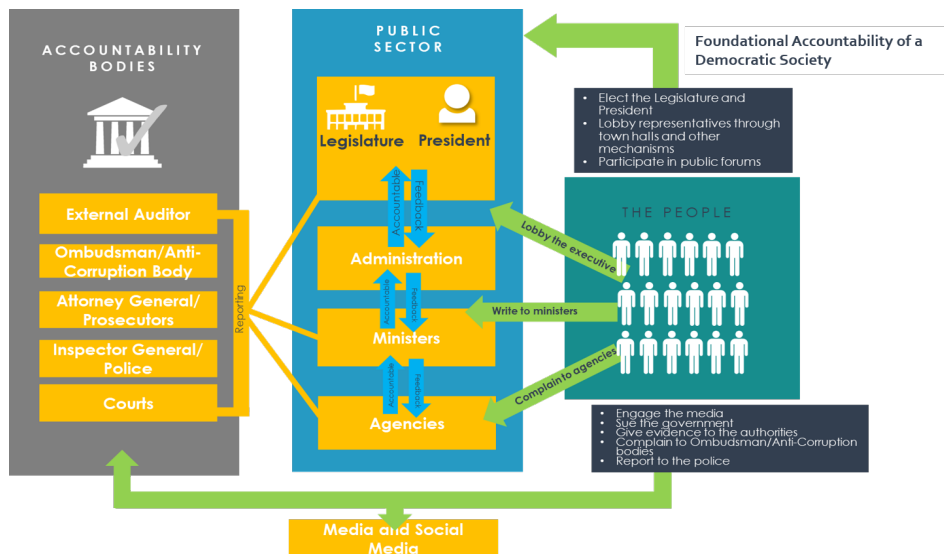


Follow-the-Money Corruption Cycle: Revealing National Accountability Failures¹

The consequence of systemic failure in national accountability systems is catastrophic corruption. Such corruption exists in the world, including in conflict-affected and fragile countries, resource rich countries, and aid-dependent countries. The purpose of this Development Practice Note (DPN) is to reveal, through a public finance lens, how corruption flourishes when there is a failure in national accountability systems. This is done through the “follow-the-money corruption cycle,” which tracks corruption mechanisms as money moves through the entire public finance system.

Figure 1: A National Accountability Framework



The democratic election system is the foundation for good governance and national accountability. This view was reported in a previous DPN on fake reform,² which argued accountability is about making performance visible to someone who has specific authority to call government to account

References:

1. By Andrew Laing, Public Economics Practice Manager, Institute for State Effectiveness
2. Laing, Andrew. “Performance and Policy Based Budgeting: How to Spot the Fakes,” Institute for State Effectiveness, 2020.

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for that performance. The primary national accountability cycle was presented as being set by the election cycle in democratic societies. Democracy is the system where the people ultimately hold government to account for its performance through electoral systems, where the people have the power to choose representatives to govern and protect their interests. Figure 1 demonstrates how this accountability system works in the public sector, where the administration is accountable to the executive and the legislature. The figure shows secondary areas of accountability where people can hold government to account in the space between elections by, for example, lobbying the executive, writing to ministers/secretaries, or submitting feedback directly to agencies. Other avenues for accountability include the use of traditional and social media, as well as seeking assistance through formal accountability bodies such as ombudsmen, auditors, and civil society organizations.³

In addition to the electoral cycle, one of the most important national accountability cycles that operates in the space between elections is the budget cycle (see Figure 2). This is the system where citizens can assess the performance of the government on an annual basis. They do not need to wait for an election to assess if the government is delivering on election promises. The budget cycle is an accountability cycle where the government makes fiscal promises to the people through the budget and reports on the results or fiscal outcomes of those promises in annual performance reports. A critical element is that annual reports include audited financial statements on their reliability, or in other words, an independent expert opinion on whether citizens can believe in the numbers presented.

National accountability is only established if there is enough information to help citizens make meaningful assessments of government promises and performance.

For this, comparability between budgets and annual reports is crucial. The principle is that reasonably educated citizens should be able to read a budget paper and an annual report

and easily compare the documented promises with the documented results. If the two documents are not easily comparable, then transparency for national accountability is compromised. Citizens and stakeholders will be in a poor position to know if a government is really delivering on its promises. Moreover, promises contained in budgets should be meaningful to citizens. Budgets are not just about providing to authorities to spend money. Good performance and policy-based budgets show a complete picture of a government's financial and non-financial promises. These include financial promises like revenue collection and expenditures, changes to wealth, assets, and liabilities (debt), and provide sufficient detail to provide meaning to citizens (like allocations for health and education by location). Non-financial promises should also be disclosed on what the government hopes to achieve by allocating these funds, such as lower infant mortality rates and improved learning outcomes.

The budget cycle should be perceived as a learning cycle.

When budgets and audits are in relatively good shape – where budgets are fiscal promises made in good faith and audits and annual reports are honest assessments of what actually happened – the public finance system becomes a learning machine. A virtuous cycle is established, and the system will be self-improving and self-cleaning. Institutions and the people inside them will learn from successes and failures, and government becomes increasingly more efficient, effective, and accountable over time. Every year, poor spending will be replaced with better spending, accountability gaps will be plugged, and policy weaknesses fixed. If budget systems are broken, for example, by acting as an auction rather than the result of a competition of ideas or audit systems are broken by functioning as a rent extraction network, then the system will never learn and government performance will never truly improve.

Figure 2 shows how the budget cycle operates and overlays with key points of corruption. This cyclical view not only exposes the potential scale of the corruption

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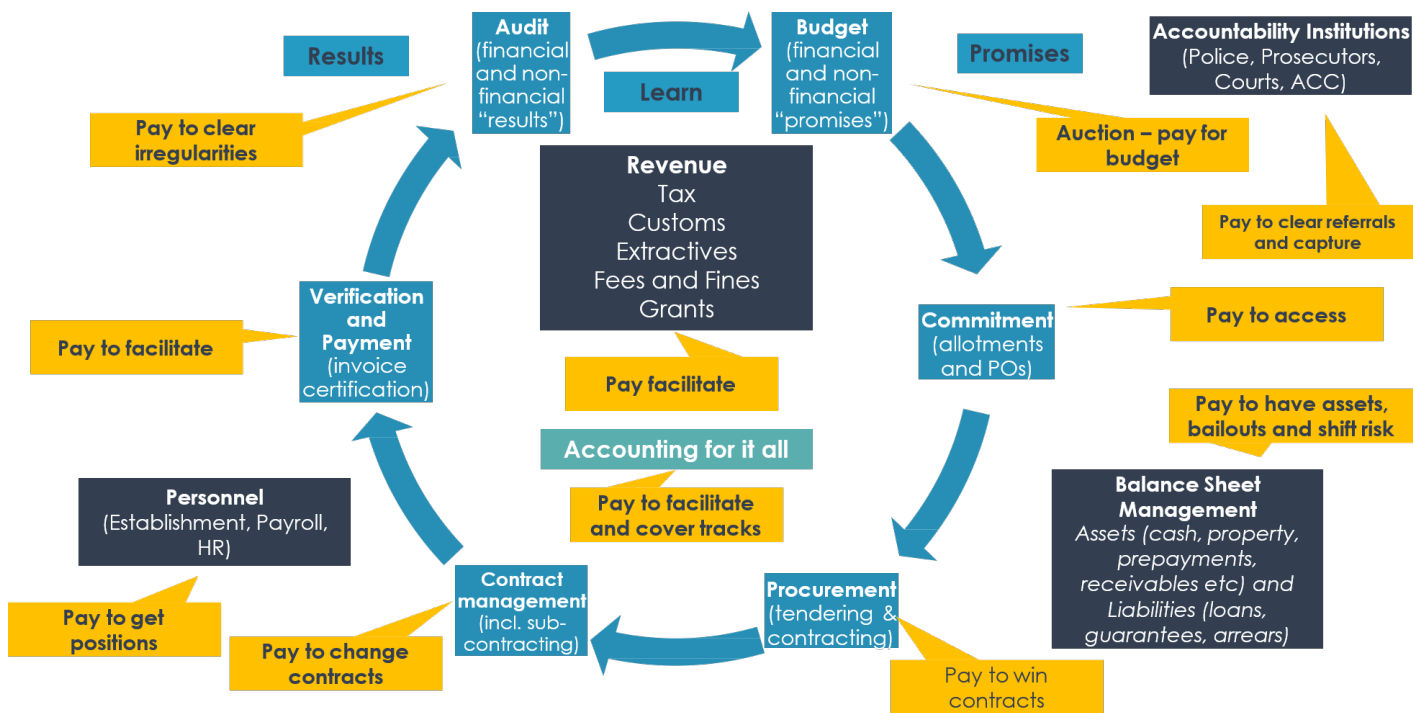
3. While this paper argues that national accountability supports the democratic system of government, the national accountability systems that operate in the space between elections can also operate in non-democratic societies, which will help deliver more efficient and effective government.

problem, but also reveals the correct focus areas to the problems. Importantly, it also highlights the theory of change to fix corruption problems – getting key points in the learning cycle working together. The expenditure cycle starts with the budget – the legal approvals to make expenditures (appropriations) using public resources. It then moves to the commitment phase, where after the legislature approves a budget, a treasury or designated budget institution grants access to those appropriations through the form of commitment and/or allotment issuances. The following procurement phase leads to the awarding of contracts, then through to the contract management phase, where contracts are enforced and/or amended before moving to the verification and payment stages where goods and services are delivered and verified and invoices are paid. The cycle ends at the audit stage, which is the system that provides public assurances that reporting on financial (and non-financial) operations are reliable (i.e. honest and believable). The budget cycle also includes the personnel and payroll system, the accounting system used to track flows and stocks

of resources, and the revenue collection system, which shows the different forms of revenue. The bottom-right box of Figure 2 presents balance sheet management systems for tracking changes in assets (e.g. cash and buildings), and liabilities (e.g. debt, guarantees, and expenditure arrears/unpaid bills).

Starting at the budget phase, people pay to get their budgets. If the budget is more of an auction⁴ where resources are allocated based on a willingness to pay, (budget authorizations are for particular projects that will benefit particular vested interests) rather than through an evidence-based assessment of the effectiveness of fiscal policy options, then corruption is flourishing throughout the parliamentary and budget formulation system. Bribes are paid for promised allocations, often in the form of project-based appropriations, programs, or subsidies for special interest groups. Essentially, people pay to get a budget. These people can be members of parliament, ministers, contractors, officials, and their agents. The size of the bribes in this stage can be massive, representing a significant proportion of the original appropriation. There are various red flags

Figure 2: Follow-the-money corruption cycle and the budget cycle



References:

4. See a previous DPN on “The Blight of Auction-Based Budgeting: What is it and how can we deal with it?”

of widespread corruption in the budget debating process within the legislature, one of which is the provision of resources to projects that have not followed due processes, like independently verified economic evaluation, fiscal impact analysis, and value for money assessments.

At the commitment phase, corruption works by people paying to get access to their allotment - the authorised allocation. Part of the system is to not just extract rents, but to ensure that the deals done in the budget phase continue through to the allotment clearance process. It is difficult for non-corrupt actors to operate cleanly in such a situation, as without access to approved funds, essential services can easily be compromised. Hence, the non-corrupt are forced to comply with the corrupt system if they are interested in delivering public services. The size of bribes here can also be massive, with anecdotal reports in some country contexts indicating that around 20% of the allocation could be required to secure the allotment release.

At the procurement stage, people pay to win contracts, on very favorable terms and at inflated prices. Such terms allow the benefits of public spending to be privatized and the risks and costs socialized – borne by taxpayers and donors. These can be standard projects linked to other projects or forms of contracts, including those associated with the provision of subsidies to public corporations and grants to non-government organizations. In the procurement stage, not only are bribery payments potentially significant, they also increase the prices paid by government, which means less money is available for genuine policy priorities. Moreover, the corruption at this phase can be so significant that the funds are used to receive essentially nothing in return, putting citizens, once again, on the losing end.

At the contract management stage, corruption works by people paying to change contracts to favor themselves. This can include allowing multiple levels of sub-contracting, which can operate when the system to verify the quality and delivery of goods and services is broken (see next paragraph). Forms of bribery here include paying to not enforce penalties for delays or the delivery of sub-standard goods or services.

At the verification and payment stage, people pay to verify that goods and services are delivered on time and to specification, and then pay again to get paid. The classic mechanism to secure a bribe is to delay processing

of invoice approvals which check that: i) goods and services are verified as delivered on time and to specification; ii) funds are available to make the payment; and iii) all other requirements are met. For such corrupt systems to work, failures in integrity procedures must occur. These can include loss of separation of duties, where different people must authorize different parts of the budget cycle, though collusion can still take place even when separation of duties principles appear to be in compliance.

At the audit stage, corruption works by people paying for audit irregularities to be cleared, whether those irregularities are real or not. Audit institutions running a broken system earn money through this process. The threat of investigation and identifying irregularities can be significant, especially under politically motivated scenarios. Some audit institutions have clear charging policies for irregularities found in high spending or important ministries like education or defense, which are also often higher than charges imposed on other institutions. In the context of a country that relies on aid from donors, conditionalities imposed by donors can also be counterproductive. There is evidence that when donors require the clearance of irregularities identified by auditors, all that happens is that the price of the clearance increases, since the cost of non-clearance has increased. Corruption in the audit phase can take other forms. For example, private provision of audit services for public sector accounts contains significant problems with appearances of various conflicts of interest. There are some red flags that may indicate that a conflict of interest is in fact real and being exploited. For example, one signal is when private auditors change when a new political party comes to power. Similarly, if there is a historical link between private sector auditors and political parties, then the signal is even greater. Other red flags include the standard example, where there has been a long history of clean audits, in direct opposition to long standing public perceptions of the problems, and the malfeasance is only revealed later after the government has fallen or the consequences of significant corruption becomes obvious (e.g. defaulting on loans and bankruptcy).

At the personnel and payroll stage, corruption works by people paying for positions. These pay-for-position schemes can be massive and are undetectable by fragmented audit systems, but are very easy to spot when looking for them specifically. Another well-known scheme

is systematic ghost worker systems, where salaries go to people that do not actually exist (or have left the civil service or died). The networks that run these schemes have a clear interest to prevent reform efforts to successfully link payroll, personnel, and establishment control systems (for authorized public service positions). Such linked systems make it easy for audits to more easily detect, deter, and refer payroll and personnel fraud. Another mechanism often adopted to extract payroll rents is through the use of batching (or grouping) of payroll transactions on the general ledger system, making it more difficult to detect inconsistencies.

At the accounting stage, people pay to facilitate movement through the accounting systems and to cover the tracks of malfeasance. “Greasing the wheels” in this context is ensuring the processors and approvers all get paid their “fair share.” One of the basic systems to cover up fraud is through the misuse or non-compliance of bank reconciliation systems. Very simply, bank reconciliations check the change in the bank balance with the change of balance in the accounting books for a given period. Even if bank reconciliations are done, which is often not the case in certain contexts, it is still very easy to fabricate these statements, although these fakes often do not hold up under scrutiny.

At the revenue collection stage, people pay to facilitate favorable treatment of what they owe. People pay for reduced tax assessments, reduced customs valuations at borders, and exemptions for extractive industry payments such as royalties and penalties. People also pay for exemptions for other fees and fines collectable throughout the system. This can be done in different ways, from direct to indirect bribes. Indirect bribes work, for example, through the political party donor system, where funds are provided to a party, with the expectation that the return will be in the form of tax concessions, exemptions, or deregulation. The purpose of tax expenditure budgets and reports (reports on the value of tax breaks offered and provided) is the standard system to make such operations more transparent. People also can pay to ensure country donor grants go to where they have vested interests and/or that reporting is opaque. For example, the transparent reconciliation of grants disbursed by the donor with grants received by the recipient and then with the expenditures made by the recipient, should be commonplace but are rare in practice, even though the

data is readily available.

During balance sheet management phases, people pay to secure favorable treatment of assets and liabilities. People pay to get access to cash, for example, at the central bank once an authority to pay has been issued. People also pay to have favorable access to non-financial assets, like free rent of government property, free transfer of ownership of public property (e.g. cars, buildings, equipment), and free clearance of prepayments and advances. This also extends to the treatment of liabilities, including favorable borrowing terms, free access to government guarantees, and free access to clearance or non-recognition of expenditure arrears. Some of these schemes can be massive in a single transaction. For example, the transfer of billions of dollars in assets for essentially nothing can occur easily in the absence of strong systems for accountability. This can be done through privatization mechanisms, public private partnership systems, procurement contracting, or very simple asset write-off and transfer systems.

SCALE OF THE PROBLEM, FOCUS AREAS, AND THEORY OF CHANGE

The scale of the problem can appear overwhelming when viewing corruption risks through a public finance lens.

In countries where the perception is that there is a massive problem of corruption, it is highly likely that all points of the public finance cycle are being exploited for corrupt purposes. This is not to say that all officials are corrupt, but that the corrupt system has been historically engrained and encouraged. The adage “most people want to do a good job, but most people do not want to rock the boat” remains true in countries with widespread corruption. It is a rational choice for clean and non-corrupt people to simply go along with the system. However, given the choice and with the right conditions (e.g. strong reform alliances and sufficient political protection) and the right incentives (e.g. increasing the costs of corruption), it is possible actors may choose an alternative, non-corrupt path. The answer is getting those conditions and incentives right.

Viewing corruption through a public finance lens allows reformers to better analyze the possible consequences of reform efforts. For example, focusing efforts on reducing corruption at the procurement stage is likely to result in corruption efforts being moved downstream. So rather than

waste time and effort at the contracting stage, corruption moves to the contract-management stage. In other words, if you cannot bribe an official to get the contract you want, you can just bribe a different official to change an existing contract to the one that you wanted in the first place. This reveals the “whack a mole” problem, when reform efforts are viewed in isolation of the “follow-the-money corruption cycle.” Similarly, putting additional controls at the procurement stage without dealing with the source of the problem upstream, for example in parliament or at the allotment phase where corrupt deals done during the allocation of project resources, will not result in any real reduction in overall corruption. It will just move corruption to different points in the “follow-the-money corruption cycle.”

From a virtuous cycle perspective, the focus areas for anti-corruption are clearly getting budgets and audits up to standard. By getting these two foundational accountability documents in order, it not only makes the secondary national accountability system work, but also facilitates institutional learning. Such systemic learning ensures only good fiscal policy gets adopted and implemented through the budget cycle. The system essentially becomes self-improving and self-cleaning.

The “follow-the-money corruption cycle” reveals that donor resources may be going to areas where reforms cost the most, rather than where reforms are most cost-effective. In the public finance area, donors put a significant amount of time and money into two particular areas: accounting and procurement systems. These are classic areas where system development costs can be significant, reflecting the “IT solutions approach” to fixing corruption problems. The “follow-the-money corruption cycle” suggests that corruption problems in the formulation and negotiation of budgets, as well as corruption in the auditing process, might be better places to focus attention. Moreover, when looking deeper into the reforms required to bust budget and audit auctions, it becomes clearer that, although the technical reforms are reasonably straightforward and not overly expensive, the political strategies required to be successful are much more challenging.

Merging fiscal reform with anti-corruption, such as measures to bust budget and audit auctions, comes with some significant risks. For example, in environments with commonplace perceptions of widespread corruption, tackling these areas may risk stability, since the corruption systems developed over time and work for many different interest groups, albeit at the expense of citizens. Hence, much importance should be placed on debating the various technical solutions and the political feasibility for success. In reality, the technical solutions are fairly simple, such as introducing policy-based budgeting or submitting financial statements for audits that are compliant with international accounting standards (e.g. International Public Sector Accounting Standards - IPSAS) and classification and reporting standards (e.g. Government Finance Statistics - GFS).

The real challenge facing government leaders and development partners is getting the right political and diplomatic strategy that will deliver sufficient success every year, over the medium term, and over election cycles. Options for political strategies for the busting of budget auctions include use of amnesties for past malfeasance (save grand corruption), along with announcements of sting operations and other techniques to collect forensic quality evidence for a comprehensive “detect, deter, and refer” policy. That said, instability risks should be weighed against the risks of doing nothing, or even doing the same things that are clearly not working. It might be that instability is the cost that needs to be borne in order to fix deep and intractable corruption problems.

Some of the techniques used by corrupt legislators, such as withholding support for a government’s budget, can be dealt with legitimately, rather than agreeing to their auction demands. In countries with strong political party discipline, pork barrelling⁵ can be limited as the party operates in unison, making it more difficult for pervasive auctions to occur in the legislature. In many countries, there are legislative provisions that allow spending to continue based on historical appropriations if an annual budget cannot be passed. In such situations, benevolent leaders can choose to not pass the budget and even

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5. Pork-barrelling is a commonly used term for the legislator’s practice of slipping funding for a local project into a budget, often on the condition of their support for a budget, policy, or other course of government action.

target misbehaving legislators through the budget itself by withholding related funds or removing party endorsements.

Corruption is often allowed to flourish as it is the mechanism used by power brokers to share power, which also means sharing the wealth. For example, peace deals based on the “spoils of war” approach require corruption to continue, where agreements distribute power, wealth, and even unfettered access to resources within particular ministry budgets, determining who gets which funds from which particular projects. Agreements with allocations to ministries have significant impacts, as big spending ministries, such as education or defense, have more scope for rent-seeking than smaller institutions. Similarly, revenue departments, like customs or tax departments, are also fought over. There are, of course, legitimate ways to share power and wealth, such as increasing funding for government opposition parties, which has also has political stability benefits as it reduces the costs of not being in government. The use of national security budgets that adopt confidential oversight mechanisms is another perfectly legitimate way to support peace deals and power sharing.

Peace deals negotiated in environments where there is a commonplace perception of rampant corruption might be better served by pursuing a “rules of the game” approach rather than adopting the “spoils of war” method. Agreeing to the rules up front before starting any game is wise. The “rules of the game” approach explicitly considers how the whole public finance system should operate under a negotiated peace deal. In particular, agreements should be sought on the extent to which rampant corruption addressed. The “follow-the-money corruption cycle” can be a useful tool to assist parties to consider the issues with the aim of securing agreements on each part of the public finance management system. On occasions, however, where spoils of war methods are adopted, negotiators and the public would be well served if they had information on the value of rents that accompany allocating ministry positions in a spoils system, and the likely impact on corruption, service delivery, and potential aid requirements if public funds are diverted.

By getting the budget cycle to work as a learning machine and a national accountability cycle, the system becomes self-improving and self-cleaning. Importantly, this theory of change does not require a significant amount of financial resources to create the conditions for effective

national accountability and continuous improvement. In this context, budget and audit reform is unambiguously more cost-effective than other governance interventions, like accounting system rollouts, which can be over hundreds of billions of dollars and still not work properly or have much impact on transparency or accountability, especially in the presence of upstream (budgets) and downstream (audits) corruption. The solution to fix core oversight institutions, such as parliament and audits, is more about getting the right political and diplomatic strategy teamed up with the right technical reform policies and a strong, well-protected reform alliance committed to resolving national accountability failures.