

# Executive Summary

In the 16 years since the start of transition in the former socialist economies of Europe and Central Asia, few issues have risen as rapidly in visibility as corruption. Reforms in the early 1990s were focused on macroeconomic stabilization, price and trade liberalization, privatization, and establishment of the legal foundations of a market economy. Institutional reforms to ensure accountability, transparency, and public sector effectiveness often took a back seat. But while corruption was barely mentioned at the start of the 1990s, by the end of the decade it had come to be recognized as a central challenge to progress in many countries in the region. Corruption has been an important issue in the discussions surrounding EU enlargement, has figured prominently in political campaigns, and has been a key concern of citizens, businesses, and international organizations alike. Leading reformers have in turn paid greater attention to governance issues generally and corruption in particular in recent years.

This report is the third in a series of studies<sup>1</sup> since 2000 that examines patterns and trends in corruption in business-government interactions in Europe and Central Asia and the progress achieved by countries in addressing it. All three studies have drawn on data from a large-scale survey of enterprises undertaken jointly by the European Bank for Reconstruction and Development and the World Bank—the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS). More than 20,000 firms have been interviewed over three rounds of the survey (in 1999, 2002, and 2005), yielding in-depth cross-country and time-series data on many aspects of the business environment,<sup>2</sup> including the frequency and cost of bribes paid by different types of businesses in various interactions with government.

## Continued improvements in many countries

The key finding of this report is that in quite a few of the transition countries of Europe and Central Asia, firms reported a smaller incidence of corruption in 2005 than they had three years earlier, continuing the trend established by

earlier surveys.<sup>3</sup> In many countries, firms are paying bribes less frequently and in smaller relative amounts (as a share of firm revenues) than in the past, and they view corruption as less of a problem for the operation and growth of their business than in 2002 (see Figure 1). Among countries showing the most dramatic improvements are Georgia and the Slovak Republic, where committed leaders are implementing strong programs of economic and institutional reform and firm-level bribery has fallen substantially. Romania and Bulgaria are also seeing some success, which bodes well for their entry into the European Union, and improvements are evident along some dimensions in Moldova, Tajikistan, Ukraine, and Latvia (an early leader in tackling corruption), as well as several other countries.

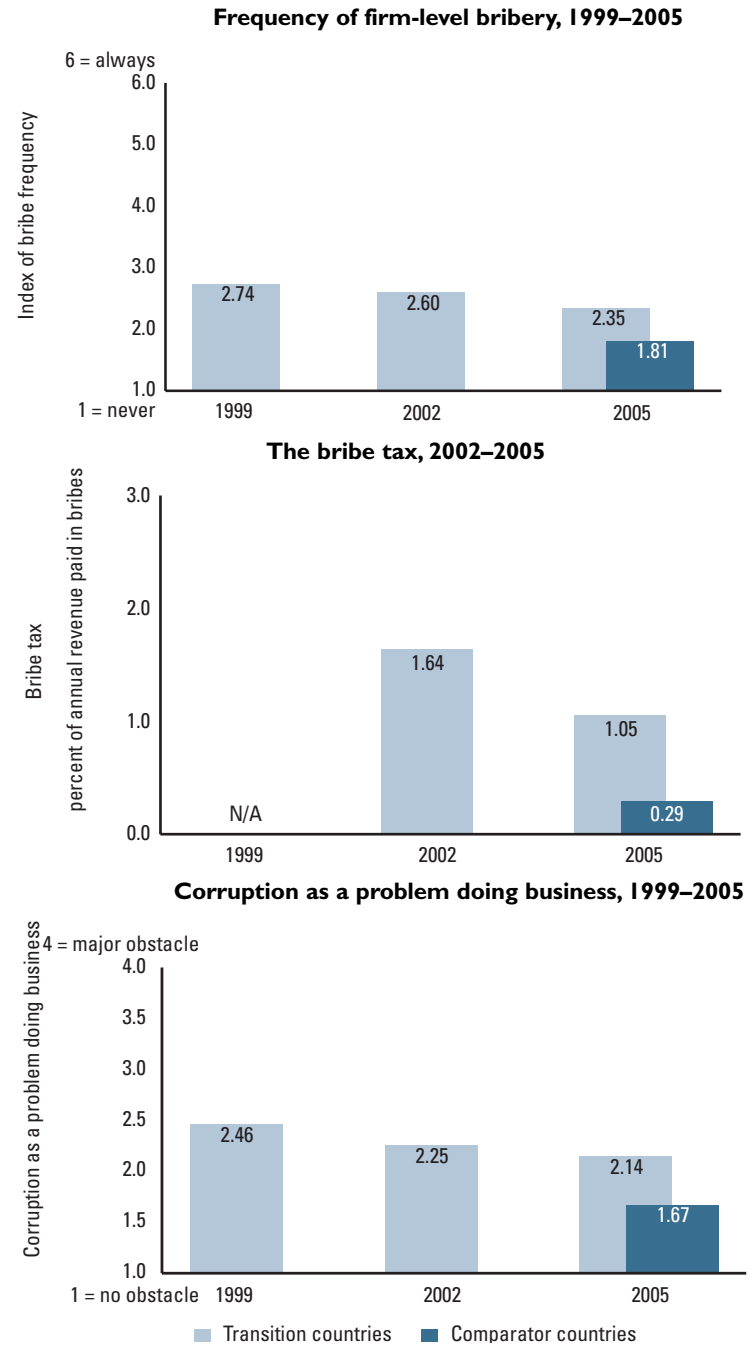
Improvement can be found in every subregion, though not in every country. Firms reported increases in the frequency of bribery in Albania, Serbia and Montenegro, and the Kyrgyz Republic (which had a revolution right at the time of the survey), and corruption was seen as a bigger problem for business in 2005 than in 2002 in Azerbaijan, the Czech Republic, and Russia. Albania and the Kyrgyz Republic continued in 2005, as in 2002, to have the worst corruption indicators of the 33 countries surveyed.

For the first time in 2004/5, the BEEPS also was conducted in a number of nontransition countries, including five European comparators: Greece, Ireland, Germany, Portugal, and Spain. A sixth comparator country, Turkey, has been included in all rounds of the survey. The results confirm the widespread assumption that corruption tends to be worse in transition countries than in Western Europe, indicating that most transition countries—including the eight new members of the European Union in Central and Eastern Europe—still have a way to go in improving accountability in government. However, along some dimensions of corruption the nontransition European comparators—most notably Greece and occasionally Portugal, Turkey, and the eastern part of Germany—fared worse than many transition countries.

## **Firm characteristics, institutions, and political systems**

Corruption does not affect all firms equally. New, private, domestically owned firms are likely to pay the most in bribes (as a share of revenues)

**Figure 1 Indicators of firm-level bribery**

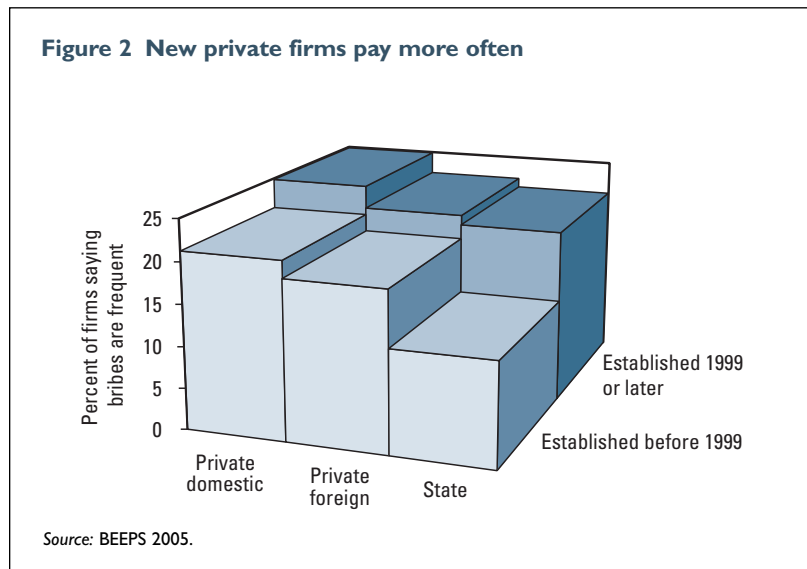


Source: BEEPS 1999, 2002, 2005.

and pay bribes the most frequently (Figure 2). Foreign-owned firms pay less in bribes, as do larger or older firms, state-owned firms, and firms in smaller towns or rural areas. This uneven incidence of bribery threatens to undermine the growth of small and medium enterprises, which are the engines of economic growth, diversification, and private-sector development throughout the region.

Corruption continues to be higher in countries where policies and institutions are weak. While richer countries tend to have better institutions and lower corruption, there is no evidence that faster economic growth reduces corruption in the short run. Indeed, state capture may be exacerbated by faster growth, particularly if such growth is driven largely by natural resource sectors as in some countries in the region.

Patterns of corruption are more complex in countries where transition is still at a relatively early stage. Firms in countries such as Belarus and Uzbekistan report lower levels of bribery in the BEEPS than one might expect based on indicators generated by experts. Such discrepancies could reflect different definitions of corruption: Open bribery may be limited due to the small size of the private sector and the stronger control environment, but corruption may still be widespread, manifest through direct state control of economic activity for the benefit of elites. Alternatively, actual bribery may be higher than firms are willing to report in an atmosphere where civil liberties are constrained. In either case,

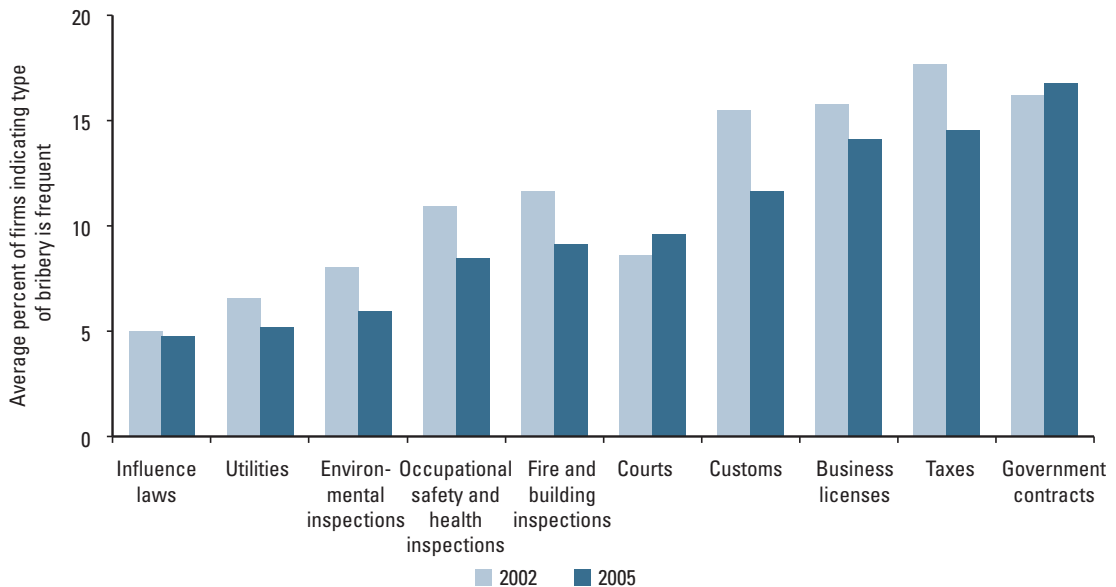


fundamental progress in improving governance is unlikely without reforms to foster more open, transparent, and competitive economic and political systems.

## Progress in some areas, but not others

The generalized story of improvement in transition countries becomes more fragmented when focusing on specific types of enterprise-state interactions. Trends in corruption related to taxes, customs, and business licensing tend to be favorable, but trends in other areas, notably government procurement and the judiciary, do not show improvement (Figure 3). The disparity in performance is not random: Areas that have received the most attention from reformers have typically shown more improvement, while those that are the most complicated or are beset with conflicting objectives have shown less.

**Figure 3 Progress in some areas, but not others**



Source: BEEPS 2002, BEEPS 2005.

Taxation has been one of the most visible areas of reform in recent years. Chronic tax evasion in the 1990s was driven in part by high and steeply progressive rate structures, and several countries in Europe and Central Asia took the lead world-wide in moving to low- or flat-rate income taxes in the late 1990s and early 2000s. These tend to be the same countries that have seen the largest declines in both corruption in tax administration and tax evasion. In the Slovak Republic, for example, a comprehensive tax and benefit reform did not result in significantly lower collections despite a decrease in rates. The BEEPS confirms that Slovak firms say they are evading taxes less often than in the past and that bribery in tax administration has declined. More generally, countries with less burdensome tax regimes tend to have lower levels of corruption in tax administration.

Two other areas where reforms are leading to lower levels of corruption in some transition countries are customs and business regulation. In southeast Europe, a multinational effort to streamline customs procedures and improve efficiency at border crossings is reducing clearance times at the borders while also helping to lower corruption. Indeed, the southeast Europe region showed more improvement from 2002 to 2005 in levels of bribery at customs than any other region. In the area of business regulation, reforms to reduce the burden on firms have included one-stop shops; streamlined, one-day business registration; and limits on the number of inspections per year. Cross-country evidence shows that countries with less burdensome regulatory systems tend to have lower levels of corruption. Most transition countries have seen improvements in the area of inspections, while the story for business licensing and permits is somewhat more mixed.

One area that has not seen overall improvement in firms' assessment is the courts. Only a handful of countries saw significant reductions in corruption in the judiciary from 2002 to 2005, and a similar number saw increases. Judicial reforms tended to take a back seat in the 1990s to other areas of institutional reform, although this is now changing, particularly in EU candidate countries. Where attention was given, judicial independence was typically a higher priority than accountability or capacity. Establishing independence without ensuring accountability can open the door to widespread corruption, which appears to have occurred in some settings. The continued large disparity in judicial integrity between transition and comparator countries and the lack of improvement in the former suggest that this relatively neglected area of reform should receive greater attention.

Progress is also lagging, according to firms, in the area of government procurement. While a few countries saw significant improvements from 2002 to 2005, corruption appears to have worsened in others. As the region continues to develop and larger investment projects become more feasible, the temptation for corruption in government procurement will get even worse. Even in the most advanced countries with sophisticated procurement systems, corruption scandals often surround procurement transactions. Indeed, some of the European comparators have higher levels of unofficial payments related to procurement than several of the transition countries. Improving procurement systems—focusing on transparency, competition, and standardization—must be a key priority for governance reforms in the coming years.

Finally, many transition countries have adopted cross-cutting legislation that requires top officials to publicly disclose their income or assets and restricts the scope for conflict of interest. Many have also adopted freedom-of-information laws, and some have strengthened systems of financial audit or established anticorruption commissions. Often these laws are elements of national anticorruption strategies. Anecdotes of successes and failures abound, and critics sometimes deride these initiatives as superficial. Reforms in some areas—such as financial audit and control—appear to have helped to reduce corruption, while reforms in other areas—such as asset monitoring—have a more mixed record, possibly due to variation in design and implementation. One striking finding is that current levels of corruption are more closely correlated with the anticorruption institutions in place in 1995 than they are with those put in place more recently, a reminder that progress takes time.

## **External and internal drivers of change**

As corruption becomes ever more prominent in the league of development ills, the importance of monitoring corruption and the institutional frameworks being employed to fight it becomes ever greater. For the transition countries of Europe and Central Asia, such monitoring has shown that policy and institutional reforms can have dramatic effects. Throughout much of the region, the past few years have seen strong economic growth and accelerating reforms in economic policies, public institutions, and the business environment. Firms, by and large, are reporting lower levels of corruption than they have in the past.

The trend is favorable but by no means irreversible. Even the world's most advanced countries must be constantly on the watch to control corruption. Continued progress in transition countries will require persistent attention to weaknesses and to new challenges as they arise. Greater attention needs to be paid to judicial and procurement reforms, among others. Regulation of conflicts of interest remains weak in many countries, and systems of asset monitoring vary greatly in implementation. Improvements in financial audit and control seem to be having some effect in reducing corruption, but they need further strengthening. Excessive immunities, the least improved area of anticorruption policies in the past decade, continue to render some politicians untouchable.

What forces have underpinned successes? First, the external environment—most notably the goal of joining the European Union—has had a major impact in stimulating anticorruption efforts in accession candidates such as Romania and Bulgaria. Indeed, the desire to meet European standards is a motivator for governance improvements far beyond the borders of the EU.

Second, the internal political system inevitably defines the incentives and sets the boundaries within which policies and institutions are formed. The opening up of closed political systems may lead to an expansion of some forms of corruption in the short term, but over time more political and economic competition helps foster the transparency and accountability that is essential for controlling corruption.

Finally, individuals matter, and strong leadership is essential in shaping and pushing reform. Every country that has achieved some success on the anticorruption front has had leaders who have tenaciously pushed the reform agenda. Romanian leaders recently strengthened the asset declaration law and have worked to support prosecutors who are keen to tackle corruption. Key Slovak leaders were instrumental in pursuing far-reaching tax and budget reforms. The Georgian government has doggedly pursued fundamental reforms in many areas since the Rose Revolution in late 2003. Leaders cannot expect to eliminate corruption, but the experience with reforms in Europe and Central Asia shows that leaders with strong commitment, courage, and support can make important strides in a relatively short period of time.

## Notes

1. The first two studies were *Anticorruption in Transition: A Contribution to the Policy Debate* (2000) and *Anticorruption in Transition 2: Corruption in Enterprise-State Interactions 1999-2002* (2004).
2. For more information on the BEEPS, see [www.worldbank/eca/econ](http://www.worldbank/eca/econ) or [www.worldbank/eca/governance](http://www.worldbank/eca/governance).
3. Neither the BEEPS nor this report address corruption in the delivery of public services to individuals and households, and patterns and trends in corruption affecting households are not necessarily the same as those affecting businesses. There is some evidence, however, that the favorable trends in firm-level corruption between 2002 and 2005 may apply also to corruption faced by households. Transparency International's *Global Corruption Barometer* (TI-GCB) surveyed citizens in 20 of the countries covered by the BEEPS. Average responses related to health, education, and the police—the three sectors that households are most likely to encounter—showed an overall decline in perceptions of corruption between 2004 and 2005. Country-level changes were correlated with changes in bribe frequency and bribe tax as measured by the BEEPS, driven largely by Georgia, which shows improvement in both the BEEPS and the TI-GCB (Transparency International, 2004, 2005).