Corruption in Public Investment IS THERE A SOLUTION?

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On the occasion of issue of the CPI 2004, Peter Eigen, founder and Chair of the Advisory Council of TI, said that corruption in public investment at a high degree was a huge obstacle to the sustainable development, caused great losses to the budget revenue much needed by both developed and developing countries for their programs to promote education, health care and poverty reduction. According to the TI, corruption is operationally defined as the misuse of entrusted power for private gain. We can generalize the corruption in the public investment in the following formula: Corruption = monopoly plus discretion minus accountability minus transparency. In this article, we try to analyze relations between corruption and public investment in order to prove that increases in public investment and distribution of such investment among too many projects may lead to a higher degree of corruption. To deal with this evil, we think the Government should perfect its policies on the public investment by making it more transparent, responsible and effective.

1. Introduction

Corruption became serious in most industries and fields last year, especially in publicly-invested projects, construction works, and land management. Notable and notorious are cases of Project 112 (computerization of administration), Điện Biên Phủ Victory Monument, PMU18, Quán Nam (Hải Phòng), and land clearance for building of Thanh Trì Bridge (Hà Nội), etc. According to an NA estimate, corruption cost 10.91% of the public investment in capital construction of VND58,125 billion in 2004; 9.5% of the public investment of VND66,800 billion in this field in 2005 and 7.8% of the investment of VND81,145 billion in 2006. According to an NA report, the corruption caused a loss of some VND8,000 billion, equaling over 50% of the budget deficit of VND13,500 billion and 5% of the budget revenue in 2007. There is no surprise when Vietnam ranked 111th among 163 countries in the CPI 2006; and 123rd among 173 ranked countries in 2007 – that is, one of hot spots in the world's corruption map.

2. Relations between corruption and public investment

a. Theorists supporting the public investment:

After the World War 2, many famous economists, such as Harrod, Domar and Rostow agreed that countries had to increase investment in order to stimulate the economic growth, and pointed out physical relations (ratio of capital to output) between investment and growth. In other words, they support and recommend governments increases in the public investment. Estimating allocation of resources to public investment and regular spending, they tend to criticize governments that allow regular spending to increase faster than the public investment, and praise ones that follow the reverse direction.

Generally, this tendency shows itself in the golden principle recommended by its exponents. This principle appreciates borrowings by governments. In their opinion, loans are necessary provided that they are turned into investment. They argue that it's reasonable to get loans to build hospitals instead of paying doctors and nurses or for medicines. This principle has been referred to as a right policy in spite of the fact that regular spending on overheads and maintenance needed for good performance of infrastructure and labor force supports a sustainable development better than increases in the public investment.

b. Complexity of investment projects and corruption:

Applying this theory, many governments of developing countries have promoted the public investment by allowing bigger budget deficits and public debt. To understand how the corruption takes place in publicly-invested projects, we had better examine some complicated aspects of such projects that provide chance for corruption.

Public expenditure on investment undergoes a complicated process of approving that contains various forms of discretion. Public- investment- related decisions usually undergo different stages of policy selection: (1) general structure of national budget; (2) size of total public investment; (3) selection of projects;

and (4) size and design of projects. In making these decisions, some high-ranking officials tend to take part in control and influence remarkably the decision making in stages (3) and (4). This situation can result in: the project is approved when its necessity is not clear; size and installed capacity of the project is not equal to demand; site and timing of the project is not reasonable; and poor quality of construction and equipment make the project short-lived, etc.

In addition, the approval is also achieved by going through various stages. For example, a civil construction work should get approvals for project design; project bidding; supervision of bidding; exchange of contracts after bidding. Writing a bid for a publicly-invested project is very complicated and vulnerable to uncertainty and disagreement. High-ranking officials can affect selection of qualified bids. Blueprint for a project seems to be spared for some companies who usually secure inside information before bidding. After being awarded the contract that promises an enormous profit, privileged companies are ready to pay big commission to some high-ranking officials who helped them win the bid. And such commission can be included in production cost or overheads when making tax declaration. In fact, awarded companies can make up for such commissions by (1) including them to production cost or bids; (2) using materials of poorer quality; (3) raising prices of raw materials; and (4) changing the volume of work done. They even employ fake documents, invoices, and subcontracts to achieve these aims.

Of course, all of these practices are approved and supported by authorized officials. They know how to use their power to ensure that their "friendly" companies are awarded contracts and investment projects are adjusted to directions that are most suitable to their personal interests.

3. Corruption leads to poor quality and performance of the project

In countries with high corruption degrees, expenditure on public investment tend to rise quickly and investment scope is bigger than what is necessary but the quality of the completed projects is poor and cost of maintenance and operation is high. They usually require regular repair and can't operate at full capacity. In other words, the corruption makes performance of investment decrease and the growth rate fall, that is, it distorts normal relation between capital and output.

When the approval of the project is affected by corrupted officials, the profitability of the project based on analyzing cost and efficiency is not considered as a criterion for selecting the project. Expenditure on investment becomes ineffective and produces almost no effects on the economic growth. Contractors are only interested in their profit and corrupted officials in bribes. It's possible to say that the corruption distorts the whole decision making process relating to the public investment and produces projects of poorer quality and performance than expected. In such a situation, there is no wonder if the public investment doesn't produce results expected by plan makers.

Widespread corruption not only reduces the profitability ratio of investments but also affects badly the profitability ratios of existing infrastructure. Explanation of this situation could be as follows:

Firstly, the corruption, to a certain extent, is a recurrent phenomenon and serious damage to existing infrastructure comes from corruption in the past.

Secondly, high public investment reduces existing resources for other expenditures, especially the ones on maintenance and repair needed for ensuring normal operation of the infrastructure.

Thirdly, lack of maintenance and repair make the infrastructure breakdown so quickly that it should be rebuilt, which provides authorized officials more chance to milk contractors.

4. Policy on public investment in Vietnam

Article 8 of the Budget Law establishes the principle of budget balancing that "The national budget is kept in balance according to the principle that revenue from tax, charge and fee should be greater than the regular expenditure and help increase accumulated capital needed for public investment with a view to ensure a balance between expenditure and revenue (...) Securing loans to make up for budget deficit must observe the principle that they should not be used for regular expenditure and only used for development projects with plan to ensure payback and budget balance with a view to repay debt when due." This principle draws a line between public investment and regular expenditure, which reflects a cautious fiscal policy.

The Table 1 shows that in the years 1997 – 2007, growth rate of public investment (15.8%) was greater than that of regular expenditure (14.8%). In addition, the public investment accounted for a big share in the total expenditure (35.1% in 1997-2007) and rose over time, from 34% in 1997-99 to 40.5% in 2002; 37% in

Table 1: Public investment and regular expenditure in the national budget (%)

	'97-'99	2000	2001	2002	2003	2004	2005	2007	Average
Growth rate of regular expenditure	3.75	27.2	9.8	9.3	22.5	15.3	11.2	10.8	14.2
Growth rate of public investment	14	10.9	35.8	12.3	12.8	12.6	12.5	11.2	15.8
Public investment * as % of total expenditure	34	34	37	40.5	37	32	31.5	/	35.1
Public investment as % of GDP	5.9	6.7	8.3	8.4	8.4	8.8	8.2	/	7.54

Source: Authors' calculation using numerical data from Ministry of Finance

* including major repair jobs.

2003. The ratio of public investment to the GDP (7.54%) was greater than the budget deficit (4.57%).

If we take into account the ODA source (not including in the budget balance) and proceeds of government bonds from 1997 to 2007, the public investment amounts to 20% of the GDP. This fact allows us to realize inadequacies in the policy on the public investment and chances for corruption to get widespread in this field.

Firstly, management of public investment fails to establish close relations between medium-term plan for socioeconomic development and resources at the macro-economic level. The budget for this year is based on the one approved in the previous year without reconsider whether a project is worth continuing and supporting or not. As a result, the list of publicly-invested projects becomes longer. According to a report by the Ministry of Finance, the public investment in the first half of 2008 equaled 40% of the gross investment amounting to VND106,100 billion. This situation started in 2006 and the public investment was still paradoxical: it accounts for nearly 50% of the gross investment but most publicly-invested projects are of poor performance. Along with careless investment from the budget is the lack of transparency and accountability. Many expenditures are not made known publicly. There is no relation between managing bodies and users and social participation in the public investment. In the auditing program in 2007, the State Auditing Agency listed 12 common violations in all stages of the public investment field, from zoning, planning, evaluating the projects, making investment decision, examining the designs, paying compensation before land clearance, running the projects and making financial reports. The most serious is violation when making decision on investment project. Investing in wrong projects and making unauthorized investment decisions caused the biggest losses.

Secondly, policy makers only pay attention to new projects and don't care about maintenance and operation of completed projects. Budget for regular expenditure and budget for public investment are made separately with the result that public resources can't be employed effectively. From 1997 to 2006, expenditure on maintenance and operation kept decreasing – from 23.4% to 16% of the total expenditure (see Table 2). And as a result, most major projects didn't reach high performance because of the lack of maintenance. In the irrigation system, some 50% of projects were of poor performance. A recent study affirmed that expenditure on maintenance of the irrigation system could produce better results than investment in new projects.

Similarly, roads and bridges haven't been well maintained and repaired. According to the WB-financed project to upgrade the road network, if current expenditure on maintenance is unchanged in 10 years, some 34% of roads will be ruined and only 10% is usable. The WB estimated that without maintenance

Table 2: Share of expenditure on maintenance and operation in the total expenditure

	1997	1998	1999	2000	2002	2003	2006
Maintenance (VND billion)	16,589	15,678	16,196	23,881	20,906	22,758	50,829
Total expenditure (VND billion)	70,749	73,419	84,817	103,151	119,403	135,490	308,058
Share of maintenance in total expenditure (%)	23.4 %	21.3%	19.1%	23%	17.5%	16.8%	16.5%

Source: Ministry of Finance

the road network represents a loss of some US$160 million a year. From a cost-effective aspect, this situation is ineffective because rebuilding of roads is costlier than maintaining them regularly.

Thirdly, fiscal discipline is not observed in controlling expenditure on capital construction works. Report on public expenditure in 2004 said that loan used as public investment increased remarkably, especially in communications projects. From 1999 to 2004, the national budget covered some 65% of investment in communications; other 35% was approved by the PM but it was not included in the national budget because it was not included in the budgetary plan in the first place.

Public works under the Ministry of Communications are carried out by contractors with an assumption that it can pay the contractors after receiving its approved budget. And as a result, the Ministry owed contractors VND14.4 billion. In 2002 alone, the debt beyond the budget for the Ministry equaled 1.5% of the GDP. The debt is included in the plan for next years and repaid by the national budget. In August 2004 for example, the PM had to supply an additional budget of VND1,762 billion to the Ministry of Communications, and 6,000 billion of which was used for paying contractors. Thus, the Ministry failed to observe the fiscal discipline and ensure transparency in balancing its budget. As a result, the budget deficit publicized every year is not true, and more importantly, repaying such debts becomes a burden on the national budget and a threat to the fiscal sustainability.

5. Some suggestions

(1) Policy makers should estimate exactly the efficiency of publicly-invested projects from then on because the corruption is so widespread. The role of public investment in the economic growth should be reviewed. Overestimating it may lead to the birth of too many ineffective projects and more serious cases of corruption while the private sector with its great potential for capital is not tapped effectively to support the sustainable development.

With increases in the flow of foreign capital and new developments of the private sector last year, the Government has a chance to adjust structure of public investment. It's more reasonable to withdraw the public investment from unnecessary fields and concentrate on key industries where the private sector can't develop. Even infrastructure projects could be assigned to private and foreign companies. This withdrawal may allow the Government to work out a new strategy on investment that supports the economic growth effectively and helps local economy integrate successfully into the world market.

(2) It's necessary to build a mechanism for monitoring and evaluation with a view to encouraging the public to supervise the public investment and provision of public goods by the government, and form an independent commission for evaluation of public investment projects.

(3) Expenditure on new projects should be proportional to that on maintenance and operation of the infrastructure. This is a measure to limit the public investment. To control capital for public investment, the public financial authority should establish a mechanism for control the public expenditure in a medium term in order to enhance the fiscal discipline, prioritize all industries and fields when allocating resources, and suggest measures to allocate and employ public financial resources most effectively in a medium term (from three to five years).

(4) Control over capital used for public investment should be made transparent. Responsibility of controllers and users of public fund must be linked together. In all major projects, cost- effective analyses should be carried out properly and made known to the public, especially the following aspects: intended results of the project, cost in detail of the project, its output and source of finance used for the project ■

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