

# Improving Governance and Fighting Corruption in the Baltic and CIS Countries

The Role of the IMF

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## Preface

The Economic Issues series aims to make available to a broad readership of nonspecialists some of the economic research being produced on topical issues by IMF staff. The series draws mainly from IMF Working Papers, which are technical papers produced by IMF staff members and visiting scholars, as well as from policy-related research papers. This pamphlet was prepared by Jeremy Clift of the IMF's External Relations Department.

This Economic Issue draws on material originally contained in IMF Working Paper 00/1, *Improving Governance and Fighting Corruption in the Baltic and CIS Countries: The Role of the IMF*, as well as the IMF Board's Public Information Notice No. 00/28, *IMF Adopts Added Safeguards on Use of Its Resources*, of April 4, 2000. Readers may purchase the Working Paper (\$7.00) from the IMF Publication Services, or download the original document from the IMF's website: [www.imf.org](http://www.imf.org).

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

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In the late 1980s and early 1990s, some 25 countries began their dramatic transformation into market-based economies by liberalizing prices, dismantling the remaining instruments of Soviet-type central planning, and starting fundamental structural economic reforms.

But among all the economies making this same transition, perhaps nowhere has the need to improve governance and reduce corruption been more evident than in the 15 independent states that emerged from the dissolution of the former Soviet Union—Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

These societies, most of them under communist rule for 70 years, were characterized by a lack of government transparency and effective rule of law for generations. 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 economic changes introduced after independence focused on correcting the systemic distortions, not enough recognition was given to the equally compelling need to overcome official corruption and develop the institutions and practices necessary to support market-oriented reforms. This important aspect of the many

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challenges faced by these countries has only recently begun to receive the attention it deserves.

Since the Soviet Union broke up, the IMF has worked with the Baltic and CIS countries to achieve macroeconomic stability and pursue critical structural reforms. In fulfilling its mandate to provide economic policy advice to its members, the IMF has also played an increasing role in seeking to strengthen governance and battle public corruption in the region.

This pamphlet briefly reviews the connections between governance and corruption and the high economic costs corruption exacts, summarizes the related steps the IMF has taken to date, and outlines an agenda for the CIS countries and the IMF in the coming years. Drawing on recent examples of corruption in the region, the pamphlet analyzes the links between governance and corruption, and emphasizes that poor governance creates opportunities and incentives for corruption. Corruption tends to worsen distortions in resource allocation, can lead to a skewed distribution of income and wealth, and negatively affects growth and living standards.

Success in reducing corruption will depend ultimately on the determination with which countries recognize and address the problem.



## Poor Governance Breeds Corruption

As commonly used, the term *governance* refers to the manner in which a government discharges its responsibilities: is the government effective, are its operations transparent, is it accountable, and does it conform to internationally accepted good practices? Governance, therefore, covers a wide range of government activities

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and is a broader concept than corruption. *Corruption* may be thought of as *the abuse of authority or trust for private benefit*, and is a temptation indulged in not only by public officials but also by those in positions of trust or authority in private enterprise or non-profit organizations. This pamphlet focuses mainly on *public corruption* and its impact; the “mafia” phenomenon so often encountered in many of these countries is not covered here.

While corruption undoubtedly will persist to some extent, regardless of the success in improving governance, poor governance creates greater incentives and possibilities for corruption. Toughening the legal strictures against, and punishments for, corruption is important, but it is even more critical that states tackle the underlying governance problems that may encourage corruption. Indeed, a fundamental assumption underlying IMF conditionality in reform programs with the Baltic and CIS countries has been that by seeking to improve governance—particularly in areas of economic policy—the IMF can also help the fight against corruption. Conditionality refers to the terms on which the IMF agrees to provide funds to a member country.

Economic governance may be seen as having three broad dimensions, although there is some overlap among them.

### Excessive government intervention and regulation

First, poor governance shows up in *excessive government intervention and discretion in economic activity, including excessive regulation of private entities and adoption of preferential schemes*, such as restrictions on foreign exchange and trade, price controls, directed credits, and tax exemptions. These offer tempting opportunities to officials to use whatever discretion they have to elicit bribes or kickbacks from those who would benefit from preferential treatment.

Although most countries in the region have substantially liberalized their economies, excessive intervention persists, either directly through state ownership, or through excessive control of economic activity and preferential schemes, as well as their discretionary application.



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For example, officials in CIS countries have abused the tax-free status and preferential trading rights granted to so-called charitable institutions (the national sports foundation in one case). Foreign firms have been barred from building hotels to protect monopoly interests of local firms, and completion of foreign-built hotels in the capital cities of more than one CIS country has been delayed because of demands by local officials for bribes.

Foreign trade officials have demanded bribes for import contract “registration,” charging by the page (short contracts are simply rejected out of hand). Foreign-owned companies, operating in a tightly controlled foreign exchange market, have been charged individualized surcharges on foreign currency.

In one country, the state energy company (headed by a close relative of a senior official) was made responsible for licensing all oil imports by private companies. A large public utility in another country was sold 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 actual corruption, they were clearly instances of poor governance that weakened those economies. Since economic liberalization has progressed quite far, however, in most of the countries in the region, governance problems of this type tend to be encountered less often, although the scale of the bribes and graft involved can still be quite large.

### Lack of government 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*. Governments must keep arm’s-length relations with the economy, including privatized enterprises, avoid conflicts of interest, ensure an efficient and well-paid civil service, create an open budgetary

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process and strong expenditure controls, set up an efficient tax administration, avoid budgetary arrears, and broadly maintain transparent government and central bank operations. Lapses in many of these areas provide a breeding ground for corruption.

Conflicts of interest continue to be a major problem in many CIS countries. For example, officials in the customs administration or other government organs, in more than one country, smuggle alcohol and tobacco products, thus undercutting the marketing efforts and profitability of legitimate companies (and in some cases joint ventures) in local markets.

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

Money from humanitarian aid programs also opens 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 below the import parity price to a well-connected trader, who reaped substantial profits. Another case of poor governance involves the construction of state-owned textile plants at 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 encourages corrupt behavior. An important contribution to reducing conflicts of interest and outright economic crimes by officials would thus be to promote transparency and accountability through greater use of independent outside audits of government and financial operations, and the accounts of central banks in these countries (as, for example, in Russia). Achieving greater transparency and accountability in the privatization under way is also essential.

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## A stable environment nourishes market activity

The third area of economic governance involves creating *a stable, rules-based, and competitive environment for efficient markets*. A strong private sector requires the rule of law; enforcement of contracts and property rights; a strong court system and effective bankruptcy procedures; stable, fair, and transparent tax systems; 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 lay the foundation for long-term growth.

Unfortunately, discretionary and unstable legal and regulatory environments probably remain the rule rather than the exception in the CIS region, with negative implications for *corporate governance*. For example, in one country the licenses of several foreign-owned financial service companies were revoked following the passage of legislation requiring all such entities to be joint ventures with local partners. This happened even though authorities had earlier passed a law on the protection of investment aimed at effectively “grandfathering” such investments.

Diluting “outsider” shareholdings by issuing additional shares of privatized companies and assigning them to dominant local shareholding groups, often at below fair market value, is common in many CIS countries. Another common practice in mass privatization programs has been to confer special advantages to domestic “investment funds” and give them 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 mainly to their own shareholders, or to engage in otherwise risky lending, which has significantly weakened the banking system.



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## Corruption Is Costly

Apart from undermining confidence in the government, and its moral authority, corruption has very real economic costs.

Corruption is likely to make the misallocation of resources worse because corrupt officials are unlikely to press for change in the regulations from which they get rich. In fact, a thriving culture of corruption may prompt officials to increase regulations and license procedures, hoping for even more bribes. Corruption may also aggravate income inequalities and poverty (some will benefit from bribery, kickbacks, and preferential deals, but these will assuredly not be the poorest).

Much empirical evidence shows that corruption negatively affects economic growth. Since corruption acts as a tax on enterprises, it raises costs and reduces incentives to invest. For example, a survey by a resident representative office of the IMF in one 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. Pervasive corruption also diverts some of the more talented individuals in society to engage in “rent-seeking” rather than productive or innovative activity.

Corruption imposes a particularly heavy burden on the most innovative and potentially most productive segments of the economy—small and medium-sized enterprises—which often lack resources to deal effectively and persistently with corrupt officials. Corruption also tends to shift government spending away from socially beneficial investments (such as health, education, good roads, and communications) toward unneeded “white elephant” projects or lower-quality infrastructure.

Many of the corrupt practices documented in the CIS countries either specifically aim at, or have the effect of, discriminating against foreign businesses. Discrimination arises not only 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, corrup-

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tion has discouraged foreign direct investment and has sometimes led investors to pull out of a country.

Corruption also reduces domestic savings and investment and stimulates capital flight, as it tends to weaken the domestic banking system. Most savers and investors hesitate to commit to an economy in which official discretion and secrecy, together with corruption, create a high degree of uncertainty.

In short, corruption is one of the most important forces inhibiting investment and growth and thereby lowering living standards in many of the transition economies reviewed. Finally, pervasive corruption, by impairing the effectiveness of aid flows to low-income transition countries, may discourage donors from providing more aid, which could also harm growth.



## Addressing Governance and Corruption Under IMF Arrangements

The IMF provides financial support to its member countries in a variety of ways, varying in duration and the kinds of policy measures that countries are encouraged to adopt. To achieve financial stability and lasting economic growth, the IMF typically advises countries to focus on correcting macroeconomic imbalances, reducing inflation, and promoting trade, exchange, and other market reforms.

More recently, in growing recognition of the adverse impact of poor governance (and the resulting corruption) on economic efficiency and growth, the IMF has turned its attention to a broader range of institutional reforms and governance issues in the reform

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programs 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* (see IMF website [www.imf.org/external/np/sec/nb/1997/NB9715.HTM](http://www.imf.org/external/np/sec/nb/1997/NB9715.HTM)). The guidelines seek to strengthen the IMF’s role in this area, in particular through:

- Pursuing a more comprehensive treatment, in both the IMF’s regular oversight of national economies and IMF-supported programs, of governance issues within the IMF’s mandate and expertise;
- Taking a more proactive approach in advocating policies and developing institutions and administrative systems that eliminate opportunities for bribery, corruption, and fraud in the management of public resources, aimed at evenhanded treatment of all member countries; and
- Increasing its collaboration with other multilateral organizations, in particular the World Bank, to make better use of complementary areas of expertise.

These principles have guided the IMF’s work in the Baltic and CIS countries. Besides its economic policy oversight and technical assistance, the IMF has approved financial arrangements with each of these countries (except Turkmenistan). In most of them, this involvement began with the Systemic Transformation Facility—a former facility designed specifically to ease transition economies into a heavy reform agenda—followed by Stand-By Arrangements and, more recently, by three-year Extended Arrangements or support under facilities for low-income countries. The IMF has tried to promote good governance in these countries chiefly by advocating measures to liberalize the economy, improve the management of public resources, and support a transparent and stable economic and regulatory environment.

IMF-supported economic stabilization and reform programs in the Baltic and CIS countries have contained measures in all three dimensions of economic governance discussed above—namely, government regulation of economic activity and preferential schemes; gov-

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ernment transparency, accountability, and good economic management; and creation of a stable and rule-based competitive environment for market activities.

To reduce the risk of IMF resources being misused by countries, the IMF Executive Board in March 2000 strengthened the IMF's existing safeguards on funding, specifying new requirements that each borrower's central bank publish annual financial statements audited to international standards by outside experts. The IMF will be able to carry out on-site checks by IMF staff, experts from other central banks, and accountancy firms.

New borrowers are required to supply detailed information about internal controls, and audited central bank statements for the previous three years (see box).

A closer look at some of the economic reform programs in the Baltic and CIS countries sheds more light on how IMF involvement might have a bearing on governance and corruption. For this purpose, five representative countries were selected and the extent of IMF conditionality examined for each of their recent IMF arrangements.

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 modifying requirements to surrender foreign exchange.
- *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 elimination of subsidies), to bringing extrabudgetary government funds under budgetary control.
- *End wage, pension, and social benefit arrears.* In all the cases reviewed, quantitative performance criteria (quarterly limits, for example) were imposed on the government's domestic expenditure arrears with a view to phasing out arrears in an orderly fashion.

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## **Documents required for countries seeking new IMF funding Specified by the IMF Board in March 2000**

### **Copies of**

- audited (or unaudited if no audit is performed) financial statements for the past three years, together with related audit reports.
- all management letters issued by the external auditors in connection with their audit of the financial statements for the past three years.
- all audit reports (including agreed-upon procedures and engagements) issued by the external auditors during the past three years.
- copies of current legislation governing the central bank.

### **Description of**

- the central bank's management structure, including the organizational reporting structure.
- the organizational structure and reporting lines of the internal audit department, including details of the senior management staff in the department and a summary of staff resources (experience and qualifications).

### **Listing of**

- all reports issued by the internal audit department in the past three years and a summary description of findings. Potentially, copies of reports dealing with operational and financial controls during the same period.
- full legal names of any subsidiaries of the central bank, and a description of their business and the nature of their relationship with the central bank.
- all correspondent banks.
- all accounts held by government agencies with the central bank.

### **Summary of**

- high-level internal controls in place for the banking, accounting, and foreign exchange departments of the central bank.



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- *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 steady progress in these areas by encouraging specific intermediate program targets to be met, and promoting effective implementation of bankruptcy laws.
  - *Improve legal, accounting, and statistical frameworks.* Action in this area entailed pressing for banking laws, tax codes, customs codes, laws on natural monopolies, and so forth; for accounting frameworks, and for macroeconomic data compilation practices that meet international standards.



## Future Areas of IMF Emphasis in Fighting Corruption

Despite the progress to date, a heavy reform agenda remains for the CIS countries. 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 have their full impact.

While IMF-supported programs so far have not directly tackled corruption in the Baltic and CIS countries, they have played an indirect role in helping address these issues through economic and structural reforms aimed at improving economic governance. In particular, policies to promote deregulation, liberalization, and privatization have aimed at creating an environment less conducive to corruption.

The IMF's technical support and training programs—focusing primarily on designing and implementing fiscal and monetary policies;

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institution building (such as developing 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 oversight and financing activities in these countries. Nevertheless, as many of the ongoing episodes of corruption suggest, much still needs to be done to tackle this serious problem.

Turning to the future, the IMF will continue 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 under way in the ongoing effort to strengthen 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. In several countries, the IMF is preparing, with the cooperation of the authorities, reports on observance of standards and codes to help identify areas where transparency can be improved. These reports will also contribute to informed lending and investment decisions by revealing the extent to which countries follow internationally recognized standards. The IMF has encouraged country self-assessments and provided technical assistance to help in this process. It has also launched and recently expanded a standard of sound practices for countries to follow in providing economic and financial statistics to the public.

To achieve greater transparency and accountability, improved economic management, and a more rules-based environment for market activity, several areas warrant further attention. These include speeding up public sector reforms and the downsizing of government (including a clearer specification of what constitutes government activity); improved management and oversight of the use of public funds; integration of all extrabudgetary government activity into the government budget; phasing out of barter arrangements in foreign trade; separation of central banking and treasury operations; and adoption of good practices in the conduct of monetary and fiscal policy and the creation of tax and customs codes.

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The IMF also suggests further attention to privatization and public enterprise restructuring; regulatory reforms (particularly less regulation of business); reform of the legal system, including strengthening of bankruptcy laws and procedures, and enforcement of contracts; greater progress on civil service reforms; and instituting independent audits for central and state banks as well as for government and public enterprise operations.

Progress in these and other areas and strict enforcement of existing sanctions on corrupt practices can bear fruit. But corruption has a long history in the region and often reaches into the topmost layers of government. Rooting it out will be difficult, particularly to the degree that these countries continue to lack a free press, an independent judiciary, and an effective political opposition. It is also crucial for the public to understand the real costs of corruption, for without public outrage, little true reform can be achieved.

These latter elements are beyond the IMF's control, and care should be taken not to exaggerate what can be done to curb corruption through greater emphasis in IMF conditionality on improving economic governance. Corruption at the highest levels must be minimized, both because of its stifling impact on growth and its corrosive effect on society in general, since the highest authorities fundamentally set the moral tone for the rest of society. The public must be made more aware of the harmful effects of corruption, as these are often not clearly understood. In addition, policymakers, the parliament, and civil society must be convinced that measures to fight corruption can be effective.

These are social and political issues 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 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. The IMF will need to maintain close contacts with non-governmental organizations (NGOs) and the private sector to keep

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abreast of the impact of measures to fight corruption and the further policy adaptations that may be called for to tackle this serious problem.

The full text of the original working paper, with supporting tables and graphs, can be found on the IMF website  
*<http://www.imf.org/EXTERNAL/PUBS/CAT/shortres.cfm>*

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