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WP/00/1

INTERNATIONAL MONETARY FUND

European II Department

Improving Governance and Fighting Corruption in the Baltic and CIS Countries: The Role of the IMF

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January 2000

Abstract

This paper examines the indirect role the IMF plays in combating corruption in the Baltic and CIS countries by promoting structural reforms that help improve economic governance and thus reduce opportunities for rent-seeking behavior. The analysis draws on examples of actual experience with corruption and outlines some of the structural measures under IMF-supported arrangements, which, if successfully implemented, can be expected to help gradually alleviate corruption. It also summarizes IMF-wide initiatives under way to strengthen public sector transparency and accountability, and highlights the key structural areas likely to receive emphasis in the IMF's future policy advice to countries in the region.

JEL Classification Numbers: D72, H10, K42, O17, P51

Keywords: Governance, corruption, transition, Baltic, CIS, IMF

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¹ This paper was prepared for the Second Annual Meeting of the Anti-Corruption Network for Transition Economies, held at the OECD Center for Private Sector Development in Istanbul, Turkey, on November 2-3, 1999; it also appears on the web page of the Network. The authors are grateful to John Odling-Smee, Jorge Márquez-Ruarte, and Oleh Havrylyshyn, as well as to colleagues from the External Relations, Fiscal Affairs, and Policy Development and Review Departments of the IMF for helpful suggestions, and to Anna Unigovskaya for research assistance.

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I. INTRODUCTION AND SUMMARY

Among all the transition economies, perhaps nowhere has the need to improve governance and reduce corruption been more evident than in the fifteen independent states that emerged from the dissolution of the former Soviet Union. These societies, which were under communist rule for up to 70 years, were characterized by a lack of government transparency and rule of law for generations; moreover, severe governance and corruption problems were endemic in most areas of the far-flung Russian empire even before the Bolshevik revolution. Under central planning, the countries in question were influenced both by the economic system in place and by corruption. While the changes introduced after independence focused on correcting the systemic distortions, there was insufficient recognition of the equally compelling need to overcome corruption. This important aspect of the challenges faced by these countries has only gradually begun to receive the attention that it deserves.

This paper examines the indirect role that the IMF plays in combating corruption in the Baltic and CIS countries by promoting structural reforms that help improve economic governance and reduce the opportunities for rent-seeking behavior. Drawing on recent examples of corruption in the region, the paper analyzes the relationship between governance and corruption, and notes that poor governance generally creates opportunities and incentives for corruption. It is pointed out that corruption tends to exacerbate distortions in resource allocation, lead to a relatively skewed distribution of income and wealth, and negatively impact growth and living standards. The discussion focuses on three broad weaknesses in economic governance: i) excessive government intervention in economic activity; ii) lapses in government transparency, accountability, and economic management; and iii) absence of a stable, rule-based, and competitive environment.

The policy content of Fund-supported economic programs in the Baltic and CIS countries during 1992-99 is examined to determine the extent to which weaknesses in economic governance were addressed. It is noted that while the IMF's direct involvement in this area has been limited, and the words "governance" and "corruption" have seldom appeared in the language of IMF-supported economic programs, many of the specific measures which the Fund has urged governments to adopt have essentially tried to address these concerns. Notably beyond the initial years, when reducing the very high rates of inflation received priority, programs in the region have typically included corrective measures in the three areas outlined above, with some shift of emphasis in recent years to the second and third areas. The paper also examines the experiences of selected countries in the region in meeting structural conditionality under recent Fund arrangements, and concludes that, despite considerable progress to date (including through IMF technical assistance), much remains to be accomplished.

In the final section, the paper notes that the IMF will continue its work to help curtail opportunities for corruption in member countries by supporting measures to liberalize the economy, improve the management of public resources, promote accountability, and

establish a transparent and stable regulatory environment. The paper concludes by outlining the key structural areas that are likely to receive emphasis in the Fund's future policy advice in the region, stressing that success in reducing corruption will depend ultimately on the determination with which countries recognize and address this serious problem.

II. THE RELATIONSHIP BETWEEN GOVERNANCE AND CORRUPTION

As commonly used, the term *governance* refers to the manner in which governments discharge their responsibilities; that is, are governments effective, are their operations transparent, are they accountable, and do they conform to internationally accepted good practices?² Thus, governance covers a whole range of government activities, and is a broader concept than *corruption*. *Corruption* may be thought of as *the abuse of authority or trust for private benefit*,³ and is a temptation indulged in not only by public officials but also by those in positions of trust or authority in private enterprises or non-profit organizations. The bulk of this paper focuses on *public* corruption and its deleterious effects.

While *corruption* undoubtedly will always be with us to some extent, regardless of the success in improving governance, it is also clear that poor governance generally creates greater incentives and possibilities for corruption. Hence, while toughening the legal strictures against and punishments for corruption is important, it is essential to tackle the underlying governance problems that may encourage corruption. Indeed, a fundamental assumption underlying Fund conditionality in programs with the Baltic and CIS⁴ countries has been that by seeking to improve governance—particularly in areas of economic policy—the Fund can also contribute to the fight against corruption.

A. Excessive government intervention, regulation, and discretion in the economy

Economic governance may be seen as having three broad dimensions, although there is some overlap among them. First, poor governance is reflected in *excessive government intervention and discretion relating to economic activity, including excessive regulation of private entities and adoption of preferential schemes*. Some specific examples would be foreign exchange and trade restrictions, price controls, directed credits, and tax exemptions. These create incentives for rent-seeking, including temptations for officials to use whatever discretion they have in the administration of state enterprises or the implementation of regulations to elicit bribes or kickbacks from those who would benefit from preferential treatment.

²See Abed (1998) for a more detailed discussion of these issues.

³ Tanzi (1998) provides several definitions of corruption and discusses factors that promote corruption.

⁴ Commonwealth of Independent States

Although most countries in the region have substantially liberalized their economies, the problem of excessive intervention persists, either directly through state ownership, or through excessive regulation of economic activity and preferential schemes, as well as their discretionary application. Recent instances of corruption in CIS countries related to this dimension of governance include: (1) the abuse of tax-free status and preferential trading rights granted to so called “charitable institutions” (e.g., the national sports foundation in one case); (2) the refusal to grant permits to foreign firms to build hotels to protect monopoly interests of local firms, and the delays in completion of foreign-built hotels in the capital cities of more than one CIS country due to the demand by local officials for bribes; (3) the demand by foreign trade officials in one country for bribes for import contract “registration,” charged by the page (very short contracts are simply rejected out of hand); (4) the levy of individualized surcharges on the foreign exchange sold to foreign-owned companies in the context of a tightly controlled exchange market; (5) the creation, in one country, of a state energy company (headed by a close relative of a very senior official) responsible for licensing all oil imports by private companies; and (6) the sale, in another country, of a large public utility at an absurdly low price to an investor with connections to government officials who negotiated the deal.

In other cases, including in the Baltic countries, informally directed credits or government guarantees—at the instigation of government officials—have made possible low-interest bank credits to dubious borrowers. Failures to repay these credits have helped precipitate banking crises. While these cases may or may not have involved corruption per se, they clearly were instances of poor governance which weakened those economies. However, since economic liberalization has progressed quite far in most of the countries in the region, these types of governance problems tend to be less frequently encountered, although the scale of the bribes and rents involved can still be quite considerable.

B. Lack of government transparency and accountability, and poor management

A second dimension of economic governance involves *transparency, accountability, and good economic and financial management by the state in those areas under its direct control*. Hence, it is important in transition economies to maintain arms length relations between the government and the rest of the economy, including privatized enterprises; avoid conflicts of interest on the part of government officials; provide an efficient and well-paid civil service; institute an open budgetary process and strong expenditure controls; establish an efficient tax administration; avoid budgetary arrears; and generally maintain transparent government and central bank operations. Lapses in many of these areas provide a breeding ground for corruption.

Conflict of interest continues to be a major problem in many CIS countries. For example, officials in the customs administration and/or other government organs, in more than one country, engage in smuggling operations to undercut the marketing efforts and profitability of domestically established companies (and in some cases joint ventures) in domestic markets for alcoholic beverages and tobacco products. In one country, all

enterprises in an important industry producing construction materials have nominally been privatized, but the resulting enterprises are all controlled by close relatives of a senior politician and the result, effectively, is a cartel with very strong government support. In another country, a local manufacturer of building materials borrowed heavily from a commercial bank to provide supplies for a project being constructed by a close relative of a senior official. Following delivery, the manufacturer was never paid but was reluctant to press a legal case due to the status of the owner. As a result, the company went bankrupt and the local bank was stuck with a large bad loan.

Uses of the proceeds from humanitarian aid programs also open up lucrative possibilities for corruption. In one recent case in a CIS country, the government bought wheat on the basis of a concessional loan and, in turn, sold it at a price below the import parity price to a well-connected trader, who reaped substantial profits. Another case of poor governance involves the construction in one country of state-owned textile plants at significantly inflated costs, reflecting the absence of transparent procurement criteria. In another case, supposedly higher competing bids for a procurement contract under a World Bank loan program were found out later to have been forged by the authorities.

An underpaid and overstuffed government bureaucracy tends to encourage participation in the above-noted types of corruption, as well as in the more obvious cases of bribery noted in section II.A. An important contribution to reducing conflicts of interest and outright economic crimes by officials would be to promote transparency and accountability through the greater use of independent outside audits of government and financial operations, and the accounts of central banks in these countries (as has recently been the case, for example, in Russia). Achieving greater transparency and accountability in the privatization processes underway would also be essential.

C. Creation of an effective environment for efficient market activities

The third area of economic governance involves the *creation of a stable, rules-based, and competitive environment for the efficient operation of market activities*. This requires a clear commitment by the authorities to the rule of law; enforcement of the sanctity of contracts and of property rights; a strong court system; effective bankruptcy procedures; a stable, fair, and transparent tax system; effective bank supervision; and the strict enforcement of bank prudential regulations. Such an environment will not only help reduce corruption, but also stimulate saving and investment—including foreign direct investment—and thereby help provide the basis for sustainable growth.

Unfortunately, discretionary and unstable legal and regulatory environments probably remain the rule rather than the exception in the CIS region, with adverse consequences for *corporate governance*. For example, in one country the licenses of several foreign-owned financial service companies were recently revoked following the passage of new legislation requiring all such entities to be joint ventures with local partners; this happened despite the fact that an earlier law on the protection of investment had been intended to effectively grandfather all such investments. The dilution of “outsider” shareholdings by the issuance of

additional shares of privatized companies and their assignment to dominant local shareholding groups, often at below fair market value, is a common occurrence in a number of CIS countries. Another common practice, in the context of mass privatization programs, has been to confer special advantages to domestic “investment funds” which are given a first call on shares in privatization at the expense of potential foreign investors. In several countries, lax bank supervision and weak enforcement of prudential regulations have enabled banks to lend primarily to their own shareholders, or to engage in otherwise risky lending, which has significantly weakened the banking system.

III. THE NEGATIVE ECONOMIC EFFECTS OF CORRUPTION

Aside from reducing the moral authority of and confidence in government, and tending to create an environment which is generally disillusioning for productive economic activity, corruption has other, more concrete negative effects on resource allocation, income distribution, and economic growth.

Corruption is likely to *exacerbate distortions in the allocation of resources*, because the officials benefiting from corruption will be less likely to press for the reduction or elimination of regulations or various distortions or exemptions which encourage corruption in the first place. Moreover, a thriving culture of corruption may encourage officials to increase the range of regulations and license procedures, hoping for even more bribes. Corruption may also *exacerbate income inequalities and poverty*, as it may help perpetuate an unequal distribution of wealth and access to education and other means to increase human capital.⁵

There is considerable empirical evidence that corruption has a *negative effect on economic growth*.⁶ Since corruption constitutes a kind of tax on enterprises, it increases costs⁷ and reduces incentives to invest. Pervasive corruption may also encourage many of the more talented individuals in society to engage in rent-seeking rather than productive or innovative activity, with adverse consequences for economic growth.⁸ Corruption, moreover,

⁵ A study by Gupta, Davoodi, and Alonso-Termé (1998) has found a strong correlation between corruption and an increase in income inequality.

⁶See Mauro, for example, (1996) and the references therein.

⁷A survey by a resident representative office of the IMF in a CIS country suggested that “informal payments” to various officials accounted, on average, for almost 40 percent of total enterprise expenses during the first year of operation.

⁸ See also Gray and Kaufman (1998), who refute the argument that corruption and bribery can “lubricate” a rigid administration by illustrating that where corruption is high, firms’ managers spend more time with government bureaucrats, as corruption fuels the growth of excessive and discretionary regulations.

tends to discourage the formation and development of potentially dynamic small- and medium-sized enterprises, since smaller entities frequently do not have the human or monetary resources to deal effectively and persistently with corrupt officials. There is also evidence that corruption tends to shift government spending away from social areas (such as health and education) and from the provision of high quality physical infrastructure towards the construction of unneeded “white elephant” projects or lower quality investments in infrastructure.

As noted in section II, many of the corrupt practices documented in the CIS countries are either specifically aimed at, or at least have the practical effect of discriminating against the foreign business community. This derives essentially from the closer contacts to be expected between government officials and the local business community, but also from the basic lack of transparency involved in most acts of corruption. IMF resident representatives in many of the CIS countries report that, in several instances, corruption has discouraged foreign direct investment and, in some instances, has led erstwhile investors to pull out of a country entirely.

Corruption can also be expected to have a negative effect on domestic savings and investment, and to stimulate capital flight, as it tends to weaken the domestic banking system. Moreover, most savers and investors hesitate to commit to an economic environment in which considerable official discretion and secrecy, together with corruption, create a high degree of uncertainty. This uncertainty will only be compounded by the corrosion of the moral authority of any state which tolerates widespread corruption.

In short, corruption can be considered as one of the most important factors inhibiting investment and growth and thereby lowering living standards in many of the transition economies reviewed. Finally, and as suggested by the example provided in section II, pervasive corruption will likely discourage the effectiveness of aid flows to low income transition countries. This, in turn, could discourage donors from providing more aid, which could also have a negative impact on growth.

IV. ADDRESSING GOVERNANCE AND CORRUPTION ISSUES UNDER IMF ARRANGEMENTS

The IMF provides financial assistance to its member countries under different types of arrangements, varying in duration and the kinds of policy measures that countries are encouraged to adopt. Typically, in supporting member countries’ macroeconomic adjustment and reform programs, IMF advice has focussed on correcting macroeconomic imbalances, reducing inflation, and promoting trade, exchange, and other market reforms in order to achieve financial stability and lasting economic growth. More recently, in growing recognition of the adverse impact of poor governance (and ensuing corruption) on economic efficiency and growth, the IMF has turned its attention to a broader range of institutional reforms and governance issues in the programs that it supports. This shift—which is in line with the increased emphasis on governance issues in member countries—is reflected in the guidelines issued by the IMF’s Executive Board in mid-1997 on *The Role of the IMF in*

Governance Issues. The guidelines seek to enhance the IMF's role in this area, in particular through:

- A more comprehensive treatment, in the context of both Article IV consultations (i.e. the IMF's regular surveillance activities) and IMF-supported programs, of those governance issues within the IMF's mandate and expertise;
- A more proactive approach in advocating policies and the development of institutions and administrative systems that eliminate the opportunity for bribery, corruption, and fraudulent activity in the management of public resources;
- An evenhanded treatment of governance issues in all member countries; and
- Enhanced collaboration with other multilateral institutions, in particular the World Bank, to make better use of complementary areas of expertise.

These principles have also been guiding the IMF's work in the Baltic and CIS countries.⁹ In addition to its surveillance and technical assistance activities, the Fund has entered into financial arrangements with each of these countries (except Turkmenistan). In most countries, this involvement began with the Systemic Transformation Facility—designed specifically to gradually ease transition economies into a heavy reform agenda—followed by Stand-by Arrangements and, more recently, by three-year Extended Arrangements or support under the Enhanced Structural Adjustment Facility (for low income countries). The IMF has tried to promote good governance in these countries primarily by advocating measures to liberalize the economy, improve the management of public resources, and support the development and maintenance of a transparent and stable economic and regulatory environment.

As illustrated in Tables 1 and 2, IMF-supported economic stabilization and reform programs in the Baltic and CIS countries have contained measures in all three of the dimensions of economic governance discussed in section II, namely government regulation of economic activity and preferential schemes; government transparency, accountability, and good economic management; and creation of a stable and rule-based competitive environment for the efficient operation of market activities. The entries in the tables indicate the frequencies with which specific measures in each of these three broad policy areas were included in IMF-supported programs in the region during 1992-99. The data show that all programs contained fairly similar policy actions, although there was a great deal of variation among countries in the sequencing and frequency of measures during the period in question, reflecting differences in initial economic conditions, the political will to reform, external

⁹ The IMF's work in the transition economies of Central and Eastern Europe is not covered here.

factors, etc.¹⁰ Variations over time (before and after 1996) in the types of measures reflect mainly the different stages of transformation, with the policy emphasis shifting from macroeconomic stabilization and liberalization in the initial years to deeper and more diversified structural reforms more recently. Table 3 summarizes this development, with measures in the second and third broad areas of governance (i.e. those related to transparency, accountability, and sound economic management; and to building a stable environment) clearly gaining weight in the more recent period. This shift reflects not only the emphasis in earlier years on liberalizing economic activity and eliminating the initial very high rates of inflation, but also the growing recognition that progress with structural reforms and good governance are essential to sustain the stabilization gains and support the recoveries underway.

To better understand how IMF involvement might have a bearing on governance and corruption, it is useful to take a closer look at some of the economic reform programs in the Baltic and CIS countries. For this purpose, five representative countries were selected and IMF conditionality examined for each in the context of their recent Fund arrangements.¹¹ By way of illustration, Attachments I-III provide information on three of the countries selected.¹² Only those measures that were thought to have an important bearing on governance and corruption were reviewed. It should be noted, however, that program content typically extends far beyond measures captured under IMF conditionality and covers a broad range of other policy actions adopted by governments. However, since the IMF exerts its most visible influence through agreed conditionality—noncompliance with which normally interrupts IMF financing and other linked lending—the discussion here is confined to the experience with conditionality. For the sake of simplicity, the period covered by each Fund arrangement is taken in its entirety, with no attempt made to distinguish between different annual arrangements under multi-year programs, nor between program reviews. For example, the “prior actions” listed lump together those imposed at different points in time, and measures in other categories of conditionality are similarly aggregated over time. The objective is to broadly capture policy conditionality and implementation over the life of the program.

¹⁰ Frequency should be interpreted cautiously. For example, a high figure in a given policy area may indicate the repetition of unimplemented measures in successive programs.

¹¹ IMF programs typically contain the following types of conditionality: *prior actions*, which need to be in place for the program to be approved by the IMF’s Executive Board; *quantitative macroeconomic performance criteria*, which call for compliance with quantitative targets for selected variables on specified dates; and *structural performance criteria or benchmarks*, which specify a timetable for the implementation of structural measures.

¹² To preserve confidentiality, countries are identified by letters rather than by name.

Attachments I-III reveal that, notwithstanding some differences among programs in the rigor with which conditionality was incorporated in similar policy areas (with “prior actions” being the most binding and “structural benchmarks” the least), all programs included measures to:

- *Liberalize the economy.* Measures in this area mostly related to lifting price controls on goods and services; opening up the trade system by phasing out tariffs/taxes and registration requirements on foreign trade; and eliminating exchange controls on current transactions, including through the modification of foreign exchange surrender requirements.
- *Strengthen the budgetary process and the treasury system.* Measures ranged from strengthening revenue collection (including through the removal of tax exemptions) and streamlining government spending (including through the elimination of subsidies), to bringing extra-budgetary government funds on budget and extending treasury coverage.
- *Eliminate wage, pension, and social benefit arrears.* In all the cases reviewed, quantitative performance criteria (i.e. quarterly limits) were imposed on the government’s domestic expenditure arrears, notably in the above categories, to ensure an orderly phasing out of such arrears.¹³
- *Reform the banking system.* Measures focused on establishing central bank independence, introducing a new chart of accounts, adopting effective prudential regulations, and strengthening bank supervision.
- *Privatize, restructure, or liquidate public enterprises.* The IMF sought sustained progress in these areas, with specific intermediate program targets to be met, and advocated the effective implementation of bankruptcy laws where called for.
- *Improve legal, accounting, and statistical frameworks.* Action in this area entailed adopting laws (e.g. banking laws, tax codes, customs codes, laws on natural monopolies, etc.), accounting frameworks, and macroeconomic data compilation and presentation practices that are compatible with international standards.

The final columns in Attachments I-III show the status of implementation of the conditionality on structural reforms under the selected IMF-supported programs. By their very nature, prior actions were fully implemented, with one or two exceptions where there was a delay or a waiver was granted for a required action. Performance in meeting

¹³ The budgetary arrears problem was also tackled through the evolution of fiscal programming practices, as arrears often reflected unrealistic budgets, which contained over-optimistic revenue forecasts and spending obligations that could not be financed.

quantitative and structural performance criteria was likewise generally good, with only minor slippages. However, compliance with structural benchmarks—the violation of which would not necessarily disrupt IMF disbursements—was more uneven, with some benchmarks delayed or postponed, although a fair amount of progress was usually made towards attaining the missed targets. The failure to meet structural benchmarks generally reflected the longer-than-anticipated time it took to obtain political consensus on the benchmark and the complexity of the measures and/or the lack of supporting institutions. Also, at times, structural benchmarks (as opposed to performance criteria) were deliberately used when, given the nature of the reform measure and the uncertainties relating to its precise timing, a more flexible approach was called for. In some cases, to ensure implementation, a missed structural benchmark was made a prior action in a later program review or a succeeding arrangement. In other cases, benchmarks were modified in light of changed circumstances or shifted to a subsequent test date, provided that the program was otherwise mostly on track.

Unfortunately, definitive conclusions cannot be drawn about whether the successful implementation of these programs actually lowered corruption, particularly in the absence of a reliable measure of corruption in these countries. Also, notwithstanding the progress to date, a heavy reform agenda still remains for the Baltic and especially the CIS countries. For example, although there is considerable empirical evidence of a strong negative relationship between the level of public sector wages and corruption,¹⁴ not all programs in these countries contain measures, other than the elimination of government wage arrears noted above, to address incentive-driven corruption. Civil service reforms are only just beginning in most countries. Some of the measures introduced (including to strengthen transparency), moreover, may take much longer to make their full impact. Nevertheless, one way of getting an approximate idea about the effectiveness of economic reforms in curbing corruption might be to compare the corruption levels in transition economies that are at different stages of economic reforms. Such an exercise, while heavily constrained by the difficulties in measuring corruption and the usual caveats for cross-country comparisons, suggests that countries that are at a more advanced stage of economic reform tend to display lower levels of corruption.¹⁵

To summarize, while IMF-supported programs have not directly tackled corruption in the Baltic and CIS countries, they have generally played an indirect role in helping to address these issues through economic and structural reforms aimed at improving economic

¹⁴ See Ul Haque and Sahay (1996) and the references therein.

¹⁵ For example, two separate sets of corruption indicators (outlined in Table 4) developed by *Transparency International* and *The Freedom House*, respectively, generally show lower levels of corruption for those transition economies in Central and Eastern Europe and the former Soviet Union that began their economic reforms earlier and made greater progress, although the relationship is less apparent for the CIS countries, where reforms have generally had a shorter history.

governance. In particular, policies to promote deregulation, liberalization, and privatization have aimed at creating an environment less conducive to corruption. The IMF's technical assistance and training programs—focusing primarily on designing and implementing fiscal and monetary policies;¹⁶ institution building (such as the development of central banks, treasuries, and tax and customs administrations); collecting and processing statistical data; and drafting and reviewing financial legislation—have been effective in complementing its surveillance and financing activities in these countries. Nevertheless, as many of the ongoing episodes of corruption suggest, much still needs to be accomplished to address this serious problem.

V. FUTURE AREAS OF IMF EMPHASIS IN FIGHTING CORRUPTION

Turning to the future, the IMF will continue its work in helping to curtail opportunities for corruption in member countries by supporting reforms in economic policies and institutions, while intensifying efforts to promote transparency and accountability. A number of general initiatives are already underway in the context of strengthening the “architecture” of the international monetary and financial system. The IMF has drafted, and is actively encouraging member countries to adopt, codes of good practices in fiscal and monetary management.¹⁷ In several countries, the Fund is preparing, with the cooperation of the authorities, experimental reports on observance of standards and codes to help identify areas where transparency can be enhanced and to contribute to informed lending and investment decisions by revealing the extent to which countries observe internationally recognized standards. The IMF has also encouraged country self-assessments and provided technical assistance to help in this process. Finally, it has launched and recently expanded a standard of sound practices for countries to follow in providing economic and financial statistics to the public.¹⁸

Within this broader institutional framework, a great deal of thought is presently being given to determining the future areas of priority in fighting corruption in the Baltic and CIS countries. Clearly, despite the progress to date, much remains to be done to find a better balance between the roles of the state and the market, and to limit the conditions that breed corruption. Staff teams working on the countries in question will be guided by the Fund-wide initiatives noted above. The recent shift in emphasis toward strengthening government

¹⁶ In the area of tax policy, for example, IMF technical assistance has generally aimed at simplifying, increasing the efficiency, and reducing the discretionary elements of tax systems in order to limit the scope for corruption.

¹⁷ The *Code of Good Practices on Fiscal Transparency* and the *Code of Good Practices on Transparency in Monetary and Financial Policies* are available through the IMF's external website.

¹⁸ Referred to as the Special Data Dissemination Standard (SDDS).

transparency, accountability, sound economic management, and creating a rule-based, competitive environment will gain considerable momentum in the period ahead. While specific policy advice will need to be tailored to the circumstances of each country, the following areas are certain to receive further attention:

- Acceleration of public sector reforms and downsizing of the government;
- A clearer specification of what constitutes government activity;
- Improvements in the management and oversight of the use of public funds;
- Integration of all extra budgetary government activity into the budget framework;
- Elimination of offsets in the government budget;¹⁹
- Phasing out of barter arrangements in foreign trade;
- Clarification of central banking functions to exclude treasury operations;
- Adoption of codes of good practices in the conduct of fiscal and monetary policy;
- Adoption of tax codes, and reform of tax and customs administrations;
- Further progress with privatization and public enterprise restructuring;
- Regulatory reforms, including further reductions in business activity regulations;
- Reforms in the legal system,²⁰ including in the enforcement of legislation;
- Further progress with civil service reforms;²¹
- Independent audits of central/state banks and government/enterprise operations;

¹⁹ “Offsets” refer to the offsetting of tax arrears against expenditure arrears.

²⁰ Notably, the further strengthening of bankruptcy laws and procedures; enforcement of contracts; protection of shareholder rights; improvements in (and better adherence to) the legal and regulatory framework for foreign investment; and promotion of an independent judiciary and court system.

²¹ Including downsizing, strengthening incentives, building administrative capacity, and reforming institutions to increase accountability and reduce arbitrary practices.

- Strengthening of and adherence to public procurement regulations;
- Adoption of laws/rules on asset declaration and conflict of interest.
- Increasing the coverage, frequency, and timely publication of economic statistics;

Continued progress in the areas listed above can be expected to reduce the opportunities and scope for corruption. Stricter enforcement of sanctions on corrupt practices will also help, notably through its demonstration effect. However, one has to bear in mind that corruption has a long history in many of these countries and is strongly ingrained in their day-to-day existence. It often reaches all the way to the top, and the absence in some cases of a free press, a truly independent judiciary, and an effective political opposition, makes it difficult to expose and challenge corrupt practices.

In the light of these considerations, care should be taken not to exaggerate what can be accomplished in reducing corruption through additional emphasis in IMF conditionality on improving economic governance. It is essential that corruption at the highest levels be minimized, both because of its stifling impact on growth (see section III) and its corrosive effect on society in general, since the highest authorities fundamentally set the moral tone for the rest of society. It is equally important to increase public awareness of the detrimental effects of corruption, as these are often not clearly understood. There is, moreover, frequently a lack of conviction on the part of policy makers, the parliament, and civil society that effective measures to fight corruption can make a difference. These are issues of a social and political nature that go beyond the scope of IMF-supported economic programs, and will take much longer to resolve. Nevertheless, the close involvement of the international community can be expected to help bring about the needed changes. The IMF will continue its efforts to improve governance and fight corruption in the region, and collaborate closely with other international organizations, notably the World Bank, to ensure the delivery of effective, consistent, and timely advice. Finally, corruption is a “dynamic” phenomenon that tends to adapt quickly to changes in circumstances. Hence, the IMF will maintain close contacts with non-governmental organizations (NGOs) and the private sector to keep abreast of the impact of measures to fight corruption and the further policy adaptations that may be called for to tackle this serious problem.

Table 1. Key Measures in IMF Arrangements to Improve Economic Governance, 1992 - 95 1/

A. Liberalization, Deregulation, and Privatization											
	Elimination of tax exemptions	Phasing out government guarantees/lending	Elimination of price subsidies	Elimination of subsidized lending	Unification of reserve requirements	Exchange liberalization	Phasing out export surrender requirements	Trade liberalization	Deregulation	Demonopolization and regulation of natural monopolies	Privatization
Armenia		1	1								
Azerbaijan	2	1	3	1		1		1		1	4
Belarus	1		3	1	1		1	1		1	1
Estonia		2									
Georgia	1	2	1	1			1		1	1	1
Kazakhstan	1	2	2	2				2			5
Kyrgyz Republic			2	1		1		1	1	1	4
Latvia	1	4	2	1				1			
Lithuania	1	2	3	1		3	1	3			
Moldova		1	1	1	1	1	1	4			2
Russia	2										
Tajikistan											
Ukraine		1	4			1		3	1	1	3
Uzbekistan		2	5	1		1	1	6	2	1	1
Total	9	18	27	10	2	8	5	22	5	6	21

1/ Measures that constitute prior actions, performance criteria, and structural benchmarks in Stand-By, ESAF, and EFF arrangements.

Table 1. (Continued)

	B. Government Transparency, Accountability, and Good Economic Management						C. Establishment of a Stable, Rule-Based, and Competitive Environment				
	Improvement of expenditure control, creation of a treasury	Establishment of independent central bank and banking system	Strengthening of tax administration	Elimination of budgetary arrears	Reform of civil service	Improvement in quality and reporting of fiscal statistics, adoption of an open budgetary process	Public enterprise restructuring	Legal reforms 2/	Introduction of international accounting standards for enterprises	Strengthening of bank supervision and prudential regulations	Improvement in accounting and reporting in the banking system
Armenia				1	1			1		1	
Azerbaijan	2	1								2	
Belarus	1	3				1	1	4	1		
Estonia											
Georgia	2	2	3	2	3		2	2			
Kazakhstan		2					5	3		1	1
Kyrgyz Republic	3	3					2	2		3	
Latvia		1								1	
Lithuania		2								1	
Moldova		1					2	2			
Russia			1								
Tajikistan											
Ukraine	3	1					1	2		2	
Uzbekistan											1
Total	11	16	4	3	4	1	13	16	1	11	2

2/ Including adoption of laws on bankruptcy, property protection, foreign investment, taxation.

Table 2. Key Measures in IMF Arrangements to Improve Economic Governance, 1996 - 99 1/

A. Liberalization, Deregulation, and Privatization											
	Elimination of tax exemptions	Phasing out government guarantees/lending	Elimination of price subsidies	Elimination of subsidized lending	Unification of reserve requirements	Exchange liberalization	Phasing out export surrender requirements	Trade liberalization	Deregulation	Demonopolization and regulation of natural monopolies	Privatization
Armenia	1	4	2	1		1					1
Azerbaijan		2	1	2		2		1			9
Belarus											
Estonia		2									1
Georgia	1	3	2				1	3		1	4
Kazakhstan	2	3	6					3		1	5
Kyrgyz Republic	1	2				1					2
Latvia		1									3
Lithuania	1		1		1			3			2
Moldova		4	4					4			4
Russia	3		6	1	1	1		3		2	2
Tajikistan		3	4	5		3	1	3			11
Ukraine	4	1	11	1		2	1	12	3		10
Uzbekistan											
Total	13	25	37	10	2	10	3	32	3	4	54

1/ Measures that constitute prior actions, performance criteria, and structural benchmarks in Stand-By, ESAF and EFF arrangements.

	B. Government Transparency, Accountability, and Good Economic Management							C. Establishment of a Stable, Rule-Based, and Competitive Environment			
	Improvement of expenditure control, creation of a treasury	Establishment of independent central bank and banking system	Strengthening of tax administration	Elimination of budgetary arrears	Reform of civil service	Improvement in quality and reporting of fiscal statistics, adoption of an open budgetary process	Public enterprise restructuring	Legal reforms 2/	Introduction of international accounting standards for enterprises	Strengthening of bank supervision and prudential regulations	Improvement in accounting and reporting in the banking system
Armenia	3	2	3	3	2	2		3		6	
Azerbaijan	6		4	1	8	1	3	9		7	1
Belarus											
Estonia	1		1							4	
Georgia	6	2	11	3	2			4		7	
Kazakhstan	2		12	2	1	1	3	3		3	
Kyrgyz Republic	3		3	2	2	1	2	2		1	1
Latvia			1		1			1			
Lithuania	3						1			1	
Moldova	2		1	2	1		1	7		1	
Russia	5	1	6	1	1	3	1	6	2	2	4
Tajikistan	1	1	5	4			1	1		3	1
Ukraine	8	2	2	2	5		1	4		6	1
Uzbekistan											
Total	40	8	49	20	23	8	13	40	2	41	8

2/ Include laws on bankruptcy, property protection, foreign investment, taxation.

Table 3. Summary: Key Measures in IMF Arrangements to Improve Economic Governance, 1992-99 1/

	1992-95		1996-99	
	Number	In percent	Number	In percent
A. Liberalization, Deregulation, and Privatization	133	61.9	193	43.4
B. Government Transparency, Accountability, and Good Economic Management	52	24.2	161	36.2
C. Establishment of a Stable, Rule-Based, and Competitive Environment	30	14.0	91	20.4
Total	215	100.0	445	100.0

1/ Measures that constitute prior actions, performance criteria, and structural benchmarks in Stand-By, ESAF, and EFF arrangements.

Table 4. Reform and Corruption Indicators for Selected Transition Economies, 1997-99

	Reform Indicators	Corruption Indicators	
	EBRD ²² 1998	Transparency International ²³ 1999	Freedom House 1997-98 ²⁴
Hungary	3.7	5.2	A
Estonia	3.5	5.7	B
Czech Republic	3.5	4.6	B
Poland	3.4	4.2	A
Slovak Republic	3.3	3.7	C
Slovenia	3.2	6.0	A
Latvia	3.1	3.4	B
Lithuania	3.1	3.8	B
Bulgaria	2.8	3.3	C
Kyrgyz Republic	2.8	2.2	D
Romania	2.8	3.3	C
Kazakhstan	2.7	1.3	D
Georgia	2.7	2.3	C
Moldova	2.7	2.6	C
Armenia	2.7	2.5	D
Albania	2.6	2.3	D
Russia	2.5	2.4	D
Ukraine	2.4	2.6	D
Azerbaijan	2.2	1.7	D
Uzbekistan	2.1	1.8	D
Tajikistan	2.0	...	D
Belarus	1.5	3.4	C
Turkmenistan	1.4	...	D

Sources: EBRD Transition Report 1999; Transparency International; and Freedom House.

²² Simple average of EBRD transition indicators covering enterprise reform, financial sector reform, and market and trade reform. The indicator ranges from 1 (least reformed) to 4 (most reformed).

²³ The index refers to perception of corruption ranging from 10 (highly clean) to 0 (highly corrupt).

²⁴ Corruption indicators ranging from A (least corrupt) to D (most corrupt); the period covered is from January 1997 through March 1998.

Selected Measures Impacting Corruption in IMF Arrangements, Country A

Stand-By Arrangement, 1997		
Conditionality	Program Measures	Implementation
Prior Actions	<ul style="list-style-type: none"> ▪ Eliminate most value added-tax (VAT) and enterprise profit tax exemptions ▪ Improve loan classification system for banks ▪ Include extrabudgetary funds administered by the treasury in the budget ▪ Phase out enterprise contributions to extrabudgetary funds and reciprocal benefits ▪ Submit to Parliament a new customs code consistent with international standards ▪ Progress with price liberalization (4 measures) ▪ Progress with trade liberalization (6 measures) ▪ Eliminate selected exchange restrictions ▪ Submit to Parliament a new central bank law ▪ Initiate full international accounting standards audit of the Savings Bank ▪ Eliminate licensing for foreign borrowing ▪ Abolish excess wage tax ▪ Progress with privatization (3 measures) ▪ Adopt measures to discourage barter in payments for electricity ▪ Move toward competitive gas market with an appropriate regulatory body 	<p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p>
Quantitative Performance Criteria	<ul style="list-style-type: none"> ▪ Ceiling on budgetary arrears on wages, pensions, and benefits ▪ Indicative target on the accumulation of gas payments arrears by the central government and state budget-financed institutions 	<p>Observed</p> <p>Observed</p>
Structural Benchmarks	<ul style="list-style-type: none"> ▪ Parliament approval of the new central bank law ▪ Progress with privatization (2 measures) ▪ Phase out and simplify business licensing ▪ Ensure full pass through of electricity wholesale to retail prices ▪ Adopt a pension reform program ▪ Make further progress with trade liberalization 	<p>Not done</p> <p>Partially completed</p> <p>Completed</p> <p>Partially completed</p> <p>Not done</p> <p>Not done</p>

Selected Measures Impacting Corruption in IMF Arrangements, Country B

Extended Arrangement, 1996-98		
Conditionality	Program Measures	Implementation
Prior Actions	▪ Implement measures to raise and rationalize government revenue (14 measures specified)	Completed
	▪ Eliminate mandatory registration of export contracts (private) at commodity exchange	Completed
	▪ Resubmit to Parliament the laws on unfair competition and on natural monopolies	Completed
Quantitative Performance Criteria	▪ Ceiling on arrears of the Pension Fund	Observed
	▪ Ceiling on other arrears of the General Government	Observed
Structural Benchmarks	▪ Submit legislation for modification of natural resource taxation	Completed
	▪ Introduce GFS classification for government expenditure	Completed
	▪ Elaborate sector-specific action plans for privatization	Progressing
	▪ Adjust utility tariffs (with two exceptions) to fully cover costs	Completed
	▪ Progress with banking reforms (2 measures)	Mostly completed
	▪ Complete a review of the effectiveness of the new Bankruptcy Law	Progressing
	▪ Discontinue budgetary support to selected budget-financed organizations	Completed
	▪ Design and implement a mechanism to deal with expenditure arrears in budgetary organizations	Progressing
	▪ Strengthen tax administration (2 measures)	Progressing
	▪ Design a stable system of revenue sharing and expenditure between different levels of government	Progressing
	▪ Submit law on protection of consumer rights	Completed
	▪ Publicize cases of seizure and bankruptcy to alert taxpayers	Completed
▪ Reduce government employment by 10,000 positions	Progressing	

Selected Measures Impacting Corruption in IMF Arrangements, Country C

ESAF Arrangement, 1997-99 (Country C)		
Conditionality	Program Measures	Implementation
Prior Actions	<ul style="list-style-type: none"> ▪ Eliminate selected wage and pension arrears ▪ Schedule repayments of budget loans by key debtor companies and ministries 	<p>Completed</p> <p>Completed</p>
Quantitative Performance criteria	<ul style="list-style-type: none"> ▪ Observe continuous ceiling on outstanding stock of external arrears ▪ Observe ceiling on outstanding stock of wage and pension arrears 	<p>Observed</p> <p>Waiver granted</p>
Structural performance criteria	<ul style="list-style-type: none"> ▪ Remove certain discretionary tax exemptions by a specified date 	<p>Completed</p>
Structural Benchmarks	<ul style="list-style-type: none"> ▪ Set up budget commission to periodically review the budget ▪ Finalize organizational structure and regulations of the treasury ▪ Introduce new chart of accounts for the Central Bank ▪ Adopt and start implementing new chart of accounts for banks (based on international accounting standards) ▪ Progress with enterprise restructuring (3 measures) ▪ Progress with mass privatization program (details given) ▪ Submit revised law on principles of the budget to Parliament ▪ Adopt action plan for civil service reforms ▪ Begin replacing scheduled indirect subsidies by direct subsidies ▪ Submit to Parliament the Code of Good Conduct for Civil Servants ▪ Provide State Tax Inspectorate with complete data on export and import declarations²⁵ ▪ Adopt by a specified date certain measures on privatization 	<p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Mostly Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed</p> <p>Completed with delay</p> <p>Completed</p> <p>Completed with delay</p> <p>Completed</p>

²⁵ As part of a broader benchmark to enhance cooperation between State Customs and State Tax Inspectorate

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