

Building Integrity and Reducing Corruption in Defence

A Compendium of Best Practices Volume II

The Donor's Dilemma: Corruption, Institutions and Aid



Building Integrity Compendium of Best Practices

Introduction

Building Integrity (BI) has made great strides since the publication of “Building Integrity and Reducing Corruption in Defence Compendium, A Compendium of Best Practice” in 2010. The crucial role of good governance in the defence and security sector is much more widely understood and over 30 NATO Allies and partners are making use of BI tools and mechanisms to mitigate the impact of corruption; and improve the transparency, accountability and integrity of their defence and security sectors.

At the Warsaw Summit 9 June 2016, Heads of State and Government of the NATO Alliance endorsed the NATO BI Policy, recognising that “corruption and poor governance are security challenges that undermine democracy, the rule of law and economic development and erode public trust in defence institutions and have a negative impact on operational effectiveness.” This represents a significant step forward in the development of BI and follows the approval of the BI Education and Training Plan in 2013.

The BI Compendium Volume I, focused on analysing corruption risks and improving good governance. This article, the first in a series which will eventually comprise the BI Compendium of Best Practice Volume II, aims to present the experience of Allies and partners in strengthening their national institutions and improving operational effectiveness. This includes lessons learned and good practice discovered through the BI Self- Assessment and Peer Review Process. Volume II will address concrete issues and nations’ experiences in confronting these issues. The series of booklets to be published will over time become a ‘library of best practice’ for BI.

This booklet, written by Dr. Andrew Wallen and entitled *The Donor’s Dilemma: Corruption, Institutions and Aid*, presents the author’s practical lessons from his service in Afghanistan in the Strategy Cell of the Combined Interagency Task Force – Afghanistan¹. Future booklets are planned to cover the experience of partners in implementing BI in their own defence establishments and case studies of other operational environments. We hope that BI practitioners will find these a valuable addition to their toolkit² in their work on good governance.

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¹ The views expressed in this article are solely those of the author.

THE DONOR'S DILEMMA: CORRUPTION, INSTITUTIONS AND AID

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*“Corruption is the existential, strategic threat to Afghanistan.”
General (Retired) John R Allen*

1. BACKGROUND

In early 2013, after more than 18 months of leading the International Security Assistance Force (ISAF) in Afghanistan, General Allen delivered his outgoing brief to President Obama (Joint and Coalition Operational Analysis, 2014). He chose to highlight the dramatic risk corruption played in the long-term security of Afghanistan, one of the most corrupt nations in the world (Transparency International 2016).

1.1 The Scale of Corruption

This pervasive corruption has damaged trust between the political elite³ and the population, drained resources from which to build infrastructure and security, and impeded development. In the 19th wave (March 2013) of the Afghan Nationwide Quarterly Assessment Research (ANQAR) survey, 85% of Afghans believed corruption in government was a serious problem and 78% of Afghans believed corruption in Government affected their daily lives. This sentiment was fueled by actions such as Afghan National Security Force leaders setting up ghost employees on the payrolls so they could collect additional paychecks, resulting in fewer security forces to protect cities, countryside and trade routes (HASC No. 112-151 2012). Perhaps the most dramatic example of Afghan corruption was the Kabul Bank crisis that dealt a devastating blow to the growth of formal Afghan credit markets, leaving entrepreneurs with fewer options to fund wealth-producing ideas.

Furthermore, corruption contributed to seemingly paradoxical situations in Afghanistan. In a country with a desperate need for electrical power, people building power lines were attacked. In a country where all would benefit from an improved transportation infrastructure, road workers were killed. In a country where access to food is an abiding concern, a notable portion of the melon crop did not get to market.

³ The political elite are the small group of people who hold a disproportionate amount of political power. In Afghanistan the political elite maintained strong patronage networks that had some basis in ethnic and tribal identity.

The international community reacted to corruption in a way that puzzled many. Donor nations⁴ continued to provide funding to Afghanistan and attempted to deliver more of the funding through official government channels (“on-budget”) while simultaneously condemning the Afghan political elite for its corrupt practices.

1.2 An Economic Framework for Corruption – Incentives

Authors writing within the New Institutional Economics⁵ tradition have made compelling arguments that the nature of a nation’s institutions is the underlying cause of economic success or failure. Drawing upon this theme, this essay offers insight into two issues affecting sustainable economic security in Afghanistan: (1) the relationship between donor nations and the political elite, and (2) the challenge of reforming corrupt institutions.

A primary assertion of this essay is that an intentional and stable relationship exists between donor nations and a recipient nation with a corrupt elite that uses a considerable portion of the donations for personal gain. As noted above, this paradox was sparked by observations in Afghanistan that were puzzling for many serving military members in the ISAF coalition. The repeated question asked therefore is: why have donor nations continued to donate to Afghanistan when they know the political elite is extracting a significant share of this funding through corrupt practices? The key insight is that donor countries receive a benefit from donating that exceeds the cost of the donation. As with free market transactions (where buyer and seller engage in trade because both parties believe they will benefit from the transaction) here the corrupt political elite and the donating nation both believe they will benefit from their interaction. Therefore, even though engaging with (and donating to) the corrupt political elite may be distasteful, it may still be preferable to the next best alternative. This less than desirable choice decision echoes Otto Von Bismarck’s famous aphorism, “politics is the art of the possible.”

1.3 Formal and Informal Institutions

A secondary and related assertion of this essay is that *formal* institutions⁶ cannot be separated from the political elite that controls these *formal* institutions. As a result, externally imposed initiatives to reform

⁴ Nations that were providing funding to support Afghanistan.

⁵ A recent book by Darren Acemoglu and James Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty* (2012) continues in the line of Oliver Williamson, Douglas North and others by asserting the primacy of inclusive institutions in combating corruption and promoting the necessary conditions for achieving the economic success of a state.

⁶ This essay uses North’s framework when defining institutions. North describes two structural frameworks that we refer to as types of institutions: “informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)” (North 1991). For this essay, informal constraints will be referred to as informal institutions and formal rules will be referred to as formal institutions.

such *formal* institutions will be limited in their ability to deter corruption, given the influence and momentum of existing *informal* institutions and, more simply, by the benefit that the political elite itself extracts from the institutional reform.

In Afghanistan, the international community imposed changes to formal institutions on the political elite through a change in the law or a decree. These externally imposed changes were only executed as the international community intended when they were compatible with existing informal institutions or when the political elite found benefit to enacting the change. Otherwise, the law/decreed constituted mere words, or worse, the changes were manipulated to benefit the political elite at the expense of other groups in society. The Kabul Bank crisis illustrates the significance of the political elite and the role of informal institutions when trying to enact substantive reform of formal institutions.

2. THE CORRUPTION GAME

What is the relationship between the political elite of a nation and donors to that nation? What are the conditions that lead donors to maintain funding to a nation while the political elite continues to be corrupt?

2.1 Corruption and the Nash Equilibrium

Economists employ a game-theoretic methodology to answer these questions drawing upon the seminal contributions of the Nobel Prize Winner in Economics, John Forbes Nash⁷. If the relevant conditions hold, a Nash Equilibrium can be said to exist whereby the donor will continue to give and the political elite will remain corrupt.

This essay provides an analytical framework for explaining this paradox, recognising the rhetoric used by donors in condemning corruption. Donors publicly denounce corruption when they donate to a nation knowing that some portion (and possibly a significant portion) of their donations will end up enriching the political elite instead of fulfilling the stated objectives of the funding.

The resolution of this paradox through the application of the Nash Equilibrium strategies will be undertaken in two stages. Firstly, the incentives facing the political elite are evaluated. Secondly, the incentives facing the donor community are assessed.

⁷ John Forbes Nash (1928-2015) was a celebrated American mathematician who was awarded a Nobel Prize in Economics in 1994 for the development of ideas in Game Theory (including the Nash Equilibrium) that have created many important insights concerning strategic behaviour and bargaining.

2.2 Incentives from Corruption for the Political Elite

The political elite has the opportunity to benefit not only from its government salary, but also from the portion of Gross Domestic Product (GDP) and donor aid (Aid) it can appropriate for its own personal gain. Of course, the political elite may also value non-financial variables such as stability, welfare and well-being of the population, and achievement of ideological, religious, or other goals.

Initially, let us assume that the political elite is solely motivated by financial gain and not ethical considerations, per se. In this case, a member of the political elite will choose to be corrupt when the financial gains from corruption exceed the financial gains from not being corrupt. An individual who is not corrupt will only receive a government salary. Conversely, a corrupt individual will receive a government salary plus the portion of GDP and Aid that he/she can extract through corruption.

Obviously, in any given year, the financial gain from being corrupt (salary plus portion of GDP and Aid) exceeds the gain from not being corrupt (salary only). Therefore, we can state that a member of the political elite will only be honest if the benefits of not being corrupt during his/her length of time in office are greater than the benefits extracted from the period in office with corrupt behaviour.

Unfortunately, and inevitably, the effect of being corrupt on longevity in power is ambiguous. It is possible that the political elite's corrupt practices will foment anger against the political elite and hasten its removal from power. However, it can also be argued that longevity in power increases due to the repressive environment developed through the corrupt behavior of the political elite (Darden 2003). In addition, funding gained from corruption could be used to finance the mechanisms needed to retain power. If being corrupt either increases longevity in office or has no effect, then there is no financial incentive for the political leader to be honest.

Proposition 1: In the absence or marginal significance of non-financial variables, financial incentives strongly favour the political elite making corrupt decisions.

As described below, academic studies broadly support the argument that financial incentives significantly favour the political elite making corrupt decisions. Therefore, the political elite must properly value non-financial variables if the corrupt use of donor funding is to be constrained and state corruption is to be reduced.

The proposition that the financial incentive for corruption strongly outweighs the incentive for honesty may seem self-evident. People respond to incentives and corruption income is generally higher than income from a government salary alone.

2.2.1 Corruption and the Case of Singapore

A sometimes quoted counter-example is that of the Singaporean bureaucracy where government employees are paid high salaries as an anti-corruption mechanism. Even so, this mechanism was not available to the Singaporeans when the Prevention of Corruption Act was enacted in 1960 due to the relatively low GDP per capita (Quah 1999). Consequently, the Singaporeans did not enact higher wages as an anti-corruption measure until much later when Singapore's GDP per capita had increased significantly.

Similarly, due to limited economic capacity, developing nations like Afghanistan (with a population of over 30 million that is some six times greater than Singapore) are restrained in their ability to enact government wage levels that would effectively eliminate corruption. The level of corruption in the Kabul Bank scandal (to be discussed in a later section) amounted to approximately five percent of GDP (valued at some US\$ 16 billion by the World Bank⁸ when the corruption was becoming public in 2010/2011), which suggests that government salaries would have to rise significantly to be a deterrent to corruption.

2.2.2 Corruption Gains from Aid

The gains from corruption, reinforced by the inflow of donor aid, exacerbate the inability of a government salary to compete with corruption income (this is particularly the case if donor aid is not being used to supplement government salaries). In these circumstances, the regular and predictable flow of aid can act as a catalyst to corruption, with the difference between government salaries and corruption gains exaggerated by the aid. This perverse incentive should not necessarily be viewed as an argument against aid, but it is critical that policy makers of a donor nation should understand and take this behaviour into account.

2.2.3 The Income Maximization and Income Satisficing Frameworks

The above discussion (particularly the simplifying assumption of solely being motivated by financial gain) infers that the political elite has an income maximizing perspective (engaging in actions that will result in the maximum income regardless of the corruption involved). The *income-maximizing framework* suggests that government wages would have to be increased to the point where they would exceed expected corruption income (a dramatic increase). However, an alternative framework is that of *income satisficing, or fair wage*. The fair wage framework assumes that government employees have a utility function that includes a preference for "fairness". The preference for fairness dominates the preference for income once the government employee's wage reaches a "fair" level or threshold. Under this framework, corruption could be eliminated at lower government wage levels if those wages were perceived by the

⁸ World Bank, October 2012 Afghanistan Economic Update.

political elite as “fair”. However, if corruption is not reduced at higher government wage levels, it can be concluded that corruption income eclipses government wages by such a margin that even large increases in wages are not a deterrent to corruption.

Similarly, if an increase in government wages is predicted to reduce corruption, but the required increase is many times what would be considered a fair wage for a bureaucrat (e.g., the average manufacturing wage), then the financial incentives would still strongly favour corruption. If, on the other hand, an increase in government wages to a fair wages level is expected to arrest corruption, then financial incentives will not support corruption.

2.2.4 The Balance of Evidence

Outside the Singapore experience, the literature (as described below) broadly seems to range between concluding that wages cannot increase enough to deter corruption and alternatively that increased wages would have to be many times that of a fair wage in order to eliminate corruption. Ni and Van (2006) using data from the Ming and Qing dynasties of China find a condition where “no fiscally feasible increase [in government salaries] could restore honest behavior.”

“Our model estimates corrupt income to be 14 to 22 times official income circa 1873 resulting in about 22% of agricultural output accruing to 0.4% of the population. By the time the Qing government attempted to curb corruption by raising salaries, rent-seeking income was so high and corruption so entrenched that a threefold increase in salary could not – and as we will show, no fiscally feasible increase could – restore honest behavior.”
(Ni and Van 2006)

In a similar vein, Treisman (2000) and Panizza (2001) do not find evidence that higher wages are associated with reduced corruption. Other empirical studies such as Rijkceghem and Weder (2001) indicate that while wage increases lower corruption, the required increase in relative wage compared to manufacturing wages would have to be exceptionally high to eliminate corruption. Le, Haan and Dietzenbacher in “Do Higher Government Wages Reduce Corruption? Evidence Based on a Novel Dataset” (2013), find a stronger relationship between increased wage and reduced corruption for lower wage countries, however; the wage increase required to lower corruption is still quite high.

2.2.5 Tentative Conclusions from the Literature Review

The weight of the literature indicates that financial incentives do indeed strongly favor corruption. Also, as noted by (Marjit and Shi, 1998), and (Chang and Lai, 2002; Qijun and Kahana, 2010), in societies where

corruption is endemic, officials may be more successful in using their influence to avoid detection and punishment. This outcome implies corrupt institutions that are robust and self-sustaining. The Kabul Bank case illustrated below indicates that Afghanistan fits this description. Under these circumstances, raising government wages will be even less effective in providing a financial deterrent to corruption.

2.2.6 Severe Financial Incentives for Corruption -- An Anecdote from the Political Elite

Corruption within the political elite can be particularly severe. In 2004, Transparency International published a report containing a list of 10 well-known corrupt political leaders and an estimated range of funds they embezzled as a result of their corruption. The leader with *the lowest annualized corruption income of those on the list* was President Joseph Estrada of the Philippines (1998 -2001). His estimated annualized corruption income was US\$ 19.5 million, compared to an annual salary of approximately US\$ 16,000⁹ per year.

This extraordinary disparity demonstrates that even if President Estrada had embraced honesty and remained in office for the remainder of his life, the discrepancy in incomes is so large that he would not have been able to live long enough to make honesty pay! While this is only an anecdote, it illustrates the powerful financial incentive for the political leadership to make corrupt decisions. Therefore, in developing an effective anti-corruption regime it is critical to pay careful attention to the incentives and disincentives for corrupt behaviour.

2.3 Incentives facing the donors and the corruption/donate equilibrium

From a financial perspective, the weight of incentives appears to strongly favour corruption for political leaders, but this tendency by itself does not guarantee a stable equilibrium where the political elite continues to be corrupt and donors continue to deliver state aid. In order to arrive at this stable equilibrium, the donor community would have to provide support either through ignorance (or neglect) of state corruption or after corruption has been discovered. This begs the question: if donors know that the political elite is stealing some portion of their donation, why do they continue to give?

2.3.1 Motivations of Donors

⁹ The President's Base Salary, Cash Gift and End of Year Bonus were included in the annual government salary calculation (Philippine Salary Schedule Year 2000 - M00-042_NBC468, Year End Bonus-BC-2010-1). Other perquisites of the office (e.g., transportation, housing in the Presidential Mansion, etc.) were not included in the calculation.

Proposition 2: Regardless of political elite corruption, donors will continue providing aid to the country (and political elite) so long as the perceived value of the benefit to the donor generated from the aid exceeds the value of the aid donated.

Proposition 2 recognises that aid donations are effectively market transactions. While the public (government) sector might be thought of as distinct from the market, the market paradigm sheds light on the motivations of donors. In market transactions, both parties receive something of value. That does not necessarily mean the donors will receive something of material value, but instead that progress will be made toward the desired policy goals they are advocating. As noted by Alesina and Dollar (2000) "the direction of foreign aid is dictated as much by political and strategic considerations as by the economic needs and policy performance of the recipients". Therefore it can be argued that the donor is simply using the instrument of state aid to purchase policy results from the political elite that requires some degree of state stability in order for the agreement to hold. Since these policy results require a stable government that can negotiate and execute agreements, the aid used to purchase the policy results commonly aligns with some form of state building.

2.3.2 Purchasing Policy Results

These purchased policy results can include, but are not limited to: favourable trade status, greater welfare for the citizens of either nation, peaceful relations with other countries, and the exercise of influence and control over citizens who are resistant to, or oppose, the donor's interests. The policy results desired by the donor nation are implemented through the leverage of donor aid. In the absence of such aid, the political elite would not deliver the desired policy results. As a result, the donor extracts some political and strategic benefits from the political elite in response to the provision of aid.

2.3.3 The Strategic and Political Incentives of Donor Nations

A donor nation typically does not donate for the purpose of combatting corruption. There are other policy objectives where they have a direct interest in the impact of state aid. If we assume that the calculation of net benefits to the donor does not factor in corruption, then the donor nation will donate as long as benefit value exceeds the value of the aid funding, irrespective of the level of corruption.

This is exemplified by the funding of coalition nations in support of Afghanistan during the rampant corruption that existed through the Karzai administration. The Afghan government opposed the Taliban, Al Qaida and other organizations hostile to the ISAF coalition and permitted coalition forces to operate within its borders. As a result, the Taliban and Al Qaida were restricted in the territory within Afghanistan

that could serve as a base from which to launch attacks against the West and they were forced to expend resources reacting to attacks from the Afghan government and coalition forces.

Therefore, it can be argued that in return for state aid, the coalition nations received support from the political elite in the fight against the Taliban, Al Qaida and other hostile organizations. While many of the political elite opposed the Taliban and Al Qaida prior to receiving coalition aid, the provision of this aid expanded the reach and ability of the Afghan political elite to oppose the Taliban and Al Qaida¹⁰.

2.3.4 Why do donors offer state aid to countries with corruption?

Optimistic donors may be prepared to provide state aid to countries where corruption persists in the expectation that some part of the aid will be directed to reducing corruption. Clearly, if the identified level of existing corruption is too high, donor aid contributions will be substantially reduced or curtailed. However, if donors believe that some effort will be made by the political elite to reduce corruption they will be prepared to tolerate a certain level of corruption. The amount of effort and finance invested by the donor in combatting corruption depends on how successful the donor believes such efforts will be relative to the cost. The experience of international aid donated to Afghanistan following the United Nations Security Council Mandate (Resolution 1386) for the International Security Assistance Force in December 2001 has demonstrated the challenges of sustaining goals and contributions during the past fifteen years. In spite of the enduring insecurity in Afghanistan, donor nations have sustained their engagement in counter corruption efforts while continuing to donate state aid in large amounts¹¹

2.3.5 The Donor-Corruption Nexus: Negative Externalities

If the relationship between the political elite and the donor reasonably approximates a market, then the political elite would provide strategic-political concessions in return for donor aid up to the point where

¹⁰ However, as noted by Mary Beth Goodman and Trevor Sutton in "Tackling Corruption in Afghanistan: It's Now or Never" (Center for American Progress, (March 17, 2015) *"the spread of corruption has not been confined to Afghanistan's political upper echelon; it has pervaded virtually every aspect of government operations and the daily existence of citizens. According to the 2012 U.N. survey, approximately half of Afghans reported having paid a bribe to a teacher. Similar numbers of Afghans reported paying bribes to customs officials, judges, and prosecutors, and slightly less than half of survey respondents reported paying off land registry officials and provincial officers. Entire government institutions have become enmeshed in complex patronage networks that stretch from minor functionaries to high-ranking ministers. Nowhere has this been more evident than in the realm of customs and border control"*

¹¹ As part of the Tokyo Mutual Accountability Framework (adopted 8 July 2012) "the International Community committed to providing over US\$ 16 billion through 2015, and sustaining support, through 2017, at or near levels of the past decade." The Tokyo Framework only accounted for economic development aid. Security Aid was greater than \$US 4 billion in 2013.

the marginal benefit from the aid equals the marginal cost of providing the strategic-political concessions. From this perspective, corruption from the political elite may actually increase the provision of aid.

The political elite may solicit the provision of additional aid knowing that some percentage of the aid will be channeled to them even if the required strategic-political concession is at the expense of the population and would have been rejected by the population. Similarly, donor nations may increase their aid levels with the expectation of extracting more political concessions as advertised by the political elite. As a result, regardless of the level of corruption, donor nations will give as long as the perceived gain from donating exceeds the perceived gain from allocating the same amount of funding on other priorities (the opportunity cost of state aid).

2.3.6. Mutual Gains to the Donor Nations and the Corrupted Political Elite

Interestingly, both the donor and the corrupt political elite are better off after the “market transaction” (trading political accommodation for aid) if their expectations are realized. This is because they will only “transact” political accommodation for aid when both parties expect to be better off after the “trade” agreement compared to the *status quo ante*.

While the strengthening of anti-corruption is commonly not the primary goal of state aid, donor nations cannot be indifferent to its success. Nations strongly prefer their scarce aid resources to be used to achieve their strategic and political goals rather than be siphoned away to fatten the purse of the political elite. One proposed remedy has been the reform of formal institutions in the donor recipient state in order to increase the checks and balances that will prevent the political elite from being corrupt. While such formal institutional safeguards may be helpful in some cases, the Kabul Bank story suggests that formal institutional safeguards alone are insufficient to reform corrupt institutions.

3. THE KABUL BANK CASE AND THE CHALLENGES OF REFORMING FORMAL INSTITUTIONS

Sound banks and stable financial institutions are critical to economic development in fragile states such as Afghanistan. They provide a mechanism facilitating those with financial assets to make deposits that can be lent to people with wealth producing ideas. Unfortunately, in Afghanistan in 2010 this mechanism was grossly manipulated with the Kabul Bank receiving financial deposits but failing to provide value in return. Funds lost to corruption from the Kabul Bank debacle amount to approximately five percent of Afghanistan's gross domestic product, a dramatically large sum¹² (MEC 2012). While the indirect effects have not been fully measured, it was undoubtedly the case that the loss of confidence both nationally and internationally from this corruption scandal has been severe¹³. An excellent reference for the Kabul Bank Crisis is the "Report of the Public Inquiry into the Kabul Bank Crisis" by the Independent Joint Anti-Corruption Monitoring and Evaluation Committee (MEC)¹⁴. The Report demonstrates the difficulty of reforming formal institutions, as part of the effort to combat corruption, when the political elite resists such reforms.

3.1 Establishment of Formal Institutions

Shortly after the 2001 invasion of Afghanistan, the international community worked with Afghan authorities to build a strong, credible set of formal institutions for the banking system. According to the MEC Report (2012), the International Monetary Fund began working with Afghan authorities in 2001 to strengthen the Afghan banking system, and by 2003 strong banking laws "based on international best practices" were enacted (MEC 2012).

The Afghan Central Bank (Da Afghanistan Bank (DAB)) was a relatively new banking system with inexperienced staff that had limited capability to perform oversight tasks. The international community recognized this deficiency and in 2005 the United States Agency for International Development (USAID) provided assistance to DAB using two competent and credible implementing partners, BearingPoint and later Deloitte (MEC 2012). The assistance was designed to expand and mature DAB's capability to ensure that the 18 banks in Afghanistan would adhere to these new formal institutional constraints (e.g., banking laws and regulations).

At this point it appeared that formal institutions were on a solid footing. Afghanistan had an excellent legal framework that incorporated best practices, and world-class firms were in place to provide guidance, assistance, and training. However, as described below, even though there were excellent formal

¹² The 2012 MEC report noted that corrupt transactions amounted to US\$ 861 million. The *New Yorker* also reported that multi-million dollar bribes had been paid to current and former senior members of the Afghan government to disregard the *de facto* theft of the loans given to Kabul Bank shareholders and executives.

¹³ As noted by a former World Bank Head of Mission in Afghanistan during a presentation at NATO HQ, the Kabul Bank Scandal was the largest bank corruption in history.

¹⁴ November 15th 2012

institutional reforms, the informal institutions and the political elite still significantly undermined the desired effect of the reforms.

3.2 Signs of Trouble

On 16 March 2011, the USAID Office of the Inspector General issued a review of USAID's Afghan bank supervision assistance with respect to the Kabul Bank crisis. The following two anecdotes from the report provide a glimpse into the audaciously corrupt environment. The formal institutional reforms posed little, if any, constraint on the activities of the political elite.

“In November 2008, one BearingPoint adviser received two death threats, apparently in conjunction with an onsite examination of Kabul Bank and another bank. With USAID's concurrence, BearingPoint discontinued participation in onsite bank examinations, and limited its technical assistance to classroom training, coaching, and reviewing information obtained by bank examiners.” *(USAID-OIG 2011)*

While accepting the general violence of Afghanistan, the intimidation of the examiners indicated that Kabul Bank's practices were, in all likelihood, contrary to the institutional reforms of the banking industry. Understandably, but with regrettable results, the protection and safety of the examiners was given the highest priority and the corrupt practices within the Kabul Bank flourished with grossly inadequate and negligent oversight.

“From May through July 2009, BearingPoint advisers encountered indications of interference in financial supervision functions. During a training course on enforcement actions, the advisers came to sense that there was something different about Kabul Bank. For example, the DAB examiners looked incredulous when the adviser suggested that DAB had the power to remove bank management. The adviser probed the views of the examiners by asking, ‘You do not think DAB can remove the chief executive officer of Kabul Bank?’ The response from the examiners was, ‘He can remove us’ *(USAID-OIG 2011)*

This excerpt of the report reveals that the bank officials were intimidated from performing their duties by the influence of the political elite. Instead of the formal institutional reforms being used to instill sound banking practices, those who enforced the institutional reforms were at risk of retribution from the political elite.

3.3 The Family Involvement

In February 2010, the *Washington Post* published an article that sent shockwaves through the Kabul community. Among the individuals included in the *Washington Post's* revelations of illicit activity with the Kabul Bank were President Karzai's brother, his former vice president, his cousin and the then current First Vice President Fahim's brother (Higgins 2010). The MEC Report (2012) notes that immediately following the release of the *Washington Post* article, the Governor of DAB, together with the IMF, decided that a forensic audit of the Kabul Bank, with technical assistance from the United States Treasury (UST), was needed.

3.4 The Logic of Cooperating with a Corrupt Government

Remarkably, the UST was reluctant to provide assistance without some assurance that the President of Afghanistan agreed to the forensic audit (MEC 2012). This is an interesting insight into how the international community (in this case United States Treasury personnel) viewed their options in confronting corruption. Essentially, even though the Afghan President's family was involved in the scandal, the UST chose channels controlled by the political elite as the mechanism by which it would provide assistance. This was the case even after the first line of institutional defence, banking laws, failed.

The international community worked with the government they knew to be corrupt instead of either replacing the political elite or trying to prosecute the theft independently. *Their decision was likely made with the understanding that replacing or prosecuting the political elite had consequences for both the stability of Afghanistan and the level of violence experienced by international actors in Afghanistan.*

The MEC Report (2012) revealed that in May 2010, President Karzai provisionally gave his consent to the forensic audit while separately in July 2010, the Chairman of the Kabul Bank, Sherkhan Farnood, exposed the Kabul Bank fraud to two American law enforcement agents because he was losing a struggle for control over the bank with Khalilullah Frozi (the Bank's Chief Executive Officer and Mr. Farnood's former bodyguard) (MEC 2012).

Ultimately, it was discovered that corrupt transactions included "*\$861 million, ... extended to 19 related individuals and businesses ultimately benefiting 12 individuals, with the remaining \$74 million being extended to legitimate customers*" (MEC 2012).

4. THE AFTERMATH: THE MANIPULATION OF FORMAL INSTITUTIONAL ARRANGEMENT

After the corruption was exposed, the political elite continued to use all mechanisms at its disposal to maintain its position of power. Remarkably, as described below, the elite defended the corrupt activities using formal institutional mechanisms intended to prevent corruption!

4.1 The Pressure for the Forensic Audit

The forensic audit was needed to obtain a full accounting of the funds, both for recovery efforts and also to build a stronger case against those who committed fraud. Afghan President Karzai initially resisted the forensic audit, but relented in April 2011 due to the decline in donor aid as the International Monetary Fund refused to renew the Extended Credit Facility Program until he agreed to the audit (MEC 2012).

4.2 The Surprising Consequence of the Kabul Bank Crisis

Now that the Kabul Bank crisis had exposed extensive corruption in the Afghan political elite, one might expect that aid funding interfacing with Afghan government would decrease. Interestingly, on-budget donor aid¹⁵ for the Afghan government continued to increase following the revelation of political elite involvement in the Kabul Bank. That being said, the donors did add control mechanisms in an attempt to mitigate further losses in aid funding to the corrupt elite.

The MEC Report (2012) described how President Karzai maintained control over the investigative process by establishing an investigative commission, led by the High Office of Oversight, to review causes of the Kabul Bank crisis. The investigative commission's report did not add credibility to the Afghan Government. As MEC noted, DAB became a focus of President Karzai's investigative commission after the DAB governor named debtors to the Kabul Bank (to include the President's and Vice President's brothers) in front of Parliament.

"The Commission's report contains an unsubstantiated suggestion that managers of Da Afghanistan Bank and Kabul Bank committed theft and may have taken bribes to present incorrect information to the government. The Commission recommended that the Directors of the Da Afghanistan Bank, Kabul Bank, and of foreign audit companies be investigated by the Attorney General's Office." (MEC 2012)

4.3 Accusing the Innocent

15 As part of the 2012 Tokyo Mutual Accountability Framework, the International Community reaffirmed its commitment to channel at least 50 percent of its development assistance through the national budget of the Afghan Government. By the end of 2013, 40-50 percent of donor funds were on-budget compared to only 10 percent in 2010.

From these recommendations, it is evident that the political elite used the investigation to their own advantage by implicating officials in DAB and foreign audit companies. A seemingly good institutional mechanism, investigating corrupt behavior, was itself turned into corrupt behavior by recommending punishment of those who were the whistle blowers against corrupt behavior.

Following the investigation, criminal indictments and convictions were also subject to the corrupting influence of the political elite. The MEC Report (2012) cites political interference as the reason behind the Attorney General's delay between preparing criminal indictments in June of 2011 and issuing those indictments a year later.

4.4 Crimes and Punishment in the Kabul Bank Scandal

As Rosenberg (2013) explained, the international donor community pressured the Afghan government to prosecute the Kabul Bank Chairman (Mr. Farnood) and the CEO (Mr. Frozi). For engineering the theft of a sum equal to approximately 5 percent of Afghanistan's GDP, they each received a sentence of five years in prison and hundreds of millions of dollars in fines. Rosenberg astutely noted that these punishments were less than certain to be executed under the Karzai administration. The fines did not come with confiscation orders and there was no conviction on a charge that would allow for the collection of overseas funds. Additionally, Rosenberg reported that both Mr. Farnood and Mr. Frozi had been under a relaxed house arrest (both had been seen out of their houses around Kabul) and there was no word as to the form of their pending imprisonment. Equally disconcerting, some of the regulators who tried to fix the problems with Kabul Bank were sentenced to between 6 and 30 months (Rosenberg 2013).

4.5 Reassessing the Guilt and Tenuous Hope for Reform

A glimmer of hope arose with new Afghan elections and the subsequent administration of the National Unity Government of Ashraf Ghani and Abdullah Abdullah. President Ghani reopened the investigation of those responsible for the Bank fraud as part of a larger anti-corruption campaign. One positive result has been an increase in Mr. Farnood and Mr. Frozi's prison sentences (to 15 years) (Shalizi and Donati 2014). Unfortunately, the implementation of Mr. Frozi's sentence was still far from satisfactory. "In November 2015, Afghanistan government officials announced a massive real estate deal ... involving 8,800 homes in central Kabul, the agreement had an initial investment of at least US\$95 million" (Transparency International 2016). Unfortunately, the deal was with Mr. Frozi and Mr. Frozi was present (out of prison) for the announcement because he was only serving his sentence at night. In an interview with Deutsche Welle, President Ghani expressed shock that Mr. Frozi was out of prison. He further stated that Mr. Frozi is "back in prison, in solitary confinement and under close attention" (Deutsche Welle 2015).

4.5.2 Tenuous Hope for Reform

The Ghani administration has made some substantive steps toward reform. However, results are tenuous and there remains a grave concern corruption will undermine the legitimacy of the government. Watchdog organizations such as Transparency International have continued to monitor Afghanistan's efforts at corruption reform. With periodic reports and tools such as the Corruption Perception Index and the Government Defence Anti-Corruption Index (GI) we can gain some insight into Afghanistan's current condition.

One area of success was the increased revenue growth for the Afghanistan government in 2015. Government revenue streams are highly susceptible to corruption and an increase in revenue growth in Afghanistan can represent a greater ability to control corruption. The United States Institute of Peace briefly describes key success factors in achieving the revenue growth.

“Some of the key success factors for the revenue growth in 2015 included strong, consistent leadership; high-level political backing; firing corrupt managers; solid processes and competent human capital in the Ministry of Finance; tight monitoring of customs and tax units; and political outreach to justify tax increases and manage political blowback” (Byrd and Payenda 2016).

Another achievement of the new administration is in procurement contracts. According to Transparency International's GI report, “the current government has significantly stepped up oversight over procurement contracts and the development of anti-corruption training for select personnel” (TI Defense and Security 2016). While the increased oversight and training represents progress in the fight against corruption, finance remains critically exposed as a corruption risk in Afghanistan. As a result, financial exposure to corruption within the Afghanistan Defence Establishment still merited the lowest score (F) given in the GI.

The GI report also emphasised that “Commitments by the President to employ merit-based recruitment and the introduction of anti-corruption training are important first steps in addressing integrity challenges” (TI Defense and Security 2016). At this point, the merit based appointments and promotions, while significant, are still not widely enough practised which leaves the Afghan National Defense and Security Forces less able to confront the significant security challenges facing Afghanistan.

4.6 The Failure of Formal Institutions to Reform the Culture of Corruption

The Kabul Bank crisis provides a rich illustration of the failure of formal institutions to reform an existing culture of corruption. Any progress in the Kabul Bank was the direct result of international pressure and was resisted with a large degree of success by the political elite of Afghanistan. Successful and lasting reform will require the acquiescence of Afghan informal institutions and political elite to the implementation of self-correcting mechanisms that do not require intervention from the international community when corruption arises.

5. CONCLUSION

5.1 The Inadequacy of Short-Run Institutional Reform

Government corruption is commonly perceived to be a major impediment to security and economic development in Afghanistan. Unfortunately, in the short-run institutional reform has been less than successful in battling corruption. Instead of compelling the political elite to make fewer corrupt decisions, institutional reforms were frequently no more than words on paper, while at other times they were manipulated to the benefit of the political elite.

5.2 The Pervasiveness of Afghanistan Corruption

This stumbling pace of reform seems to be an all too common reality for Afghanistan. The pervasiveness of corruption in Afghanistan makes reform particularly contentious. There are personnel in all levels of government who have an investment (quite literally a financial investment) in the current corrupt system and reforms to that system will be resisted as a threat to the investment. The problem is analogous to a cancer that has spread throughout the body. Enacting a cure (reform) that is strong enough to kill the cancer (corruption) could also kill the patient (open revolt from the political elite). Unfortunately, the patient cannot live with the cancer either. The extent of corruption undermines the government's legitimacy in the eyes of the people. As such, reformers will need to find a way to incentivise the political elite and their patronage networks to give up their investments.

5.3 The Power of the Political Elite

The Kabul Bank Crisis illustrated the difficulty of battling corruption with formal institutional mechanisms. The lesson from the unsuccessful efforts is not that formal institutions are impotent to constrain behavior. Instead, the basic lesson is that reform of formal institutions (e.g., constitutions, laws, property rights) may be accomplished on documents and in bureaucratic structure, while the intent of the reform is undermined when the political elite is hostile to the change. The deeper insight is that meaningful changes to formal institutions require the support or at least acquiescence of the political elite. This insight is in contrast to reforming formal institutions as a mechanism to compel the political elite into making fewer corrupt decisions.

5.4 The Conundrum for the Donors

Persistently corrupt behavior leaves donors in a difficult situation. The donors may be faced with choosing between their funds being siphoned off to a corrupt political elite, or losing influence to achieve their goals. Even though the donor community to Afghanistan expressed great concern with corruption, they continued to donate and Afghanistan continued to be one of the most corrupt nations on earth. By examining the incentives of the donors and the political elite, this essay provides a set of conditions that explain the equilibrium of donors continuing to give while the political elite remains corrupt.

5.5 Corruption and Incentives

An important lesson from the Afghanistan experience is that in order to influence short-term corruption, donor nations must take into account the incentives of the local political elite. Further, donor nations looking to reduce corruption should consider both financial and non-financial incentives when building a framework by which to deter corruption. This incentive based framework may require a significant

understanding of informal institutions and a personal knowledge of the political elite. The requirement of an incentive based anti-corruption structure is not mutually exclusive to the enactment of formal institutional reforms. However, a donor nation should recognize that the effectiveness of formal institutional reforms would be dependent on understanding and influencing informal institutions and the political elite.

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