideration. As a first approximation, a fine of 30 times the amount of the bribe would seem to be an adequate as such a value would well correlate with the advantage achieved by help of bribery, and clearly reveal the expected penalty at the stage of bribery.

Similar to other penalties, such as debarment or nullity, fines sanction companies. These sanctions reduce the attractiveness of bribery to corporations and lower the likelihood that companies will induce employees to pay bribes. When compared to debarment or nullity, the imposition of fines offers some advantages.

First, nullity is a sanction that is not well balanced to the *mens rea,* the guilty mind, which is commonly seen as a key determinant of criminal liability. In the case of a minor facilitation payment that was helpful in acquiring a major contract, nullity would impose a sanction that may be regarded too harsh. Weighted monetary fines would be more flexible, automatically generating a mild penalty if flowers were given to a low-level clerk while heavily sanctioning major monetary transfers to key decision makers.

Second, some of the costs that go along with debarment can be avoided by imposing fines. Debarment impedes procurement agencies from giving contracts to a firm that may be best qualified. Debarment hurts not only the company but also the public by limiting competition. Fines are a mere transfer of resources that avoid this disadvantage. Thus to the extent that fines can be imposed, they are preferable to debarment.

Third, with fines, the circumstances for detecting malfeasance can be taken into account. As mentioned above, nullity generates adverse incentives for managers who will prefer to destroy evidence of malfeasance rather than risk seeing their contracts nullified. Fines can be designed such that this adverse incentive is avoided. Reduced fines can be imposed on companies that come forward with evidence after observing that a contract was obtained with the help of bribery, thus enhancing the manager's incentives to investigate allegations in order to obtain lenient treatment for the company. This type of leniency can be easily implemented as contracts can include a clause that fines will be reduced in case of self-reporting.[6]

Fourth, it makes sense to impose fines unconditionally, subject only to recourse through the civil courts. Fines may then be superior to debarment,

6. Monetary fines are also superior to liability to restitute damages. Such damages arise for taxpayers who paid overpriced prices or received bad quality work or for competitors whose rights were violated by a biased bidding. Such a legal provision on restitution cannot be made dependent on a company's effort to come forward with evidence and report the infraction.

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which tends to involve a considerable degree of discretion of the procurement agency, rendering incentives to managers uncertain.

V. Discussion

Maintaining the validity of contracts and imposing fines on bribe-paying companies would reconcile anti-corruption with the preservation of investor confidence. There is no doubt that intergovernmental organizations should help in imposing penalties on perpetrators. This seems to be the accepted practice nowadays. Intergovernmental organizations, such as the World Bank and the IMF, might consider a general validity of contracts contingent on substantial contract fines that are negotiated. The fine should amount to a large multiple of the bribe given with a rebate for companies that come forward with evidence. It will be crucial that the commitment to enforce these contract penalties remains uncompromised. Hall (2010), for example, shows that the World Bank remained silent about the decision of Nigeria's government to drop a corruption prosecution against a former regulator, and he argues that the World Bank's vested interest in a continued restructuring and privatization of Nigeria's energy sector may have motivated its position on this matter. A clearer commitment to fight corruption may be needed to avoid such perceptions.

Not all cases of corruption involve quantifiable bribes. If the close relative of the head of state is given free shares of a local joint venture that profits from government contracts, laws may have been violated but no bribes were paid. A related problem arises if office holders were extorted. In such cases, the fine may correlate with the contract value.[7] Setting the fine equal to 100% of the gross value of the contract would act as a strong deterrent to pay bribes. Bribes of 3–4 percent of the gross contract value have occurred in the twelve Siemens cases listed in the formal complaints by the Justice Department and the Securities and Exchange Commission.[8] A fine of 30 times the value of the bribe would have come close to the gross contract value—an amount which can

7. One may also consider employing a company's net profit from a transaction for determining the size of a fine. Profits, however, are often private knowledge, unobservable to third parties and manipulated by a company that is supposed to pay a fine. Above, a profit accrues only to a company that was successful in obtaining the contract. As argued in section III, attempted corruption is then insufficiently deterred and companies retain the incentive to extort cheating officials.

8. See ProPublica, December 22, 2008, "Help Us Name Names in Siemens Corruption Scandal". Article accessed online (Sep. 19, 2012): "http://www.propublica.org/article/help-us-name-names-in-siemens-corruption-scandal-1222."

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serve as a substitute to determine the fine if bribes are unobservable. While such a substitutes may have to be employed sometimes, it does not perform as well as pegging the fine to the size of the bribe. Such a fine can be calculated already when the infraction takes place, inducing even myopic companies to become aware of the risks. Above, accidental, minor violations such as the payment of speed money or flowers to the secretary would not entail an excessively harsh punishment but a fine that is automatically adjusted to the gravity of the offense.

The enforcement of contract penalties is a more controversial issue. International arbitration, such as the World Bank's International Centre for the Settlement of Investment Disputes, commonly promises a speedy settlement, yet often at the expense of transparency. If a bribe-paying investor is found guilty, he may be denied reimbursement of his expenses from his home country's export credit insurance. However, arbitration judgments are not necessarily published and may be avoided by prior settlement. Both sides would then agree on a payment without anyone admitting guilt. This may allow the investor to obtain reimbursement of the monetary fine from his export credit insurance. More transparency and a clear published verdict must be required in exchange for unbending enforcement of contracts; however, the extent to which this can be achieved with the help of international arbitration remains to be seen.

The question of who should be the recipient of the fine will also be controversial. Contract conditions could state that the fine should be paid to competitors who lost business to the bribing company, to whistleblowers who helped uncover a case, or to the public that was disadvantaged—for example due to inflated prices. Either of these options is reasonable. Simply allocating the fine to the government's budget, on the other hand, may be inferior as it may impede the government's incentive to contain bribery.

A final concern is how to deal with contracts that are completely at odds with the public interest. If governments negotiate and sign desperately overpriced, low quality contracts with sole source providers, should a newly elected government be allowed to nullify such contracts *ex nunc*, but not *ex tunc*? Arguing in favor of unconditional validity would push the argument too far. One may concede that *ex nunc* nullification should be allowed, and that investors should thus not be entitled to sue for forgone profits, given that these are grossly exaggerated. But investors would still be allowed to sue for lost transaction-specific investment. From my point of view, this appears to be a feasible and fair solution. However, evidence on bribery alone would then be insufficient to terminate contracts *ex nunc*. Complementary evidence on overpricing or low quality would have to be submitted. In any case, this point reveals that completely deleting nullity from the toolbox of anti-corruption is not feasible or desirable.

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VI. Conclusion

Corruption is reduced not only by mechanisms of deterrence, such as strict criminal codes that create a high risk of detection. Corruption is also undermined by the risk that bribes may not be reciprocated. This chapter reviews recent proposals for reform and considers how they might be leveraged by intergovernmental organizations.

Intergovernmental organizations are part of a political network aimed at enforcing international business transactions. This may put them in a dilemma when investors have paid bribes. If governments are allowed to renege, investor confidence is undermined. Thus, if intergovernmental organizations maintain a strong position against reneging, they might involuntarily become complicit in the enforcement of corrupt transactions. A feasible policy that reconciles anti-corruption with investor's confidence requires the unconditional validity of contracts and substantial fines being imposed on a briber.

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