

GOVERNANCE TOPICS BY HILLS PROGRAM ASSOCIATES

The Organization for Economic Cooperation and Development (OECD), a transnational governing body committed to democratic government and the market economy, defines corporate governance as “the system by which business corporations are directed and controlled.” In a free-market economy, businesses are largely self-governors; that is, they take it upon themselves to formulate the “rules and procedures for making decisions on corporate affairs,” and actively work to adhere to them. The World Bank views these policies as necessary to “encourage the efficient use of resources and...to require accountability for the stewardship of those resources.” Operating within this framework are corporate executives and managers, who are charged with creating internal governance policies and designing a cohesive strategy, and shareholders, who elect a board of directors that serve in an oversight capacity. Ideally, there exists a healthy balance in the governance structure among the board, the CEO and management, and the individual shareholders, a balance that also takes into account the rights and interests of outside stakeholders.

Corporate governance is achieved largely through the structure and actions of the corporations themselves. Thus, the principal tenets of good governance take into account institutional notions of transparency, effective board structure, and accountability. Corporations are accountable to both investors and the public, and, through extensive and transparent financial disclosures, they fulfill these responsibilities. There are also myriad considerations when organizing a board of directors: It must be an appropriate size; sufficiently composed; and qualified enough to provide the governing expertise required of them. There must also be a system of checks and balances, in which independent directors and auditors guard against both accidental and intentional wrongdoing. Finally, shareholders must be given a fair, credible voice in the corporation, manifested in their voting and other participatory rights.

At a macro level, meaningful corporate governance is achieved when individual firms are responsive to the demands of public sector institutions invested in governance issues. These include domestic government agencies, such as country-level securities and exchange commissions; international governmental organizations, such as the United Nations; international financial institutions, such as the World Bank, the International Monetary Fund, and the OECD; and non-governmental organizations, such as Transparency International. These public sector organizations provide external oversight for the private sector.

It is important for both developed and developing countries to recognize the value of corporate governance when adjusting their own economic systems. “An investment in good corporate governance, professional integrity and transparency,” wrote former Federal Reserve Chairman Paul Volcker and former Securities and Exchange Commission Chairman Arthur Levitt, “will pay dividends in the form of investor confidence, more efficient markets, and more market participation for years to come.”

Sources:

OECD, found in Felipe B. Alfonso, “Corporate Governance: Main Themes and Issues for Discussion,” Asian Institute of Management, 8 November 2003.

Levitt and Volcker, “In Defense of Sarbanes-Oxley,” *The Wall Street Journal*, 14 June 2004, p. A16.

Corruption

Widespread corruption is more than an issue of individual vice; it is a systemic problem, perpetuated by systems of governance that create incentives for misbehavior. In both private firms and public agencies, combating corruption requires ensuring that effective, accountable governance structures are in place. The sources of this problem—and thus the nature of the solution—may vary from firm to firm, place to place.

While there are innumerable forms of corruption, much has to do with bribery and graft. The World Bank Institute (WBI) estimates that more than \$1 trillion in bribes and illegitimate transactions occur each year. Bribery is defined as the intent to offer payment to an individual in exchange for something—patronage, rewards, etc. Graft is the reciprocal action—receiving, or acting on, a bribe. Corruption can take other forms, as well. Extortion is when politicians use their influence to award contracts as a means of bypassing competition and efficiency-standards, and they rely on their status to award political appointments to those close to them, without a formal search-and-interview nomination process (in effect, “clearing” the market). Organized crime syndicates also develop in areas where policing and regulatory oversight are weak.

Corruption is wide-ranging problem, inherent in every capital market system where profit can be gained through financial transactions and policy outcomes. However, corruption is especially rampant in developing and transitioning nations, where governments tend to be in flux and are often unstable. When governments attempt to raise revenue through taxes, duties, tariffs, etc., corporations can effectively seek to reduce the costs imposed on them by bargaining, or bribing, government officials. The result is a diminution of costs placed on their particular business by the government while competitors are forced to pay. It is difficult, if not impossible, to tackle the problem of corruption without a thorough rule of law, competent administrators, and far-reaching public sector and corporate governance standards.

These rules and policies serve to provide fledgling corporations in developing national economies with the guidance they need to run their organization efficiently and transparently. Not surprisingly, it has been found that those developing countries best able to reduce corruption levels and augment governance standards see major boosts in their economic growth and development.

Sources:

Corruption and the Global Economy, edited by Kimberly Ann Elliott, Institute for International Economics, Washington, D.C., June 1997.

Susan Rose-Ackerman, Corruption and Government: Causes, Consequences, and Reform, Cambridge University Press, New York, 1999.

Governance Standards/Laws

Even the best corporate and public governance practices are strengthened by the existence, guidance, and public understanding of governance standards. Such standards exist in several forms: voluntary standards adopted by international, regional, or professional organizations; and standards put into national or international law. In addition to establishing appropriate practices for public and private actors, the standards also serve to publicize these practices, clarifying behavioral expectations in the public mind while laying out the “rules of the game.” As such, published governance standards, whether legally binding or voluntary, can help level the playing field by informing potential investors or business partners of the business environment of a given country or region with regard to anti-corruption measures, conditions, and penalties.

The United States was the first country to criminalize international bribery through the enactment of the Foreign Corrupt Practices Act of 1977, and United States leadership was instrumental in the passage of the Organization for Economic Cooperation and Development (OECD) Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. Domestically, the US has addressed corruption with the passage of the Sarbanes-Oxley Act (2002), which includes measures to reform corporate business practices to increase transparency and accountability.

One important aspect of international governance standards is their leveling effect between and among nations. Domestic anti-corruption efforts are important, but only go partway towards good governance. International standards offer further insurance by streamlining market choices in an economy with imperfect information. As markets and nations become increasingly interconnected, corruption across borders becomes just as important as corruption within a country or institution. Seeing the need to manage this interconnectedness in a way that reduces the likelihood of corrupt practice, organizations like the United Nations, the OECD, the Council of Europe, and the European Commission have each established guidelines on corruption and corporate governance. Additionally, the United States, Great Britain, the Netherlands, Japan, and other nations have adopted legislation criminalizing the bribery of foreign public officials. International financial institutions such as the World Bank and International Monetary Fund further reinforce international standards by making bailouts contingent on countries' adoption of governance reforms, including policies to reduce corruption.

Despite the promise of well-publicized international and national documents on governance standards, doubts remain as to the efficacy of these attempts at reform. Some scholars compare the current wave of anti-corruption efforts with earlier reformist trends, which often met with little success. Other critiques cite the misplaced tendency toward "one size fits all" models of governance reform among international policy documents, which ignore particularities of individual nations. However, there is reason to believe that current efforts will have a greater impact than previous attempts, as more attention is dedicated to the subject. Corporate and public governance reforms are increasingly central to development discourse, and are gaining more recognition as critical elements to economic stability.

Sources:

S. Prakash Sethi, *Setting Global Standards: Guidelines for Creating Codes of Conduct in Multinational Corporations*, John Wiley & Sons, Inc, Hoboken, 2003.
OECD, *OECD Principles of Corporate Governance*, Paris, 1999.

Procurement

One of the most important intersections between the public and private sectors is government procurement of privately produced goods and services. Anti-corruption efforts, focusing on improving the efficiency of government purchasing decisions as well as on reducing malfeasance, aim to increase accountability in government spending, transparency in contract awards, and adherence to International Competitive Bidding principles by both private and public parties. Corruption in government procurement exacts costs from taxpayers, either when firms are overpaid, or when services and goods provided are of inferior quality. This corruption also exacts costs from firms and consumers when firms pay bribes to public officials in order to secure a contract.

The principal challenge of procurement reform is to strike a balance between excessively rigid regulations that limit the efficiency by tying officials' hands and permissive structures that may allow for corrupt practices. No matter where a given government agency or body finds this balance, it is clear that in order to streamline government purchases and reduce waste, procurement practices must be transparent and accountable to the public.

Transparent procurement markets help ensure the promotion of information within and among economies. Transparency can empower economies to learn from each other, and can enable industry to decipher procurement markets operating within member economies, ultimately allowing the market to serve the public more efficiently.

Another component to good governance in procurement is accountability in government spending. Adherence to International Competitive Bidding principles, for instance, ensures that governments award public contracts to the best and

most efficient firms, and that firms get the opportunity to enter into open and fair competition for such contracts. Some components to these guidelines and principles are transparency in contract awards, prohibition of pre-bid communication between firms and the government, and publishing procurement opportunities and contact details of contracted firms.

Sources:

APEC Government Procurement Experts Group, "Non-Binding Principles on Government Procurement," 2004.
Susan Rose-Ackerman, *Corruption and Government: Causes, Consequences, and Reform*, Cambridge University Press, New York, 1999.

Public Sector Governance

Public sector governance refers to a broad range of topics, comprising the administration of public institutions, procurement, management of the civil service, and enactment of government policy. Once considered a problem unique to the public-sector, corruption is certainly still most prevalent in government. Of all forms of corruption, it is arguably that found in the public sector that is most costly to society. Corruption in the public sector tends to affect larger and more vulnerable populations – taxpayers, citizens, and government dependents – than does corporate corruption. Governance reform touches public expenditures, tax policy and administration, civil service, decentralization, and publicly owned enterprises.

As development efforts of international financial institutions have demonstrated, good policies are necessary but insufficient steps towards economic stability. A functioning and dependable infrastructure is an equally crucial ingredient to development. Breakdowns in government infrastructure contribute to underdevelopment, obscure progress, and encourage rent-seeking behavior. Well-crafted policy that is fraudulently enacted not only fails to serve the interests of the public, corrupt enforcement also hinders evidence-based debate on the value of development programs and initiatives by distorting that policy's observed effects.

Government corruption impedes economic growth, distorts incentives, and cheats taxpayers by misdirecting public funds. A well-functioning public sector, however, can help a market, economy, or nation take advantage of globalization. The World Bank acknowledges the need to address "dysfunctional public institutions that limit accountability, set perverse rules of the game, and are incapable of sustaining development," and considers public institutional reform the single greatest obstacle to development. With this in mind, the Hills Program seeks to improve understanding and dialogue among public officials, private entrepreneurs and corporate managers, academics, and others with a stake in development related to the public sector.

Issues of public governance have not yet received sufficient attention, due in part to a widely held perception that governance issues were not quantifiable, and could not be examined in the same way as other macroeconomic data. In recent governance discourse, however, it has been convincingly argued that governance can be measured, monitored, and rigorously analyzed. This new perspective is helpful to governments, academics, and citizens alike, as it permits real analysis of a large and critical problem.

Public expenditure is one area in which corruption and reform can be measured. Transparency and accountability in budget management are necessary for effective checks on government spending, as are independent audits of government budgets. The same is true of tax administration and procurement. Reforms in these areas include electronic or e-government, which consists of digitizing government services and documents, and can help governments publicize important information. Another broad component to public sector reform is decentralization of government institutions, which can increase accountability by clearing up opaque bureaucracies while improving state agencies' responsiveness to citizen needs. However, decentralization may also provide greater opportunities for corruption, as there are fewer safeguards

against the manipulation of and by local officials. All of the above point to the complex and multifaceted challenge of public sector governance, which requires multiple, dynamic solutions depending on local circumstances.

Sources:

Susan Rose-Ackerman, *Corruption and Government: Causes, Consequences, and Reform*, Cambridge University Press, New York, 1999.

The World Bank, "Public Sector Governance" [Electronic bulletin board (cited 24 June 2004)]; Available from <http://www1.worldbank.org/publicsector/>.