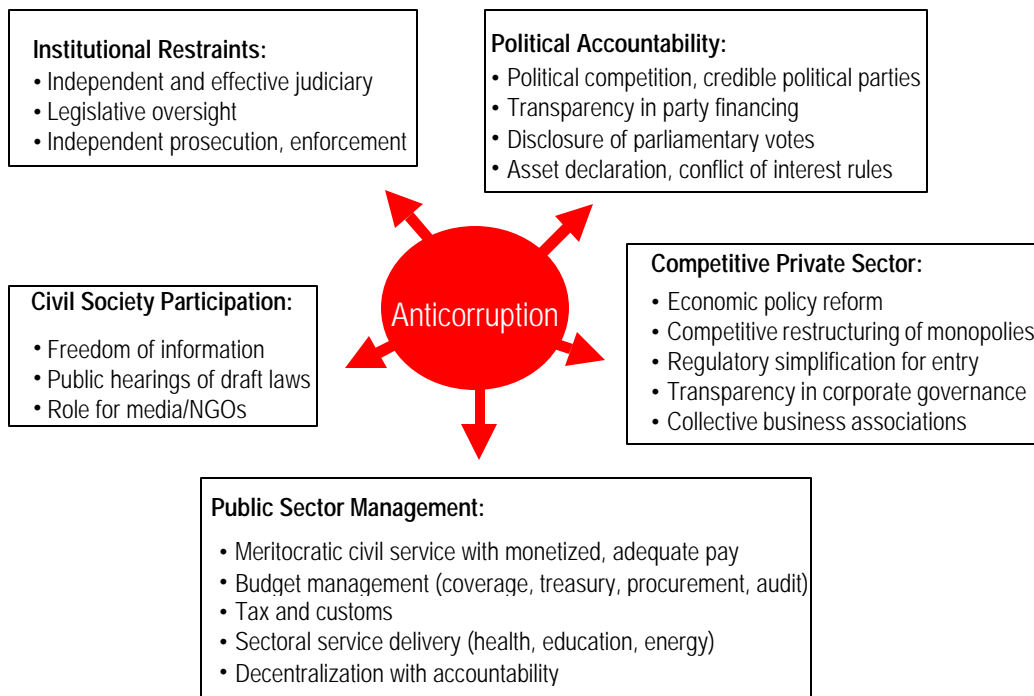


Chapter 4: A Multi-pronged Strategy for Combating Corruption

To be effective, efforts to reduce corruption must move beyond a narrow response to its immediate manifestations to a broader approach of addressing its underlying causes. The preceding chapters have demonstrated the complex mix of historical legacies, institutional factors, and policy choices that have influenced the incidence of state capture and administrative corruption across the region. Dealing with these problems will require a multi-pronged strategy tailored to the specific pattern of corruption in each specific country.

To date, anticorruption programs have largely focused on measures to address administrative corruption by reforming public administration and public finance management. But with the increasing recognition that the roots of corruption extend far beyond weaknesses in the capacity of government, the repertoire has been gradually expanding to target broader structural relationships, including the internal organization of the political system, the relationship between the state and firms, and the relationship between the state and civil society.

Figure 4.1. Multi-pronged Strategy: Addressing State Capture and Administrative Corruption



Experience has demonstrated that there is no single model to determine how these relationships should be structured to minimize the risks of corruption. Indeed, a wide range of diverse models is available from contemporary practice and historical experience. Though the methods may differ across countries, the goals are the same: enhancing state capacity and public sector management, strengthening political accountability, enabling civil society, and increasing economic competition.

This chapter defines and describes five key building blocks of an anticorruption strategy, illustrated in Figure 4.1. The next chapter shows how the strategy can be tailored to countries confronting different profiles of corruption.

Increasing the Accountability of Political Leaders

The first block consists of actions that can be taken to increase political accountability. Political accountability refers to the constraints placed on the behavior of public officials by organizations and constituencies with the power to apply sanctions on them. As political accountability increases, the costs to public officials of taking decisions that benefit their private interests at the expense of the broader public interest also increase.

Accountability rests largely on the effectiveness of the sanctions and the capacity of accountability institutions to monitor the actions, decisions, and private interests of public

officials. *Transparency* via public scrutiny has proven to be one of the most powerful forms of monitoring public officials. Such transparency can be fostered by a number of measures, including: opening sessions of the parliament, government, and the courts to the public; registering lobbying activities; and publishing the voting records of parliamentarians, annual reports of government bodies, trial records, and the decisions of judges. Among these, effective laws on disclosure of conflict of interest, including the receipt of gifts and other benefits received from private sources, are particularly lacking throughout the region (see Box 4.1). To be fully effective, however, such laws

Box 4.1: Disclosures of Conflict of Interest

Lawmakers and policymakers in countries liable to state capture are uniquely vulnerable to conflicts of interest. Laws designed to prevent decisionmaking in a situation of conflict of interest typically require state officials to declare their assets and may also regulate the receipt of gifts by public servants. Such laws feature in many countries, including Albania, Czech Republic, Estonia, Georgia, Latvia, Lithuania, Poland, and Russia, but vary widely in the effectiveness of their implementation and in the extent to which they require public access to the information contained in declarations. Latvian law reinforces the incentives created by disclosure by penalizing illicit enrichment of officials who cannot justify possession of assets in excess of their normal sources of income. Lithuania has successfully used the asset declaration law to remove corrupt public officials from office.

need oversight and implementation bodies. Public access to information on the interests of high public officials, as found in Georgia and Latvia, can reinforce the impact.

Effective sanctions on politicians can be enhanced most effectively through a meaningful degree of *political competition* in the electoral process. Such competition increases the likelihood that alternative candidates and parties will seek to expose corruption in government or hold politicians accountable for the poor performance associated with high levels of corruption. The issue of corruption has been a key factor in elections across the region in such countries as Bulgaria, the Czech Republic, Latvia, and Poland, among others. However, excessive political competition can become a destabilizing factor if it leads to fragmentation of the political system or if it undermines the legitimacy of existing state institutions. This is most likely to occur when political parties are organized largely around rival ethno-linguistic groups with competing claims to the definition of the nation-state, as in Bosnia and Herzegovina. Excessive political competition can undermine state capacity and thus create conditions especially conducive to administrative corruption, but conducive to state capture as well.

Political competition is most effective in promoting accountability when it is channeled through organizations that provide broad constituencies with vehicles—such as mass-based political parties and interest groups—to express their collective demands to political leaders. While mass-based political parties are gaining credibility in CEE, in many other transition countries they remain unstable and tenuously linked to broad constituencies. This exacerbates politicians' dependence on powerful firms and financial interests—sometimes outside the country's borders—for sources of financing and on electoral tactics such as vote-rigging, intimidation, and acquiring a monopoly over election coverage by the media. It is imperative that political parties be held to the same standards of accountability as those described above. Effective, well-monitored rules on political party financing are of particular importance (see Box 4.2).

Accountability mechanisms need not be entirely based on external constituencies and competitive pressures. Indeed, in certain contexts, such mechanisms can also be created within government bureaucracies by establishing ethics codes, regulations on lobbying, disciplinary committees, prohibitions on conflict of interest, and mandatory disclosure of income and assets. Ensuring credible sanctions and effective internal monitoring of bureaucratic behavior is critical to the success of such an approach.

Strengthening Institutional Restraints

The institutional design of the state can be an important mechanism in checking corruption, in particular, the effective development of institutional restraints within the state most effectively achieved through some degree of separation of powers and establishment of cross-cutting oversight responsibilities among state institutions. Effective constraints by state institutions on each other can diminish opportunities for the abuse of power and penalize abuses if they occur. An independent and impartial judiciary is often the most important constraint, as the existence of genuine legal recourse underpins the credibility of other institutions of the state and allows these institutions to be credibly challenged when needed.

Box 4.2: Political Party Financing: Experience And Mechanisms¹

Experience worldwide shows the immense difficulties of installing an effective system of party funding that will not be open to abuse. Many countries have experienced malpractice in public procurement that provided kickbacks for party funding, as well as a plethora of other improper channels involving state-owned enterprises, privatization, and the leverage afforded by appointments and control rights at all levels of government. However, international experience also shows that regulation of party funding can be effective if well-designed, backed by effective sanctions, and accompanied by a parallel diffusion of appropriate ethics and norms. Ultimately it is committed politicians and citizens who have asserted the principles that should govern party financing and have driven through new laws and regulations. These rules need oversight, enforcement, and monitoring. This requires reliable judges or electoral authorities and an active investigative press. In some cases, the shame—and electoral consequences—of political exposure have proved effective. There is no single prescription for success, as party financing rules have to operate in an environment of institutions and degrees of rule-respect that varies across countries, but many countries have found a selection of the following mechanisms to be helpful.

- *Leave a paper trail.* Ensure that all donations and other sources of party revenue are made public, that donors and the amounts of their donations are identified in the public record, and that candidates disclose links to lobbyists, as well as sources, types, and amounts of support, both before and after elections. Expenditures and their purposes should be similarly published and available for audit.
- *Ban the use of state resources for political purposes.* Parties in government should not use state funds, postal services, cars, computers, or other assets for political purposes or in election campaigns.
- *Limit expenditures.* Make party politics as inexpensive as possible. Usually the demand exceeds the supply of funds, leading to a search for funding that may breach legitimate frontiers. There is a lot to be said for reversing this relationship by mechanisms used in a large number of Western European and other countries: (i) allocating free time slots on TV and radio to qualifying political parties, with no additional time allocation permitted; and (ii) imposing legal limits on spending, with actual expenditures subject to audit and to effective sanctions in the case of breaches of the limits.
- *Consider public funding.* Many countries have established partial public funding, recognizing that political parties play a public interest role: they make an essential contribution to political contestability and the decentralized expression of diverse values and interests. Public funding reduces the scope for private interests to “buy influence” and can also help reinforce limits on spending, because of the electorate’s resistance to excessive public expenditure.
- *Build public service neutrality.* Ensure that the public service is politically neutral and that public servants are neither allowed nor required to make contributions to political parties as a way of obtaining public sector employment. This will contribute to a meritocratic public service that will resist party bias and will encourage decisionmaking in the public interest.
- *Limit types of donors.* Some countries have outlawed donations from both public and private sector companies, such as France since 1995, or foreign donations.
- *Ensure oversight.* Set up an authoritative and independent Electoral Commission or Court to be responsible for the integrity of all issues regarding party finance and electoral rules. Such commissions have been set up in Canada, India, Ireland, and South Africa.

The institutional arrangements governing the distribution of the legislature, executive, and judiciary vary across Central Europe and the CIS. Most CIS countries have presidential or semipresidential systems, while most countries in Central Europe have parliamentary systems, within which the balance of power varies considerably. In principle, devolution of powers from the central to subnational levels of the state could also contribute to institutional restraints. But experience within the region indicates that decentralization in the absence of effective capacity and accountability often increases vulnerability to corruption. In many countries of the region, corruption at the subnational level has become a particularly serious problem.

Audit organizations can also have an important role. A good—but rare—example is Poland's Supreme Audit Chamber, which investigates and publishes reports on abuses in procurement, management of public assets, and other diversions of public funds. For full effectiveness, State Audit Offices should be backed by parliamentary committees that review and follow up on their reports. By contrast, watchdog enforcement agencies have a mixed record and have too often been subject to capture themselves. A condition for their effectiveness is the prior establishment of a core of strong, independent, and credible professionals in the judicial, prosecutorial, and police arms of the state.

A frequent complaint is favoritism of the state in cases brought by citizens. Box 4.3 describes mechanisms to prevent and resolve disputes between citizens and the state.

Box 4.3: Transparency and Recourse in Administrative Decisionmaking

Government decisions are less prone to corruption when they are predictable, transparent, and accountable. Administrative procedures law provides the legal foundation for sound government decisions by providing rules for the way government bodies behave. These procedures protect the rights of citizens by guaranteeing participation in government decisions by interested parties, openness and transparency of decisions, adequate responses to public inquiries, and the availability of recourse. Mechanisms of recourse include appeal within government bodies, judicial scrutiny, and ombudsmen. Explicit administrative procedures allow citizens who are affected by administrative decisions to know that decisions will be made according to predictable rules rather than the will of the administrator.²

In the context of corruption, one of the crucial differences between CEE and CIS countries involves differences in administrative procedures. Most countries in Eastern Europe possess at least basic guidelines for administrative decisionmaking and dispute resolution, unlike most in the former Soviet Union. In an attempt to strengthen public administration and protect the rights of their populations, a number of transition countries are developing their own administrative procedures. Latvia, for example, is introducing legislation to create a system of administrative courts dedicated to the adjudication of disputes between citizens and the state. The Latvian government considers the introduction of such courts to be integral to the efficiency and credibility of government decisionmaking.

Judicial systems in the region are generally considered to be capable of independent decisionmaking, although in some countries judiciaries have not yet established effective autonomy. In others, their capacity for independence is not always matched by performance, and lower courts are often managed by the Ministry of Justice with oversight provided by the procuracy.

Raising judicial credibility is a challenging task. Judicial independence is critical but must not come at the expense of accountability. Reforms specifically aimed at raising judicial accountability consist of setting and monitoring judicial performance standards and ethical behavior, introducing greater transparency in relations between judges and litigants, publishing trial records and judicial decisions, and introducing transparent methods of case assignment. Private lawyers may also play an integral role in facilitating judicial corruption, by acting as an intermediary between the judge and the litigant. The enforcement of professional behavior in the legal professions can be strengthened by professional associations that set and monitor standards for legal practice and by developing a system of consumer protection.

Budgets should be aligned with judicial functions. A mismatch between judicial functions on the one hand and judicial capacity and resources on the other has placed severe limits on the ability of the judiciary to deliver its services efficiently and honestly. Such a mismatch also creates an imbalance between demand for and supply of judicial services. In the Slovak Republic, for example, there have been serious backlogs of company registration applications and in Poland long delays are common in the registration of land transactions through underresourced courts. Few courts are specialized in commercial matters. Largely as a result of the perceived unreliability of the formal institutions, there is a disturbing trend in some countries for commercial disputes to be settled privately and occasionally by force.

Where budget stringency persists, judicial functions should be trimmed and alternative modes of delivering these functions should be explored. For example, registry functions can be assigned to special-purpose bodies; the enforcement of court decisions in the Slovak Republic, although still regulated, has been partially devolved to the private sector.

Independent prosecution remains a crucial challenge for countries in the region. Often the legal framework for anticorruption is incomplete or unclear. Because direct evidence of corrupt acts is often difficult to obtain, many countries have criminalized activities that are often associated with corruption, such as laundering proceeds from corruption and other crimes. Box 4.4 provides more detailed information on the legal framework for prosecution of money laundering cases.

Box 4.4: Anti-money Laundering

“Dirty” money is “laundered” to make it appear “clean” when illegally obtained money is transformed so that it appears to have come from legitimate sources. The series of transactions can be complex, but three basic steps are typically involved: placing the illicit cash in the banking system, layering transactions to make it difficult to trace the funds, and integrating the illicit money with money from legitimate sources.

Legislation is needed that defines money laundering, declares it a criminal offense, and designates a state authority to receive suspicious transactions reports, maintain and analyze these data, cooperate with other countries in investigations of financial crimes, and coordinate efforts with international institutions. Financial institutions should be obliged to review transactions and report suspicious activities to authorities, and to have written policies and procedures in place so that the institution can be confident its customers are not using it for the purpose of money laundering.

Some countries in transition have anti-money laundering laws in place, but few enforce them effectively. Common weaknesses include: failure to criminalize the transfer or possession of money obtained from illegal activities; failure to oblige non-bank financial institutions (such as insurance companies, securities firms, investment companies, or cambios) or businesses often used by money launderers (casinos, bookmakers, garages) to report suspicious transactions; failure to provide the legal basis for seizure of proceeds from illegal transactions; and lack of capacity and resources to enforce the law.

Strengthening Civil Society Participation³

As stakeholders in the quality of governance and institutions mediating between the state and the public, the organizations that comprise “civil society”—citizens groups, nongovernmental organizations, trade unions, business associations, think tanks, religious

organizations—can have an important role to play in constraining corruption. Under communism, however, civil society was severely repressed. In a few cases, the power of collective will managed to overcome the repression— a strong trade union movement in Poland helped create political competition and supported social cohesion through the painful periods of reform, and civic associations were a feature of other CEE transitions. Yet such organizations were the exception; early in the transition, and even today, NGOs in many countries are still in the early stages of development or remain as appendages of the state.

More recently, there has been an emergence of greater civil society activism in the transition countries regarding corruption. Twenty-six civil society initiatives against corruption in 17 transition countries were surveyed for the purposes of this report. These grass-roots⁴ initiatives demonstrate the varied role that participation by civil society can play in fighting corruption. Most of the activities have revolved around three key themes: creating public awareness about corruption; formulating and promoting action plans to fight corruption; and monitoring governments' actions and decisions in an effort to reduce corruption. (See Box 4.5 for an example.)

Box 4.5: Giving the People Voice

The People's Voice Program⁵ in Ukraine aims to build integrity at the municipal level through strengthening the voice of citizen groups demanding better governance and services, and by facilitating more responsive public organizations. Through surveys, information on the problems associated with major services is gathered. This information is then used by citizen groups to put pressure from below on local leaders to improve service delivery. The project also supplies technical assistance to municipal agencies that should enable them to be more responsive. Surveys of households, enterprises, and public officials have revealed a high level of dissatisfaction with the quality of public services, while also showing that most citizens (more than 90 percent) have never filed any complaints, believing that this would be fruitless. The survey information has been widely disseminated through the media, public discussions, conferences, and through NGOs. Initial implementation results are encouraging. The municipal officials in Ternopil reacted to the survey results by creating task groups to work on the most critical problems revealed by the surveys. These groups are currently developing proposals to deal with the problems identified. An interesting initiative has emerged in the city in response to the citizens' demands— Service Centers, a one-stop shop where citizens can pay for all municipal services. The Service Centers are also proposed to be used for filing and monitoring the citizens' complaints.

To raise public awareness, organizations have often made use of country surveys on corruption, service delivery surveys, and diagnostic assessments. Seminars, conferences, and workshops have helped to publicize information about the patterns and severity of corruption and to develop action plans. These can include attempts to influence new legislation that will aid corruption control or to lobby for new institutional devices to prevent or penalize corruption. Others focus on judicial reform and freedom of information. Advocacy for legal and judicial reform, business deregulation, privatization, and procurement reform are common themes of civil society interventions. Some monitoring activities have focused on privatization plans, procurement reforms, allocation of housing, and legal reforms.

Civil society is most effective when the government treats it as an ally, rather than an enemy. In the Slovak Republic, for example, the national chapter of Transparency International was entrusted with the first draft of the National Program for the Fight Against Corruption and has regularly been invited to monitor procurements and other state decisions.

The Role of the Media⁶

Free and open media help check the level of corruption by uncovering and shedding light on abuses. The greater openness felt by the media since the fall of communism has brought with it a plethora of stories of fraud, corruption, and criminal activity, making the media perhaps the most persistent institution in the fight against corruption. Journalists have paid dearly for this: in the territory of the former Soviet Union alone, more than 200 journalists have been killed in the line of work as they investigated stories on corrupt officials or criminal gangs.⁷ Though most countries of the region now have a free and open press, many factors continue to weaken the media's potentially powerful contribution to limiting corruption, including: lingering state controls; conflicts of interest generated by ownership arrangements; and corruption in the media itself. Legal guarantees to free speech form the foundation of a vibrant media. But the press may yet be inhibited in other ways, most notably by libel laws and intimidation. In Turkmenistan, the media are expressly forbidden by law from publishing any sort of criticism against another person or institution except criticism issued by the president himself. In some countries, violence against journalists has resulted in strong self-censorship.⁸

Lingering state pressure even on privately owned media is still a serious problem. In Croatia, for example, journalists who criticized the regime of former President Tudjman found themselves faced with surprise tax inspections, shut out of the national distribution monopoly, or cut off from the national airwaves.⁹ Similarly, journalists in Ukraine who dig up information about public officials have reported various forms of state intimidation.¹⁰ Government monopolies on printing, supply of paper distribution, and television signal transmissions continue in many countries, creating pressures for self-censorship.

The conflict of interest that characterized the old system of state-owned media has in many instances taken on a new form, as the business interests that are capturing the state also gain control over the media. While the news business could be a major industry with high profit prospects, the partisan nature of the ownership structure has limited its growth and development. An appropriate system of corporate governance within the media would ensure that the editorial side of the business operated separately from the business and revenue side. Allowing free entry, particularly of foreign press if it is non-partisan and competitive, can also help mitigate the problem of "media capture." Foreign investment in media in the Baltics has helped to create a highly diverse and competitive media culture. In Russia, where media organizations are often firmly aligned with concentrated business interests, a Russian language daily was recently created by foreign investors whose leading marketing angle is the newspapers' independence from the internecine battles among the so-called oligarchs.¹¹

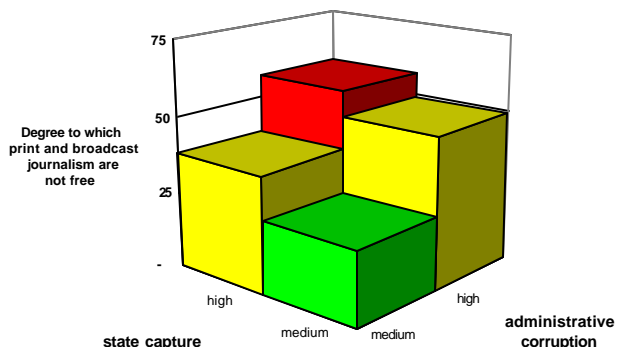
Some countries, most notably those in Central Europe and the Baltic states, have made giant strides toward creating a free press, while at the other extreme, many of the Central Asian republics and Belarus still repress the media. Freedom of the media is highest in countries with the lowest levels of administrative corruption and state capture. (See Figure 4.2¹².) A policy of

openness, formalized in laws guaranteeing free access to information, strengthens tools for oversight and enlists the media as an ally in controlling corruption.

Creating a Competitive Private Sector

The transition period has witnessed a rapid concentration of economic power, while strong remnants of the state's capacity to intervene in the economy, inherited from the previous command system, have survived in many countries. The privatization process has been susceptible to manipulation by powerful state actors, enabling them to gain control of substantial parts of the economy. In many cases, monopolies were privatized in the absence of regulatory frameworks. The rapid concentration of economic power was reinforced by corruptly assigned subsidies, guarantees, directed net lending, and corporate tax arrears. Banks that were infiltrated by criminal networks are now the foundation of money laundering and other scams. Market entry has been hindered by the oppressive application of start-up rules and inspections; lack of access to bank and equity finance; and licensing and permit delays that disproportionately penalize small businesses. Inadequate mechanisms to register asset transactions foster unclear ownership structures, often masking manipulation by powerful economic and state interests. This combination of concentrated economic power and bureaucratic control has created a receptive environment for state capture and administrative corruption. Tackling this concentration of power and reducing discretionary and coercive intervention constitute the most formidable challenges of the transition, especially in light of the political constraints (see Box 4.6).

Figure 4.2. Media Repression



Source: BEEPS and Freedom House

Box 4.6: Challenges of Confronting State Capture in the Energy Sector

Large infrastructure monopolies represent powerful economic interests that are able to exercise considerable influence over legislation and regulations even in cases where the scope of their activities has been formally reduced. To cite three examples:

The introduction of foreign investors to the oil sector in Kazakhstan reduced the scope of Kazakhoil's activities. Despite this, Kazakhoil remains extremely powerful and was able in 1999 to secure changes in the Petroleum Law that strengthened its own position in the industry at the expense of making the investment climate in the sector less attractive to foreign investors.

In the latter part of 1998, there was widespread speculation in Russia that international donors would push for the break-up of Gazprom as a condition of their further lending to Russia following the August 1998 financial crisis. Gazprom responded to this by securing passage through the Duma of the Gas Supply Law. This law guarantees Gazprom's right to continue to operate as a monopoly.

The Russian Government made a commitment to enact a pipeline law. Both Gazprom and Transneft have a vested interest in such a law and succeeded in pushing a draft law through a first reading of the Duma late in 1999. The draft law contains provisions that are of significant concern to foreign investors and was strongly opposed by the Ministry of Fuel and Energy. Despite this, the law passed its first reading. Gazprom subsequently realized that certain provisions in the draft law were also detrimental to its interests and with the change in the composition of the Duma following the 1999 Russian elections, the law was taken back to the drawing board.

The ability of powerful economic interests to capture the state can be constrained by: (i) economic policy *liberalization*; (ii) introducing greater *competition*, especially in concentrated sectors, by lowering barriers to entry, requiring competitive restructuring, and clarifying ownership structures; (iii) *regulatory reform* at all levels; (iv) a stronger and more transparent framework for *corporate governance*; (v) instruments of *voice* for business associations, trade unions, and concerned parties; and (vi) *transnational cooperation*.

Economic Policy Reform.¹³ Although significant increases in economic liberalization have occurred since the onset of transition, many countries still have not significantly deregulated prices or other aspects of production or trade. For example, in Russia and Belarus, prices are controlled for several important product categories and public procurement at nonmarket prices remains substantial. Implicit price subsidies, in the form of tax and utility arrears, are commonplace in countries such as Georgia, Moldova, and Azerbaijan. Such interventions provide politicians and bureaucrats with discretionary power that is highly subject to abuse. Liberalization can help to reduce this discretionary power, but only if reform is undertaken in a transparent and nondiscriminatory way; otherwise, there is a risk that the reform process itself will be corrupted.

Enhancing Competition. Transparency in formulating and implementing economic policy is crucial to combating corruption, especially in the areas of privatization and regulation. Most of the state assets that remain to be privatized are large and many are in the natural resource or infrastructure sectors. Competitive restructuring of these firms prior to privatization on a case-by-case basis can reduce possibilities for corruption, although political obstacles can impede this process. Competent agencies to administer law on competition policy, antimonopoly laws, and unfair trade practices can also help. Competition can also be strengthened by introducing greater transparency in the ownership structure and operations of firms and banks, through requirements on financial disclosure and arm's-length relationships, efficient registries, and better supervision of their operations by independent regulatory bodies.

Regulatory Reform. Proper regulation of utility companies and other industries in which competition remains imperfect is important to reducing corruption. The establishment of independent regulatory agencies, both at the central and at the local level where regulatory capture is most pronounced, can be effective in promoting efficiency and limiting opportunities for corruption, as long as such institutions operate with transparency (public hearings), simplicity (well defined, rules-based principles), and accountability (election of regulators or term limitations). Similar practices for regulating more routine aspects of business operations, such as registration (one-stop registration) and workplace safety (simple and clear rules for site inspections), are crucial to limiting harassment of businesses by bureaucrats and promoting new entry and growth. For all types of regulation, firms should be provided with low-cost methods of disputing administrative decisions. Box 4.7 outlines the different approaches to business regulation that have been utilized in three of the most successful of the transition countries.

Box 4.7: Regulatory Reform in Hungary, Poland, and the Czech Republic

The experience of Hungary, Poland, and the Czech Republic in reforming their economic regulations demonstrates that improved regulatory performance is not exclusively a function of reducing the number of regulations in force. Clear rules defining when government intervention is appropriate as well as improvements in the quality of regulatory instruments are critical in establishing effective regulations that are enforced in accordance with the rule of law.

Hungary has focused on improving the quality of its regulations and on eliminating unnecessary regulations.¹⁴ Although nearly two-thirds of its firms are still required to obtain licenses in order to operate, the government ranks high in the quality of its operations, placing first out of 20 transition countries in the EBRD Governance Index. While Hungarian entrepreneurs display confidence about their relationship with government officials (only one-quarter of firms doubt the security of their property rights), ensuring the transparent and consistent application of official requirements will remain a critical challenge in the coming years, especially as functions shift to local governments.

Poland's efforts to improve its regulatory environment have focused on establishing explicit rules to define when economic regulation is appropriate. The first step to reduce the role of government was taken in 1988 with passage of a liberal Law on Economic Activity. Over the next ten years, the absence of clear principles or criteria to guide government intervention led to the gradual but steady growth of licensing and permits requirements. By 1997, permit and licensing procedures were identified by entrepreneurs as the greatest obstacles to business operations.¹⁵ Poland's leadership in the region in terms of private sector expansion and public sector contraction was being subtly undermined. With the second Law of Economic Activity, passed in 1999, the parliament has now sharply reduced the number of activities subject to licensing and created a comprehensive approach to licensing and permit requirements. Poland now faces the challenge of adapting its rules for creating and implementing regulations to bring them into accordance with its enacted regulatory principles. Distortions at the subnational government level in the implementation of licensing and permit rules, especially relating to land and construction, will also need to be tackled.

The Czech Republic began the transition period with a deep ideological commitment to giving free rein to market forces. The government sought to remove or limit regulations even in those areas where government involvement is usually seen as essential, such as in the securities market. In response to repeated crises, the present government is defining a more activist role for government, but little attention has been given to improving regulatory quality or to creating clear principles concerning government intervention in the economy. Regulatory expansion is occurring without sufficient attention to enhancing transparency and accountability. The problems caused by the successive approaches to regulation are evident: fully 50 percent of respondents doubt the security of their property rights and entrepreneurs believe that crime and corruption are their most serious obstacles. The Czech Republic's current predicament demonstrates that regulatory reform requires the creation of effective regulatory institutions and a framework of market rules as much as it requires the elimination of unnecessary rules.

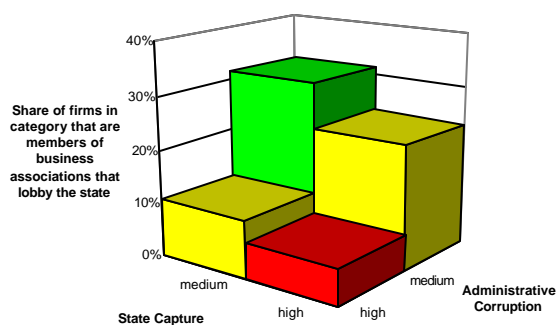
Corporate Governance.¹⁶ Weak institutions for corporate governance not only result in inefficiency, they encourage corruption. Poorly governed managers often use their positions to extract favors from the state which they can later expropriate, rather than reinvest into restructuring their own firms, to avoid sharing their gains with other stakeholders. Corrupt behavior is often difficult to detect, especially in countries where transactions are obscured through the use of barter and other money surrogates as the means of payment. A wide array of corporate governance reforms have proven effective in curbing both incentives and opportunities for corruption, including: public disclosure of share ownership and cross-holdings; strong penalties for insider trading and pyramid schemes; the appointment of outsiders to boards of directors; the introduction of regular, published independent audits of financial accounts based on standardized rules; the establishment of an effective legal framework for the exercise of creditors' rights; and the strong enforcement of ethical standards. Box 4.8 provides an example of ethics reform in firms in transition countries that was achieved through collective action within the business community.

Box 4.8: Business Ethics

Business associations in some EU-accession countries, such as the Czech, Hungarian, and Polish Business Leaders Forums, have focused on strengthening ethics codes. There have also been a number of business-led efforts in Russia to improve standards of corporate behavior. A small management consulting company in St. Petersburg, Sovereign Ventures, prepared a Declaration of Integrity in Business Conduct requiring signatory companies to adopt a "no-bribe" pledge. More than 100 companies have so far signed the Declaration. In St. Petersburg, the Association of Construction Companies has expelled nine companies for violating their rules of ethical conduct, which cover "unfair" practices such as failing to fulfill building contracts.

Business Associations. A challenge for countries in transition is to find ways in which diverse private interests can compete with one another in an open and transparent way. One mechanism, often overlooked in transition countries, is the use of collective business associations as legitimate instruments to represent collective interests in the formulation of law and policy. As shown in Figure 4.3,¹⁷ countries in which firms can find expression in legitimate collective associations are less likely to suffer problems of capture and administrative corruption.

Figure 4.3. Business Associations and Corruption



Source: BEEPS

Transnational Cooperation. Foreign direct investment does not always import higher standards of corporate behavior into transition countries, especially those in which state capture and administrative corruption have already reached high levels.¹⁸ Indeed, corruption in international trade, especially bribery of licensing and customs officials, is one of the most common and costly forms of corruption, resulting in the loss of billions of dollars each year in fiscal revenues in countries in transition. Proceeds from corruption often end up in foreign bank accounts or are laundered through foreign banks. The international community has mobilized to develop instruments against transnational corruption. As described in Box 4.9, a number of international conventions that have the aim of intensifying and harmonizing the detection and punishment of transnational corruption, and which have potential importance for countries in transition, are available for signature.

Box 4.9: International Collective Action

Council of Europe Criminal Law Convention on Corruption (European Treaty Series No. 173; <http://conventions.coe.int>). Open for signature on January 27, 1999, the Convention requires signatories to make the following practices criminal offenses: bribery of public officials, trading in influence, laundering of proceeds of corruption, and other common forms of corruption. The Convention also provides for the investigation and prosecution of corruption, protection of persons collaborating with investigating or prosecuting authorities, and the adoption of measures on gathering evidence and confiscating proceeds. It provides for international cooperation—mutual assistance, extradition, and the provision of information—in the investigation and prosecution of corruption. A novel element of this convention is active monitoring by the Group of States against Corruption (GRECO).

Council of Europe Civil Law Convention on Corruption. (European Treaty Series No. 174; <http://conventions.coe.int>). Open for signature on November 4, 1999, this Convention is the civil law counterpart of the Council of Europe's Criminal Law Convention on Corruption. It is the first attempt to define common principles and rules at an international level in the field of civil law and corruption.

The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (<http://www.oecd.org/daf/nocorruption>). Patterned on the longstanding U.S. Foreign Corrupt Practices Act and effective on February 15, 1999, this Convention commits 34 signatory countries to adopt common rules to punish companies and individuals who engage in bribery. The Convention makes it a crime to offer, promise, or give a bribe to a foreign public official in order to obtain or retain business. A related text effectively prohibits tax deductibility for bribe payments made to foreign officials. Twenty countries have already changed their domestic laws in accordance with the Convention.

The Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime. This Convention requires parties to the agreement to ensure that domestic law permits the seizure of property and bank records or transaction documents connected with suspected criminal activity, and criminalizes the acquisition, possession, concealment, or transfer of property one suspects as being involved in criminal activity. It further obliges signatory states to enforce confiscation orders made by a court of another signatory state, and to designate a central authority responsible for the communication with, and execution of orders of, other signatory states.

The E.U. Council Directive on Prevention of the Use of the Financial System for the Purpose of Money Laundering. This Directive requires member states to stop transactions in which money laundering is suspected and obliges financial institutions in their countries to obtain identity documentation from clients before opening accounts and to provide evidence of suspicious transactions to authorities.

Reforming Public Sector Management

A fifth building block consists of reforms in the internal management of public resources and administration to reduce opportunities and incentives for corruption. Reforming public sector management and public finance requires: instilling meritocracy and adequate pay in public administration; clarifying governance structures; enhancing transparency and accountability in fiscal management; and policy reforms in sectoral service delivery. In most cases, greater public oversight can play a key role in the reform process.

In part due to the legacy of the *nomenklatura*, the practice of political patronage in public administration continues to be an important source of corruption in transition economies. Political patronage can be a source of accountability to the patron, but it can also undermine continuity and the development of standards, institutional values, and memory in the public sector. This opens the way to conflict of interest, misprocurement, and theft of public funds. The short-term and uncertain nature of many political appointments also decreases the time horizons of public sector workers, creating incentives for predatory behavior.

A first step in reforming public sector management is to eliminate patronage by instituting *meritocratic systems* for appointment, promotion, and performance evaluation and, where feasible, establishing an independent civil service oversight body. Poland, Latvia, and Kazakhstan are now starting down this path. In parallel it will be important to increase salaries, relate them to skill and responsibility, and regularize the extensive nonsalary benefits that provide broad scope for discretion and corruption. This applies especially to CIS countries where average monthly salaries are often less than US\$30, although there are a host of *ad hoc* and uneven noncash allowances. Poland and Georgia, for example, allowed higher salaries for public servants who successfully cleared competitive examinations but fiscal and political constraints have prevented other countries from undertaking such reforms.

Review of governance and functional structures in ministries and agencies should also be a high priority. Especially in the CIS countries, administrative restructuring needs to focus on separating regulatory and economic functions. Some administrations have moved central government functions into quasi-private-sector structures. These structures blur the lines of policy direction and accountability and also create an unnecessarily large number of highly paid supervisory jobs which can serve to multiply political contacts and opportunities for pay-offs. Off-budget agency funding contributes to budget fragmentation and lack of transparency. There is also a small but important category of agencies, such as the committee on statistics, that should not be subject to political direction and whose independent functioning needs to be safeguarded. Such agencies need statutory protection, elimination of party political appointments, professional management, and freedom from political interference.

To improve transparency and accountability in fiscal management it is crucial to *ensure full budget coverage and control*. Both CEE and CIS countries (e.g., Azerbaijan, Latvia, and Poland) divert substantial resources into off-budget accounts that typically lack oversight and transparency. These off-budget transactions take different forms, from extra-budgetary funds to lack of integration of investment planning and external financing into the budget. In the Czech Republic and several other CEE countries, a further challenge is the significant magnitude of contingent liabilities stemming from nontransparent off-budget commitments.

Another challenge is to institute the key elements of a functioning budget system that ensures accountability. *Budget formulation* is often flawed by ambiguity between executive and legislative roles, poor parliamentary processes, lack of strategic policy coordination and consultation, and inability to impose trade-offs at the executive level. Expenditure projections lack a medium term perspective and revenue forecasts are unrealistic, leading to ad hoc and nontransparent adjustments during budget execution. Expenditures on defense and internal security tend to be even less transparent and accountable than other expenditures. Unclear appropriations and unreliable disbursements often leave public managers unable to deliver reliable services. They also undermine the accountability of budget managers and undermine monitoring and evaluation. Progress is being made but it has been slow and sporadic.

Reforms to promote greater accountability and control over budgetary expenditures *require robust accounting and auditing and a strong budget execution process*. *Treasury systems* are crucial here, and a challenge in many CIS countries and some CEE countries is to bring the bulk of public expenditures within the accounting and reporting framework of treasury systems. Investment in information technology—seen in the treasury, accounting, and audit systems in

Russia and Kazakhstan—needs to be well grounded in broader institutional reforms. Transparent and competitive *procurement* is essential to prevent corruption from inflating public expenditure. In this context, web-based procurement can be a valuable aid to transparency.

The effectiveness of *external and internal audit* entities varies greatly. In some countries such as Kazakhstan and the Kyrgyz Republic, the external audit entity is constitutionally dominated by the executive, thus limiting its independence and credibility. To be effective in reducing corruption, external audit must be independent and equipped with strong auditing and diagnostic skills, moving beyond individual fault to target systemic weaknesses. Internal audit also needs to be developed further. Parliamentary and public oversight needs to be strengthened, with public dissemination of audit findings and scrutiny by Parliamentary Audit committees—which too often do not exist.

Corruption in *customs and tax administration* lowers state revenues, creates a distorted private sector environment, and is often linked with smuggling and organized crime. Reforms to simplify tax policy and eliminate discretionary exemptions help, as do professional staff, standardization of forms and procedures, and transparent systems such as the use of computerized risk analysis at the borders. It is important to eliminate one-on-one contact between taxpayers and officials and ensure that operating and management systems are efficient and easily monitored, including through periodic taxpayer surveys.

Finally, administrative corruption can be profoundly damaging to the level and quality of *service delivery* across key sectors. It is often deeply rooted in distorted policies, as illustrated in the energy and health sectors. Corruption, for instance, plagues the interface with customers and lies behind the low collection rates reported by many electricity, gas, and district heating companies. In Azerbaijan, the state-owned Baku Electricity Company reports a household collection rate of 12 percent despite employing 1,000 payment collectors. Sale of the distribution company (Armenia, Georgia, Moldova, Poland, and Ukraine), or privatization/management contracts (Albania, Azerbaijan, Bulgaria, Estonia, Latvia, Romania, and Russia) can help, as long as tendering and contracting processes are transparent and contract execution can be monitored. Reducing noncash transactions including barter and arrears offsets can also reduce private rent-seeking, as noncash exchange at artificially inflated rates is a standard method of extracting private gains.

Health services are characterized by interdependence of supply and demand, asymmetric information, gatekeeper power, divergence between public and private interests and incentives, and other characteristics that provide fertile ground for corruption. Patients, especially the poor, are in a uniquely weak position to counter these difficulties. Remedies include a set of reforms in health care financing, together with complementary measures to reallocate resources to priority areas, reduce waste in the health system due to malpractice in the procurement of equipment and pharmaceuticals and a variety of other abuses, and strengthen the professionalism and pay of health care personnel. Most importantly, health care systems require basic oversight and accountability (see Box 4.10).

Box 4.10: Tackling Informal Payments and Structural Reforms in the Health Sector

Informal payments in the health sector in CEE and CIS are a frequent and growing practice and an impediment to health care reform. Survey data in 1999 show that informal payments for inpatient care were about US\$160 on average per visit in Kazakhstan. In the Kyrgyz Republic these payments had to be made in about 85 percent of visits. Solutions to the increasingly entrenched practice of informal payments will need to reach deeply into the structures of the sector and society:

- Governments must make clear that side payments and other "off-budget" exchanges between public employees and citizens are unacceptable and not to be tolerated. Without a clear policy framework that clarifies the government's position regarding informal payments, it is difficult for a single sector, such as health, to do so. National perceptions can also be at odds with policy in the health sector. For example, despite national policy against informal charges, the recently revised Code of Ethics of the Hungarian Medical Association does not condemn such practices, making them extremely difficult to root out.
- Existing public health systems are bloated and inefficient. In an effort to retain the largesse of the past in the face of budget constraints, there has been a bias toward maintaining past facilities without culling assets, personnel, or services to maximize resource use. The result is a high level of fixed assets alongside inadequate funding for salaries and equipment, leading to alternative sources of funding among front line providers. Closing down redundant hospital capacity and reducing overstaffing should offer the opportunity to reduce costs and raise the salaries of remaining doctors and other medical personnel. In the Czech Republic and Slovenia the number of physicians has declined somewhat (although further reductions are needed) and their earnings have exceeded or kept pace with growth in overall wages; side payments to physicians now appear less common than in the other countries in Eastern Europe. Higher earnings may offer a possible, partial solution at least in some settings. However, this is unlikely to be a solution in itself. Effective strategies could include voluntary severance pay schemes and establishment of loan funds to encourage the development of private medical practice, alongside the introduction of medical standards and disallowance of outdated medical practice by those unable to master basic skills.
- Governments need to be aware that comprehensive, free services cannot persist in a budget-constrained environment. In addition to contracting capacity and raising salaries there needs to be an acknowledgement that government cannot afford everything that is in place. This means either that the scope of services and fixed assets in use need to be reduced and/or that users be required to cover the costs of some aspects of care.
- Health systems require oversight and accountability for all providers with swift punishment for transgressors. Performance is both hard to measure and a new concept in health care. However, achieving a more affordable, fair, and equitable system requires that relative performance be assessed and that performance benchmarks be set and providers held accountable for results. Fundamental to this are use of acceptable accounting standards, procurement rules, and ex-post auditing of hospital accounts combined with tools to ensure that hospital managers comply with national policies regarding informal payments. Experience shows that the development of professional medical associations and peer review can help raise standards. Policy statements in the absence of monitoring and enforcement has proven and will continue to be ineffective in reducing the prevalence of informal payments.
- Private services are increasingly being seen as alternatives. The weakness of public health services has led to a search for alternative care, but much of the "private care" is currently either financed partly by government or uses public infrastructure and equipment to treat private patients. For many countries, especially the poorest, rationalizing and raising standards in public health services will remain the highest priority. Development of genuinely private health services will require a framework to regulate and monitor the quality, reliability, and cost-effectiveness of care, determine issues relating to access, and provide transparent criteria for licensing and monitoring private health insurance funds.

Based on Lewis (2000).

Decentralization of service delivery can in principle make the state more responsive to the needs of the people and to improve service delivery. However, in countries where the accountability and capacity of subnational governments is weak and there are few safeguards against the manipulation of municipal assets and enterprises for the private gain of local officials,

decentralization can actually increase corruption, bias resource allocation, and adversely affect access and quality in basic social services. This has occurred in parts of Central Asia, the Caucasus, and Baltics. In many CIS countries, improving accountability at the local level for local expenditures and to the central government in cases where expenditures are only administered by the local level (deconcentration) is a necessary first step. Reform efforts should strongly focus on creating regional/local capacity in financial management and auditing, before (or while) the decentralization process gets underway.

In parallel with reforms in sector policy and institutions, strengthening public oversight over the quality of service delivery can promote improvements in certain contexts. In Armenia, Latvia, and Albania, civil society groups have initiated periodic *user surveys* of service delivery, published findings, and ranked public entities according to their efficiency, integrity, and adherence to service standards. This has provided a powerful impetus for internal reorganization to realize efficiency gains, develop performance standards, and sow the seeds of transformation from a command and control orientation to one of service delivery and accountability.

The Multi-pronged Approach

Taken together, the five building blocks of a multi-pronged approach to combating corruption might appear overwhelming as they entail significant changes in the structure of existing economic and political institutions, in the nexus of relationships within the state and between state and society, and in the existing policy practices of governments. No government has the capacity to simultaneously pursue reforms in all these areas. Moreover, in the transition countries, the legacies of communism, the underdevelopment of public administration, and the political constraints holding back reform heighten the magnitude of the challenges.

To be effective, a multi-pronged approach requires some guidelines for the selection and sequencing of reform priorities tailored to the particular contours of the corruption problem in each country. Feasible entry points need to be identified. Coalitions of support for anticorruption efforts need to be assembled. A strategy of operationalizing reforms needs to be developed. These issues are addressed in the following chapters.

¹ The box on political party financing is based on: De Winter (1999), Kaid and Holtz-Bacha (1995), King (2000), Pujas and Rhodes (1999), and Rhodes (1997).

² Galligan and Smilov (1999).

³ This section is based on Paul (1999).

⁴ Although home-grown, many received donor support.

⁵ The project is supported by the World Bank and by the Canadian International Development Agency.

⁶ This section is based largely on Nelson and others (1999).

⁷ The Glasnost Defense Foundation (www.gdf.ru) maintains a *Memorial Book* containing the names of 209 news people who lost their lives performing their professional duties. Cited in Nelson and others (1999).

⁸ McCormack (1999).

⁹ Nelson and others (1999), p. 8.

¹⁰ Nelson and others (1999), p. 8.

¹¹ Dow Jones & Co., publishers of the *Wall Street Journal*, and the Pearson Group, publishers of the *Financial Times*, teamed up with *Moscow News* to create the new daily in 1999. Nelson (2000).

¹² See Annex 1.

¹³ This section draws heavily from Broadman and Recanatini (2000).

¹⁴ As determined by the recent EBRD Business Environment and Enterprise Performance Survey, Hungary has one of the most active governments, ranking 3rd (out of 20 countries) in the State Intervention Index.

¹⁵ Ewa Balcerowicz, Leszek Balcerowicz, Iraj Hashi, eds., "Barriers to Entry and Growth of Private Companies in Poland, the Czech Republic, Hungary, Albania and Lithuania," CASE Reports No. 14, 1999.

¹⁶ This section draws heavily from Broadman and Recanatini (2000).

¹⁷ See Annex 1.

¹⁸ See Hellman, Jones and Kaufmann (2000b).