

Department of Economic and Social Affairs
Division for Public Economics and Public Administration

ECONOMIC GOVERNANCE: GUIDELINES FOR EFFECTIVE FINANCIAL MANAGEMENT



NOTES

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The designations “developed” and “developing” economies are intended for statistical convenience and do not necessarily express a judgement about the stage reached by a particular country or area in the development process.

The term “country” as used in the text of this publication also refers, as appropriate, to territories or areas.

The term “dollar” normally refers to the United States dollar (\$).

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FOREWORD

Good governance is considered synonymous with sound development management. However, economic governance of national state is facing serious problems because its traditional sovereignty over economic affairs has been imperceptibly eroded to other levels of world economy. Globalization represents a growing constraint on countries to utilize their own country-specific national policies which can be overridden by the power of foreign government and foreign based multinational corporations. As a result, the search for effective governance has to proceed at the institutional and territorial levels, in addition to the nation state.

The slow economic growth in developing and transitional economy countries and its negative global implications has alerted the international financial organizations to promote and implement action-oriented responses to enable these countries to enhance financial resources mobilization and their efficient, effective and rational utilization to achieve sustainable economic development with social justice.

Developing and countries with economy in transition have recognized the need to reorient their tax systems and strengthen their administrative capacity with a view to closing the “compliance gap”, being the gap between actual and potential revenues. While tax reform has generally come to mean the redistribution of existing burdens downward, cutting back tax expenditures and broadening the tax base, in recent years, these policies have been pursued in the context of intense competition for capital investment consequent upon globalization of financial markets.

Another important constituent of economic governance – public expenditure management has its approaches and recommendations solidly anchored on the economic, social, administrative and implementation capacity realities of the country concerned. With a view to ensuring that the government’s financial resources are used lawfully, efficiently and effectively and with transparency and accountability, it would be necessary to devise strategic method of public financial management and control.

The reduction of the role of government in the economic sphere and the recognition of private sector as ‘engine of economic growth’ has meant that government has a new vital role in creating an effective legal and regulatory framework in which private sector will be enabled to operate.

The need to evolve basic principles and guidelines for ensuring effective economic governance in developing and transitional economy countries cannot be overemphasised. I am happy to note that the Public Finance and Private Sector Development Branch has made a commendable contribution by bringing out this publication on this topical subject. I am sure that public officials, academic community and research students concerned with this subject will find this publication of considerable interest and will stimulate further study and research.

This study was prepared for the Public Finance and Private Sector Development Branch by Suresh Shende, Interregional Adviser in Resource Mobilization. The views expressed are those of the individual and do not imply any expression of opinion on the part of the United Nations.

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EXECUTIVE SUMMARY

There is widespread awareness that lack of accountability, good governance and transparency in government operations impede the progress towards sustainable economic development. Traditionally, international financial organizations have advised member countries to pursue sound economic policies – policies that promote growth through low inflation, sound and prudent monetary and fiscal policies and a sustainable balance of payments position. Presently, in the context of changed economic environment, it is necessary to broaden the scope of the economic policies to include other elements, popularly known as “second generation reforms” which are considered vital for economic growth and financial stability, namely:

1. Reduction in extravagant and unproductive government expenditure;
2. Higher spending on primary health and education; and adequate social protection for the poor, the unemployed and other vulnerable underserved sections of the society;
3. The creation of a more level playing field for the private sector activity, by increasing the openness, stepping up the privatization process, reducing the power of monopolies through appropriate legal and administrative measures, and setting up more transparent and simpler legal and regulatory systems and frameworks;
4. Stronger banking sector which protects small savers and other depositors, and reduce risks for shareholders and creditors by enforcing stricter prudential standards and information disclosure requirements;
5. Reform of tax systems to make them more efficient, effective, equitable and fairly comprehensible; and
6. Greater transparency and accountability in government and corporate affairs.

These elements could be considered to constitute the basic framework of good economic governance.

The concept of governance in the context of promotion of sound and sustainable economic development comprises of efficient government, effective civil society and successful private sector. Good governance is based on participatory and democratic traditions, promotion of equity and equality, gender balance and promotion of synthesis of diverse perspectives and mobilization of resources for social purposes, and in the final analysis based on the rule of law. Effective economic governance, in this context, would seek to evolve well structures, harmonious and complementary fiscal, monetary and trade policies and establishment of monitoring and regulatory authorities for promotion and coordination of difference economic activities.

“Corruption” most often applied to abuse of public power by politicians and civil servants for personal gain, is motivated by greed and by the desire to retain or increase one’s power. Controlling corruption has emerged as one of the most important concerns within the international community. Corruption is a pervasive phenomenon which can be found in a wide spectrum of countries of vastly differing ideologies, economic conditions and social development. There has been unmistakable attitudinal change towards corruption: governments have become unable to conceal evidence of corrupt practices, level of public tolerance for corruption has declined and spread of democratic process affords less opportunities for practising corruption. Higher public investment, regimes of regulations and authorizations, higher taxes, trade restrictions, lower salaries of public officials and other discretionary powers wielded by public officials are the main causes of corruption. The economic consequences of corruption are increased transactions costs and uncertainty, inefficient economic outcomes, undermines State’s legitimacy, hampers growth of competitiveness and affects the performance, integrity and effectiveness of government institutions. Developing and transitional economy countries should establish proper institutional framework for fighting corruption and enhance the morale of public officials by meeting out strict punishment to corrupt officials

Developing countries with economy in transition must grapple with the problem of maximizing the mobilization of financial resources from both domestic and foreign sources and ensuring that they are used in the most efficient and productive manner to benefit all sections of the population, and that public financial operations are reliably and promptly accounted for to inspire the confidence among the citizens and foreign donors and investors.

Fiscal policy plays a major role in promoting and sustaining stabilization and growth, in the context of close interdependence between fiscal, monetary and external sector policies. Weak fiscal discipline, on the other hand, in an unstable economic environment may give rise to large fiscal imbalances which are financed through inflation. Many countries run fiscal deficits to finance their public expenditure because their tax bases are too limited to allow a high tax burden. Even when broader tax bases are available, tax administrations are too inefficient to collect taxes legally due. Widening of the tax base through legal and administrative means is an effective answer to realize the full tax revenue potential. Greater efficiency in the collection of taxes can reduce the budget deficits, halt the deficit financing and consequential inflationary pressures. Higher inflation has critical allocating and distributional implications that impede growth and encourage capital flight.

Tax evasion and tax avoidance at both national and international levels have serious implications for fiscal policy, in that they violate the principle of fiscal equity and undermine the concept of voluntary compliance with tax laws. They can greatly diminish the value of codified tax incentives and thereby affect allocative behaviour to thwart redistributive programmes, create artificial biases in macro-economic indicators and increase tax burden when tax rates must be increased to offset the revenue losses incurred, thereby imposing an unfair burden on taxpayers who cannot shift their tax liabilities. Taxpayers have experienced the futility of paying taxes, since in many countries, the public expenditure has failed to yield commensurate benefits to the population at large. The scope of measures adopted by tax administrations to combat tax evasion and avoidance, varies according to the characteristics of the country concerned, its legal structure, its political

structure and other factors. These measures have included greater reliance on indirect taxes, reliance on declarations and withholding of taxes by third parties, cross-checking of information, auditing of cases, as well as enactment and enforcement of penalties. International tax evasion and avoidance can be countered by conclusion of bilateral tax treaties providing mutual assistance and exchange of information.

As observed by the Group of Experts on Public Administration and Finance, in many countries, financial management capabilities have been eroded by the pursuit of financial populism ineffective and distorted budgetary mechanisms and breakdown of existing financial management institutions. The countries will have to harmonize methods of strategic management and control of aggregate financial variables with processes for changing expenditure priorities and enabling effective and innovative management of service delivery institutions.

Financial management reforms typically incorporate the following components, namely use of structured planning and programming as a means of evaluating and selecting ways of achieving desired objective; taking resource allocation decisions within the framework of a unified budget; integration of budgeting and accounting; encouragement of financial accountability; preparation of consolidated reports and measurement of outputs and inputs. The scope of public accounting systems may be extended to establish multiple accounting structures to generate data required for managing public affairs and measure the cost, performance and productivity of government programmes and projects. At times, the performance of traditional audit is hampered by weakness of the accounting systems, lack of trained auditors, insufficiency of financial resources allocated for audit, absence of clearly defined audit standards, and less than full independence enjoyed by audit authorities. A comprehensive methodology of evaluation incorporating target efficiency goals, target efficiency-related reporting and analysis needs to be developed to facilitate audit of performance and link it more closely with programme and project implementation. In short, a sound public financial management system must be supported by an appropriate audit system which will determine how public resources have been used,

evaluate the results achieved with those resources and verify compliance with legal accounting and administrative provisions and procedures.

The advent of globalization coupled with liberalization of international capital markets has engendered critical problems in the domestic and international financial systems, including financial sector vulnerabilities, in the form of unsound financial and banking systems and deficiencies in financial incentive structures, institutions and policies with widespread loss of confidence in financial markets. This situation has highlighted the need for establishing regulatory oversight and market discipline as complementary means for achieving a stable and robust financial system. Supportive legal and regulatory environment, strong internal governance, external discipline provided by market forces as also external governance provided by regulation and supervision at both domestic and international levels are the attributes of a sound financial system. The growing accent on privatization has imposed new tasks on governments, such as, setting up legal and regulatory framework, regulation of monopolies, protection of consumers and in

general, creation of necessary environment for private sector to operate efficiently. In short, there is a growing awareness amongst financial system regulators to develop a consistent international framework of financial and supervisory standards and best practices to promote strong and healthy financial systems in all countries.

In conclusion, it has been acknowledged that sound governance is essential for ensuring sound and sustainable human development. The challenge facing all countries is to create a system of economic governance which promotes the process of decision making which directly or indirectly affect a country's economic activities or its relationship with other economies. Developing and transitional economy countries will have to strive to reduce, if not eliminate altogether, the subversive impact of corruption in its economic activities, establish strong institutional framework and strengthen the administrative and technical capacities of its public administrators to achieve sustainable socio-economic development.

1. INTRODUCTION

There has been a perceptible growth of awareness amongst the international development organisations, national governments and the academic community about the impediments to the economic development process caused by lack of accountability, good governance and transparency in government operations. The consequences flowing from the absence of any of these factors in the developing countries and transitional economies have manifested themselves through lack-lustre performance on the economic front, erosion of public confidence in the ability of the government to raise the living standards of the population and calling in question the development strategies adopted thus far by these countries in conjunction with the developed countries and international organisations through bilateral and multilateral aid programmes. Indeed, despite the presence of natural, material or financial resources in some of the developing or transitional economy countries, they have not been instrumental in significantly changing the conditions of life of a vast majority of the population primarily as a result of the absence of accountability, good governance and transparency in government operations.

Good governance consists of effective and well co-ordinated efforts directed to achieve optimum results through a harmonious blending of natural, material, human and financial resources for increasing the socio-economic welfare of the population. Good governance has necessarily to be complemented by strict accountability and transparency in government operations. While the developed countries have been able to harness their abundant physical and financial resources through good governance to establish firm foundations for their economic and social infrastructure, developing and transitional economy countries will have to incorporate lessons of good governance to implement their development strategies. While good governance encompasses the idealistic and all-pervasive attributes which promote socio-economic welfare of the population at large, we have a limited task of identifying the factors which are applicable to good economic governance and that too, further restricted to laying down guidelines for effective financial management.

Good governance, and more particularly, economic governance, necessarily implies utmost integrity, moral rectitude and probity in public life on the part of persons entrusted with responsibilities in

all spheres of the national life. The basic structure of civilised life in a society is dependent upon the ability to govern according to the will of the people in a democratic way. Hence, the basic concepts of good economic governance will involve a democratic structure, adherence to the principles of morality, and efficiency and effectiveness of operations to ensure sound financial management. In this context, the principles of good economic governance appear highly relevant for developing countries and transitional economies embarking on programmes for sustainable economic development.

Developing countries and transitional economies situated in different continents have vastly different economic background, potential and aspirations. Similarly, notions of democracy and morality differ from country to country, although the basic ingredients of both these concepts are relatively non-controversial. It would be indeed difficult to lay down a common framework of good governance applicable to all developing countries and transitional economies.

Hence, this publication has the modest ambition to identify all such precepts of good economic governance which may appear to be so basic, fundamental and non-controversial that they may be found useful by these countries. In the ultimate analysis, good economic governance will be conditioned by effective economic policies, adequate institutional and regulatory framework and efficient and well-trained administration. As the emphasis here is on laying down guidelines for effective financial management, there is the further requirement of appropriate setting of the fiscal policy within the overall framework of harmonious and well co-ordinated monetary and trade policies along with the fiscal administrative set-up which possesses the attributes of efficiency and effectiveness.

Every effort is being made to explain in a cogent and intelligible manner the basic canons of good economic governance with special emphasis on efficacious financial management techniques, applicable primarily to developing countries and transitional economies.

2. CONCEPT OF GOOD GOVERNANCE

Governance in broad terms signifies the exercise of political, economic and administrative authority to manage a nation's affairs comprising the complex range of mechanisms, processes,

relationships and institutions through which citizens and groups articulate their interests, exercise rights and obligations and mediate differences. Governance is not the sole prerogative of the State but its functions could be assumed by or delegated to specified institutions and organizations in the private sector and the civil society. Such organisms operate in a legal or policy framework defined by the State but having autonomous existence and exercise political, economic and administrative authority.

There is consensus amongst international development organisations that good governance is the basic pre-requisite for sustainable economic development. In fact, capacity building for effective and sound governance is a primary means of poverty reduction programmes. Considering the diversity of attributes of physical and financial resources possessed by different developing countries and transitional economies as also their own perceptions of sustainable economic development, there would be different approaches to the question of appropriate governance strategy for each of these countries. The expression sustainable economic development has been defined in the Brundtland Commission Report (1987) as the meeting of the needs of the present generation without compromising the needs of the future generations, while UNDP regards the human development as a process of enlarging the choices for all people in society. Moreover, it gives the highest priority to poverty reduction, productive employment, social integration and environmental regeneration.

The concept of governance in the context of promotion of sustainable economic development comprises of the efficient government, effective civil society and successful private sector. Good governance has many characteristics. Good governance systems are **participatory** in that the members of governance institutions have a voice in the decision-making process based on **democratic** traditions. The procedures and method of decision making reflect **transparency** to ensure effective participation. The governance system aims at bringing about **sustainable** development. Good governance **promotes equity and equality** of treatment to all based on the concept of non-discrimination. The basic consideration in good governance is being able to **develop the resources and methods of governance**. In the context of social development parameters, it promotes **gender**

balance, promotes **synthesis of diverse perspectives** and **mobilises resources for social purposes**. Good governance strengthens **indigenous mechanisms** and **ensures effective and efficient use of resources**. All civilised societies are **based on rule of law** which promotes good governance. Good governance **engenders and commands respect and trust**.

The persons entrusted with the task of taking decisions in government, private sector and civil society organisations have to be **accountable** for their actions to the members of public and institutional stakeholders. Governmental organisations have to be **service oriented**, responsive to the hopes and aspirations of the people, act as **facilitative and enabling, regulatory rather than controlling**, take ownership of solutions to national social problems and able to **deal with temporal issues**.

One of the major problems before the developing countries and the transitional economies is to create a conducive economic environment for economic growth and social progress. Each country must ascertain and evaluate its stock of natural, physical and financial resources and formulate its strategy for economic growth on the basis of its ability for capacity building, resource mobilisation, strengthening of the institutional framework and administrative capability. There should be positive steps taken to promote private sector development by creating conducive atmosphere for its nurture and healthy growth. Wherever possible, attempts should be made to encourage and foster private-public sector partnership and establish adequate legal and regulatory framework to provide a level-playing field to both public and private sectors of the economy.

Economic governance consists of the entire institutional framework of the government engaged in the evolution and implementation of the general economic policy in all its manifestations affecting its internal and international economic relations. Economic governance would also necessitate evolving on a permanent basis harmonious fiscal, monetary and trade policies and establishment of a monitoring authority for effective co-ordination between different economic activities. In the interest of decentralisation of functions, the central bank of the country should be endowed with a great deal of autonomy and authority to implement monetary policy as recent experiences of the developed

countries have shown. Wherever there is an independent planning authority entrusted with medium and long-term planning of the national resources, there is further necessity for close co-ordination with such planning authority.

Economic governance presupposes the existence of well-defined and well established institutional framework which is competent to undertake the implementation of economic policy laid down by the Government. The institutional framework should be capable of making structural adjustment and effectively implement stabilisation policies whenever required to do so. In fact, effective economic governance primarily depends on the strength of its institutional framework, the flexibility, manoeuvrability and resilience to the changing political, economic and social environment and the ability and competence of the persons to take bold, practicable and rational decisions. Where the institutional framework is fragile and the decision makers are incompetent or indifferent, even the best economic policies will be worthless.

Economic administrators have always a heavy responsibility to shoulder in taking pragmatic, intelligent and quick decisions on matters which are constantly in a state of flux. The competent, intelligent and versatile administrators can function effectively only when they have the necessary infrastructure to work on and possess the modern electronic equipments and office automation, in the form of computers, and other ancillary means of information technology. Moreover, apart from their proper orientation and advanced training in economic administration, these administrators should be exposed to the recent trends in management education at regular intervals so as to give them a global perspective of their tasks. Economic administrators cannot remain isolated in their economic doctrinaire approach in relation to their tasks since events in political, social and environmental fields do affect economic policies.

There has been growing realization in the recent past that although the State is a big motivating force for development, but it is not the only one and that the private sector will have to increasingly assume the role of engine of economic growth. Sustainable human development requires in part creation of additional employment opportunities which will provide enough income to improve living standards. There is no denying the fact that the private sector

will henceforth provide the primary source of opportunities for productive employment. Globalization has changed the manner of operation of industry and enterprises. Developing countries and transitional economies will have to take necessary steps to encourage and promote private sector development by creating a stable macroeconomic environment, through maintenance of competitive markets, ensuring gender equality, promoting enterprises that generate most jobs and opportunities and most important, enforce the rule of law. Governments in these countries will have to promote foreign direct investment in desirable directions and help to transfer knowledge and advanced technologies from developed countries.

The Secretary-General of the United Nations in his report (A/52/428) to the Fifty-second Session of the General Assembly stated The Government's activities can be redefined and reduced in scope as it withdraws from the direct provision of services and manufacture. Experience has shown that Governments can continue to play a vital role in creating an effective legal and regulatory framework in which the private sector is enabled to operate. As those in countries moving towards a market economy keep pointing out, the private sector cannot develop fully unless the Government institutes a legal framework that guarantees and protects private property, govern business relationships and enforces the commitments involved in business contracts. Suitable enforceable legislation is needed as related to the personal liabilities of owners and the bankruptcy of businesses as well as the obligations of those involved. An adequate legal framework is vital in developing an enabling environment in which business creation and operation can function successfully.

Last two decades have witnessed widespread changes in the relationship between governments and the private sector in developing countries and transitional economies. Governments have consistently favoured the role of the private sector to boost economic growth, generate employment and improve income distribution. These countries would find it to their advantage to pursue market-friendly development strategies and fundamentally change the role of the government from owner and operator to policy maker, facilitator and regulator. Wherever such changes have taken place in these countries, the private sector has assumed the prime role of engine

of growth, generating sustained increases in income, and enabled government to invest in broad-based, long-term development programmes.

The trends of globalization, privatisation and deregulation are seen to imply stronger markets and weaker governments. While governments, in the new context of the growing importance of the market and the private sector, have a diminished productive role in economic development, it would be important to note that all governments will retain responsibility for providing a regulatory framework for the effective operation of a competitive market system.

Governments have to intervene, where appropriate, to invest in infrastructure, to facilitate the development of productive sectors, to provide an enabling environment for the promotion of the private sector, to ensure proper social safety nets are in place, to invest in human capital and to protect the environment. Governments provide the framework within which individuals can plan their long-term prospects. In recent years, governments have sought assistance in detaching themselves from their production activities, transferring current activities into the private sector, right sizing themselves, retraining their professionals in contract management and regulation management, and developing facilitative managers rather than productive managers. They will continue to do so. In all these activities, they will need to redirect and strengthen their own administrative systems. Without efficient and responsive public administration systems, governments may not be able to bring about necessary changes in support of economic growth. While some governments can rely mostly on themselves, others may remain heavily dependent on technical assistance and information on the experiences of other nations in fine-tuning the relationship between government, society and private sector. For Member States, the relevant United Nations agencies, including the United Nations Programme in Public Administration and Finance remain the core institutions for assisting such a change and transformation process.

There is clear imperative necessity in ensuring sound, well managed and effective use of natural resources. Since environmental degradation affects the qualitative and quantitative aspects of human life, environmental protection and ecological balance provide a basic building block of all forms of human resource development. Development and

environment are inextricably interlinked and the one cannot be addressed without reference to the other.

As more governments realize the importance of a sustainable environment as critical to human development, and focus on the past improprieties, implausible policies and lack of consideration, they will surely need assistance in articulating and integrating environment policy with other development policies. As this concern for environment is fairly of recent origin and has already constituted a major component of national governments priority, there is every likelihood of several developing countries and transitional economies turning to the international organizations for assistance in improving their policy process, developing appropriate management functions and structures, and improving their human resources capacity in this area.

Current social conditions in many parts of the developing world call for an active and vigorous programme of administration to deal with many complex and urgent social problems. Well-being and welfare of people, the principal asset of every country, unequivocally defines the agenda for harmonious and co-ordinated socio-economic development. Their energy and initiative represent the driving force for development and their characteristics determine the nature and direction of sustainable human development. The benefits of investing in human resources go beyond increasing the productivity of labour and facilitating access to global opportunities. Existing social conditions are the starting point for development and determine the priorities and direction of a country's public administration and management development system. Poverty and disease, urgent need for education and sustainable livelihood, sudden economic hardships caused by natural calamities and disasters, decaying and economically unviable industries causing problems of unemployment, rehabilitation and retraining of labour and similar urgent problems require government intervention and response. Governments will still be involved in the creation of conditions that will provide wide and equitable access to assets and opportunities. Governments will require effective, efficient and responsive social administration systems and civil servants will need to have appropriate mechanisms and capacity to manage social programmes.

United Nations General Assembly in its resumed Fiftieth Session reaffirmed that democracy, and transparent and accountable governance are indispensable foundations for the realization of social and people-centred sustainable development. In fact, decision-makers and aid agency professionals in many developing countries and transitional economies are increasingly turning to administrative decentralization - which involves deconcentration, devolution and delegation- as a strategy for addressing a number of critical governmental needs. Foremost among these are, strengthened governance, increased transparency and accountability, and more effective and efficient production and delivery of public goods and services. Improving and enhancing governance is the basic pre-requisite for the success of any agenda and strategy for socio-economic development. The quality of governance may be considered as the single most important development variable within the control of individual governments. While democracy is not the only means by which improved governance can be achieved, it can be considered as the most reliable one. By providing for greater popular participation, democracy increases the likelihood that national development goals will reflect broad societal aspirations and priorities. By providing appropriate mechanisms and channels for government succession, democracy provides incentives to protect the capacity, reliability and integrity of core state institutions, including the civil service, the legal system and the democratic process itself. By establishing the political legitimacy of governments, democracy strengthens their capacity to carry out their policies and functions efficiently and effectively. By making governments accountable to citizens, democracy makes them more responsive to popular concerns and provides added incentives for transparency in decision-making.

In the context of development, improved governance has several implications. In particular, however, it facilitates the design and pursuit of a comprehensive national strategy of development. It ensures the capacity, reliability and integrity of the core institutions of the modern State. It implies improving the ability of government to carry out governmental policies and functions, including the management of implementations systems. It means accountability for actions and transparency in decision-making and this also signifies the opportunity for people to participate openly in the

democratic process. Improved governance will require an effective, efficient and responsive public administration system.

Public administration, particularly that part thereof engaged in financial management, plays a pivotal role in the development process. Indeed, public administration is viewed as government in action, and development as the object or purpose of all government action, whether direct or indirect. It is recognised that the role, state and operation of public administration is interlinked with the unique socio-economic and political complexion of each country. While the main responsibility for improving the public administration rests with the national governments, in considering the main ingredients that will define the role of future public administration, and the areas in which critical capacity building will take place, it has been observed in the Report of the Secretary-General to the ECOSOC on Public Administration and Development (A/50/847), that three trends are affecting public administration in developed, developing and with economies in transition countries, namely

- (1) Rapidly changing domestic and international conditions and increasing demands for services. These will require innovative policies at the strategic levels and improved service delivery systems at the operational level. Innovativeness defined by creativity and flexibility to respond to rapid change will be a core requirement for development administration and governance;
- (2) Continuing response of public administration to core responsibilities. Public administration will continue to fulfil critical functions in development-supporting measures for economic growth, protecting the environment, determining the relationship between the public and private sector, reducing poverty and illiteracy and other social development activities, thereby achieving the goals of sustainable development. Therefore, exceptional capacities to govern for development are essential for public administration; and
- (3) There is greater demand for participation and transparency. To fulfil critical future- shaping functions, public administration needs to establish a dynamic people-oriented system through strategic restructuring for transparency and participation, as well as outstanding professionalism by attracting

bright, energetic, visionary people in public administration.

These common trends and challenges facing the community of nations in public administration and development are complex and resolutions are neither straightforward nor easy to implement. Also, no resolution is able to address all aspects of these complex issues. This realization leads to the conclusion that public administration dealing with financial management must approach development with directness, pragmatism, openness and flexibility.

3. ISSUES RELATING TO CORRUPTION

INTRODUCTION

There is a growing perception that most developing countries and transitional economies have often been burdened with economic structures and institutions which hinder rather than facilitate the achievement of significant economic growth. Due to inadequate institutional arrangements and insufficient financial resources, many such countries have experienced serious constraints in implementing poverty reduction programmes and ultimately, in raising the standards of living of a vast majority of the population. The gradual but ever-increasing intervention of the State in the economic sphere extended far beyond the traditional role of provision of essential socio-economic infrastructure, maintenance of law and order, defence and foreign affairs. The stabilization of the economy during the course of economic downturn resulted in public works programmes and expansion of public sector also meant the State undertaking to ensure distributive justice. Public sector was assumed to promote social welfare, all economic decisions were presumed to be made in a rational and transparent manner, and implemented by public servants with utmost honesty and integrity.

Over the years, most developing countries and transitional economies have noticed that these idealistic notions regarding financial management have undergone significant changes revealing lack of governance, absence of transparency in the decision making process and prevalence of corrupt practices on the part of bureaucrats who have distorted the directives of policy makers and subverted the economic process for self-aggrandisement. Corruption practised by civil servants and their

political masters is no longer considered as a moral dilemma or a social disease but, justifiably, as an economic malaise eroding the foundation of the economic superstructure of the country seriously affecting the entire developmental process and reducing economic efficiency. While effects of corruption have been mostly focussed on economic efficiency, corruption can also have distributional consequences. It has been observed in a Working Paper of IMF (WP/98/76) that corruption increases income inequality and poverty through lower economic growth, biased tax systems favouring the rich and well-connected, poor targeting of social programmes, use of wealth by the well-to-do to lobby Government for favourable policies that perpetuate inequality in asset ownership, lower social spending, unequal access to education and a higher risk in investment decisions for the poor. The impact of corruption on income inequality and poverty is considerable. It was noticed that a worsening in the corruption index of a country by one standard deviation (2.52 points on a scale of 0 to 10) is associated with the same increase in Gini co-efficient as a reduction in average secondary schooling of 2.3 years. A one standard deviation increase in the growth rate of corruption (a deterioration of 0.78 percentage point) reduces income growth of the poor by 7.8 percentage points a year. The study concluded that these results are valid for countries at different stages of economic development, with different growth experiences, and using various indices of corruption. They hold even when controlling for other factors that affect income inequality and poverty, such as, natural resources, capital-output ratios or capital productivity, educational attainment, access to education, and distribution of land. The results further showed that higher social spending reduces poverty but has no other effect on income inequality. These findings suggested that adverse distributional consequences of corruption could be mitigated by sound management of natural resources; broad-based, labour-intensive growth; efficient spending on education and health; effective targeting of social programmes; and increased access to education.

The increased attention now paid to corruption reflected the growth of that phenomenon in recent decades which culminated in a peak in corruption activities in the 1990s. The extent to which the role of the government in the economy has grown since 1960s brought about, firstly, a large increase in the

level of taxation in many countries; secondly, a large increase in the level of public spending; and thirdly, probably but not statistically ascertainable, a large increase in regulations and controls on economic activities on the part of governments. However, the impact that high taxes, high level of spending, and new regulations have on acts of corruption is considered to be a function of time and of established norms of behaviour. In a developing country with traditionally well-performing and honest civil services, the short-term impact of a larger government role on public officials may be limited, with their strong resistance to corrupt practices and bribery attempts. But in countries without such traditions, the more invasive role of government, played through higher taxes, higher public spending, and more widespread regulations, would have a more immediate impact on the behaviour of civil servants and on corruption. This would be manifested if the fiscal policy suffers from lack of transparency in policy making, in fiscal reporting, and in the assignment of responsibilities to public institutions. As mentioned earlier, high and rising corruption increases income-inequality and poverty by reducing economic growth, the progressivity of tax system, the level and effectiveness of social spending, and the formation of human capital and by perpetuating an unequal distribution of asset ownership and unequal access to education. Wide publicity given to the statement issued at the 1996 Annual Fund-Bank Meeting by Mr Michel Camdessus, Managing Director of the International Monetary Fund that governments must demonstrate their intolerance for corruption in all its forms and by Mr James Wolfensohn, President of the World Bank that the cancer of corruption must be dealt with have certainly stimulated renewed interest in the subject of corruption.

While determining the causes of corruption, it is necessary to define corruption. According to the World Bank, corruption means the abuse of public power for private benefit. Another more neutral definition is that corruption is the intentional non-compliance with arm's length relationship aimed at deriving some advantage from this behaviour for oneself or for related individuals. Indulgence in corrupt practices is not necessarily or exclusively the prerogative of public officials. However, corruption as applicable to public officials means any act of commission or omission in the performance of public duties which results in personal advantage, benefit or

gain, either immediate or deferred, to such public official or to any other person connected with such official to the detriment of public interest. The essence of an act of corruption is that the public interest is, directly or indirectly, irremediably jeopardised. The direct detrimental effect of corruption is felt when an income-tax official deliberately makes an under-assessment of tax liability in return for a pecuniary consideration or when a customs official purposely overlooks certain dutiable goods for illegal gratification. On the other hand, the public interest is indirectly prejudicially affected when a public official in the public works department deliberately awards a contract to build a bridge, dam or road to an incompetent civil contractor against established procedure for a monetary consideration and the contractor using inferior and sub-standard material causes monetary loss to the government.

Public officials engaged in corrupt practices may be compensated by the benefitted party in a variety of ways, such as, direct monetary payment, presentation of costly articles, or things convertible in money or in the form of advantage, benefit, facilities or gain which, but for the payment made therefor by the bribe-giver, would have been required to be paid for by the public official. The common form of non-monetary ostentatious gifts generally is jewellery, costly clothes, antiques, furniture, fixtures, land, farm, farmhouses, apartments or houses. Another form of indirect compensation may be to arrange for admission of public officials' children or dependent relatives to prestigious schools, colleges or universities in the same country or abroad by payment of capitation fees, huge donations or payment of fees and living expenses in foreign countries, purchase of air-tickets for pleasure trips abroad or holiday package tours in foreign countries, or even meeting the medical expenses for the public official or members of his family, etc. The indirect forms of compensation or illegal gratification to the public official for the benefits provided to the bribe-giver are no less reprehensible. The basic characteristics of these advantages, benefits or facilities provided to the public official by the bribe-giver represent items of comfort or luxury which are wholly beyond his purchasing power represented by his emoluments or remuneration in the public service, or other legally available means and represent the enjoyment of a benefit which, in the normal course, he could not afford. In a direct manner, the State

suffers a monetary loss several times the cost of the advantages, benefits or facilities enjoyed by the public official as a result of his corrupt practices.

The State may also suffer financial or material loss as a result of acts of commission or omission on the part of public officials which may not be attributable to corrupt practices but due to ignorance of the established procedures or the relevant statutory provisions, negligence or carelessness or plain human error. While ascertaining the reasons for the financial or material loss suffered by the State, a specific finding will have to be given that the erring public official or any person related to him did not derive any monetary or other advantage, benefit or facility as a result thereof.

The public official's acts of corruption or corrupt practices need not result from interaction with members of public, private sector or charitable organisations in their dealings with the government. Such corrupt practices can also arise in dealings with other public officials in purely administrative matters, such as, transfers, postings, taking decisions in vigilance matters, awarding punishment for wrongful acts, use of discretionary authority for use of government property or assets, such as, residential accommodation on concessional rent, holiday homes, or for nomination of public officials for fellowships in prestigious universities or institutions of higher learning, executive training programmes, conferences or seminars held in developed countries etc. Although no bribes are taken from members of public and no direct financial loss accrues to the government, there are many indirect adverse consequences: inappropriate or wrong posting of incompetent or corrupt officers, selection of worthless or inept officers for training abroad ultimately results in inefficiency and ineffectiveness in public administration.

CAUSES OF CORRUPTION

Corruption has stemmed primarily from activities of the State being associated with the monopoly power and discretionary authority wielded by the State. Greater the extent and scope of authority of the State, greater the prevalence and perpetuation of corruption in the State, with the notable exceptions, such as, Canada, Denmark, Finland, the Netherlands and Sweden. Even though these countries have large public sectors measured in terms of share of tax revenues or the extent of public

expenditure with reference to the GDP, they have been generally regarded as the least corrupt countries of the world, with the result, the extent of State intervention in economic activities cannot be an infallible or incontestable indicator of corruption prevalent in any country. However, economic policies intended to bring about liberalization, stabilization, de-regulation and privatization may reduce the scope and opportunities for rent-seeking behaviour and corruption. There are specific characteristics of government's activities which result in opportunities for corruption as follows:

1. **Higher public investment** : In the post-war era, economists had considered capital accumulation and capital formation as twin pre-requisites for economic growth and the mechanical relation (capital:output ratio) between increased capital spending and increased growth. There was added emphasis on increased share of capital vis-a-vis revenue expenditure and raising financial resources by public debt to finance capital expenditure. Capital investment involved exercise of discretionary authority on the part of ministers or high level officials for selection of specific projects and their exact location as also regarding the size and design of each project which led to corrupt practices where controlling and auditing mechanisms were either not developed or the institutional controls were weak or even non-existent. Large public investment projects usually involves awarding contracts to a number of national or foreign private enterprises which routinely pay commissions or bribes at a fixed percentage of the value of the contract to execute the project. In some developed countries, payments of bribes to foreign politicians or civil servants are treated as legitimate and tax deductible business expenditure. Public officials entrusted with execution of projects have a vested interest in expanding the scope or size of the project to get larger bribes. Ultimately, corruption increases the cost of the public investment project with the diminished rate of return and, quite often, raising the tariff for the service offered by the public utility thus adversely affecting the interests of the lower-income groups. In short, execution of large public investment projects involves corruption which flourishes in the absence of proper audit and controls.

2. **Regulations and authorisations**: In many countries, basic economic policies and programmes are implemented through a host of rules, regulations

and authorisations. Most economic activities can be carried out only with permits, licences or sanctions given by public officials on the basis of rules or regulations. These public officials possess enormous discretionary authority and powers to authorise, inspect, or refuse permission for carrying out the specified activities. They can delay taking decisions resulting in enormous financial loss to the affected parties. In short, wherever there is public contact between a public official and citizen relating to grant of permit, licence, authorization, approval to carry on any economic activity, there is a strong possibility of corrupt practices unless there is adequate supervision, inspection or control over his functions.

3. **Taxation:** Taxes are what we pay for a civilised society but most taxpayers want the civilization at a discount. The reluctance to comply with the statutory obligations stems from the inability to perceive any direct quid pro quo with the tax payments. Hence, there exists the natural tendency to pay bribes to tax officials to reduce tax liability, to gloss over tax defaults to avoid penalties or delay due tax payments without any liability to pay penal interest. In most developing countries, tax authorities enjoy ill-defined discretionary powers to select cases for detailed scrutiny, pursue tax litigation in higher forum, write-off huge tax arrears as irrecoverable, waive penalties or penal interest and settlement of complicated cases of tax evasion. Such exercise of discretionary authority in favour of a taxpayer sometimes results in corrupt practices unless there is adequate supervision or control over the official's performance or accountability for his actions. The low emoluments paid to tax administrators is also a relevant factor in determining the extent of corruption, having regard to the vast powers and discretionary authority vested in them and the constant temptations of receiving large bribes.

4. **Trade restrictions:** Countries suffering from adverse balance of trade are forced to regulate import trade through quantitative restrictions and quotas resulting in corrupt practices in grant of import permits and quotas. Similarly, domestic industries desiring protection from foreign competition may have to pay bribes to raise tariff barriers, to ward off cheaper imports and thereby create quasi-monopoly for themselves. Open economies are generally associated with lower levels of corruption and wherever foreign trade is free of government restrictions, there is little scope for corrupt practices.

5. **Subsidies and provision of goods at below market price:** Government subsidies can constitute important source for private gain for public officials and corruption can thrive when poorly targeted subsidies are appropriated by unintended beneficiaries or non-entitled firms. Many countries routinely provide essential items of daily necessities at below market price, such as, electricity, water, public housing, education, health care, etc. Since there is usually excess demand compared to available supply necessitating unavoidable rationing, this leads to use of discretionary authority by public officials in choosing the beneficiaries leading to corruption.

6. **Low salaries of public officials :** Traditionally, salaries of public officials are below those of private sector employees for a variety of reasons, namely, existence of perquisites in the form of low cost of government-provided accommodation, quasi-permanent tenure, pensionary benefits, etc. In most countries, public sector salaries are not indexed for inflation with consequent fall in real purchasing power. Such situations force most public officials to resort to corruption to maintain their standard of living particularly when chances of being caught are slim.

7. **Other discretionary decisions :** Many countries permit their senior public officials vast and unregulated discretionary authority in dealing with important matters enabling them to collect quid pro quo from intended beneficiaries. Some examples are given below:

- (i) De-regulation of use of land from agricultural purposes to industrial or residential use;
- (ii) Permission to use government land for exploitation of mineral resources, felling of forest trees or allotment to private builders at below market price;
- (iii) Permission for foreign direct investment against domestic industry or against national interest in non-strategic areas;
- (iv) Decisions relating to privatization of public sector enterprises, more specifically in regard to conditions attached to the process; and
- (v) Decisions granting monopoly rights regarding export, import of scarce natural resources, such as, gold, oil, exotic timber, etc.

Whenever high public officials are allowed to use discretionary authority without adherence to proper procedures, there is considerable scope for unchecked corruption.

8. **Indirect factors promoting corruption:**

Certain sociological factors likely to promote corruption are: an index of ethno-linguistic fractionalization, i.e. societal divisions along ethnic and linguistic lines; favours shown by public officials to their kith and kin, or persons belonging to the same caste, religious or regional background; quality of bureaucracy; status and prestige in society of public officials. Where recruitment and promotion in civil service is not based on merit, the degree and extent of corruption is high. Conversely, where political patronage and interference in matters of recruitment, transfer, promotion and postings is negligible, the civil service is likely to be efficient and practically free of corruption. Moreover, the scope and extent of corruption depends upon the punishment meted out to corrupt public officials. Where there is no code of conduct to determine aberration from good behaviour, or procedures to deal with corrupt officials are vague, uncertain, long-winded or time consuming, practically no punishment is meted out to corrupt officials. It has been the experience of senior officers in developing countries that where administrative authorities engaged in vigilance matters are incompetent, indifferent or incapable of discharging the burden of proof and establishing corruption, courts are known to give benefit of doubt to the guilty public officials and absolve them of any wrong-doing. In fact, the attitude of judiciary in dealing with cases of corruption moulds the mind set of the corrupt elements in any society. These factors necessitate laying down proper procedures and methodology to detect corrupt practices, identify corrupt elements, attempt to neutralize their corruption by prompt action and stiff punishment to the guilty. The attitude of society towards corruption in public services and corrupt officials is also relevant. Where society tolerates corruption or treats it indifferently as inevitable, and corrupt officials are not looked down upon or subjected to social sanctions, there is little hope of eradicating corruption.

CONSEQUENCES OF CORRUPTION

Among the various undesirable consequences of corruption, the most important is that it slows

down economic growth through various means, namely:

- (1) Bribe-givers become aware that an up-front bribe would be required to be paid before the economic activity is commenced and that such bribe would also be payable out of the returns on investment thereby making them discouraged to invest. Empirical evidence suggests that corruption lowers investment and retards economic growth significantly.
- (2) Where corruption becomes a lucrative activity and officials enrich themselves without fear of punishment or sanctions, the desire to get involved in productive activities gets discounted. If talented, efficient, and well-educated persons get lured by possibilities of enrichment through corruption, there will be less inclination towards productive activities with adverse consequences for the country's growth rate.
- (3) In developing countries and countries with economies in transition, rampant corruption may erode the efficacy and effectiveness of the aid flows from bilateral or multilateral sources. Financial resources received through aid may be used for unproductive and wasteful government expenditure. Donors who insist on good governance and proper accountability may justifiably scale back funds to such countries with adverse welfare effects on underprivileged sections of the population.
- (4) Corruption in revenue administration is particularly reprehensible because it brings about diminution in tax revenues which adversely affects the ability of the government to improve living standards of the population and seriously undermines the economic welfare. Moreover, by lowering tax revenues and raising public expenditure, corruption leads to adverse budgetary consequences and fuels inflationary pressures.
- (5) Adoption of corrupt practices in awarding contracts for public procurement may lower the quality of infrastructure and standards of public services.
- (6) Corruption may also distort the composition of public expenditure by inducing corrupt public officials to choose government expenditure less on the basis of public welfare than on the opportunity they provide for demanding bribe. There would be greater inducement to prefer large projects as an

excellent measure to extract bribes. In fact, there are far greater opportunities to make money on large infrastructure projects than on selection of school textbooks.

In the ultimate analysis, the socio-economic welfare of the large sections of the population is sacrificed for the illegitimate personal gain of the few highly placed public officials and their political masters.

ECONOMIC COSTS OF CORRUPTION

Several studies carried out to address the issue of economic impact of corruption have led to the following conclusions, namely:

A. While there is general consensus that corruption is widespread, there are significant variations across and within regions. For example, empirical studies have revealed that Botswana in Africa and Chile in South America have experienced much less corruption than many industrialised countries.

B. Corruption raises transaction costs and uncertainty in an economy.

C. Corruption leads to inefficient economic outcomes. It affects and inhibits foreign direct investment, diverts talent to rent-seeking activities and diverts sectoral priorities and technology choices, by, for example, creating incentives to contract for large defence or infrastructure projects rather than for rural health centres which specialize in preventive care. Corruption also pushes industrial units into underground (informal) economy, undermines the government's ability to raise revenues and forces to raise tax rates higher on fewer and fewer taxpayers. This situation reduces the capacity to provide essential commodities for the benefit of underprivileged sections of the population and subverts the rule of law.

D. Corruption is unfair as it imposes a regressive tax which falls heavily on small-scale industries and service activities.

E. Corruption undermines State's legitimacy.

It might be argued that there are some unjustified advantages or positive effects of corruption whereby individuals and business concerns are enabled to get over troublesome regulations and ineffective legal systems. However, it may not be possible to gloss over the nefarious effects of the discretionary

authority exercised by corrupt public officials and politicians over the creation and interpretation of counterproductive regulations. Unfortunately, corruption engenders the unhealthy growth of excessive and discretionary regulations. The loss of time experienced by busy entrepreneurs and managers in complying with time-consuming regulations at times, equals the time taken in meeting the demands of corrupt public officials in negotiating for approvals, permits and sanctions of various kinds.

Developing countries and transitional economies are more prone to be affected by corruption for a variety of reasons, namely:

a. The widespread poverty and low levels of public sector salaries which do not keep pace with inflationary conditions;

b. Lack of any social security apparatus which takes care of different categories of contingencies, such as, illnesses, accidents, unemployment etc;

c. Opportunities presented by complex, poorly defined, constantly changing and inadequately circulated rules and regulations;

d. Lack of properly established laws and principles of ethics, or code of conduct applicable to public officials and almost total absence of institutional framework charged with enforcing them;

e. Lack of watch-dog agencies supplying information on which detection, investigation and enforcement is based, namely, accountants, investigative reporters, and press being weak. The fundamental weakness in investigating the existence of corruption is that both the bribe-giver and bribe-receiver are contented parties who are least likely to lodge a complaint. The investigating agencies have to watch the public official's outward manifestations or the external signs of riches. Even if the existence of corruption is ultimately proved, the punishment may be neither commensurate with the crime in a society with rampant corruption nor the risk of losing the low-paying government job be considered a serious matter.

Evidence shows that in developing countries with weaker administration and political institutions, the corruption problem can become an integral part of the system. In many countries, it has endangered the democratic traditions as also constituted the main source of public discontent. Apart from increasing income-inequality and poverty, corruption through its

negative impact on overall economic growth has resulted in poor targeting of social programmes, lower social spending, unequal access to education and higher risk in government investment decisions affecting the poor. Corruption has hampered the growth of competitiveness, frustrated efforts aimed at poverty eradication, lowered public spending and investment and undermined the performance, integrity and effectiveness of government institutions. In this perspective, amongst other institutions, the role of the supreme audit institutions in fighting corruption and financial mismanagement cannot be underestimated. They can recommend practical approaches towards improving the effectiveness of institutional framework, devising strategies to check improper use of discretionary authority and suggesting remedial measures to prevent recurrence of mistakes resulting in losses to the State Exchequer.

INSTITUTIONAL FRAMEWORK FOR FIGHTING CORRUPTION

There has been growing realization in most countries that unchecked and rampant corruption is injurious to the economic well-being of the population and urgent steps are required to stem its proliferation. Although the costs of corruption are well known, critics and sceptics question the wisdom of establishing institutional mechanisms of fighting corruption. Judging by the insignificant rate of success in anti-corruption drives, the task of establishing a fool-proof case against a delinquent public official to the satisfaction of the judicial authorities is extremely difficult. England took nearly a century in controlling corruption, while Hongkong SAR and Singapore have taken a relatively short time in almost eradicating corruption. Amongst developing countries, Botswana, Chile, Poland and Uganda are well-known examples of countries successful in anti-corruption activities.

In every developing country and transitional economy, there is need to establish a Central Vigilance Organization (CVO) at the national level entrusted with the task of dealing with anti-corruption activities in all spheres of the nation. In the case of a federation, there should, in addition, be a state-level vigilance organization (SVO) which will be independent of the national apex organization. The CVO will be headed by a Chairman who would normally be the retired judge of the highest court of

the country or a retired civil service official of the highest rank with a known reputation for integrity and honesty. Similarly, the SVOs should be headed by a Chairman who would be the retired judge or civil service official of the highest rank in the State concerned with similar attributes for probity in public life. In case the workload so justifies, the CVO and SVOs can appoint Members to assist the Chairman in discharging the functions. These organizations should take a final decision on cases of corruption of public officials, including politicians holding public offices for awarding punishment in case of misdemeanour. The CVO and SVOs should have administrative staff generally drawn from the higher echelons of the Central/ National civil or police service to serve for a fixed period on deputation basis. This would ensure objectivity and impartiality, and not allow them to grow roots in the state concerned.

Every organ of the central/national and state government, variously called as the ministry/ department or an attached office or depending on smaller size of units, a group of such attached offices should have a Vigilance Cell (VC) headed by a Director of Vigilance, an officer generally drawn from the central/national police organization known for integrity and balanced judgement who should work under the supervision, direction and control of the CVO / SVO. The Directorate of Vigilance in the ministry/department or attached office should be the focal point for all vigilance matters in respect of the officers and staff of the relevant organisation, examine all matters concerning corrupt practices on the part of the public officials within its jurisdiction and forward its recommendations for action against the concerned official to the CVO/ SVO. The term corrupt practice should refer to any act of commission or omission on the part of a public official who has misused or compromised his official position for an immediate or deferred benefit, any advantage, benefit or facility for himself or any person related to him or any entity associated with him.

The Director of Vigilance should not be subordinate to the administrative head of the ministry/ department or attached office or the minister in charge of the organization, so as to maintain his independence, objectivity or impartiality. He or any officers subordinate to him should not depend upon the head of the organization

or the minister concerned for his career advancement or appraisal of his annual performance.

Any decision taken by the CVO or SVO on any matter referred to it by the Directorate of Vigilance, can be challenged by the aggrieved party, **only in respect of a question of law**, before the highest court in the case of the decision of the CVO or before the highest court in the State, in the case of the decision of the SVO. In all other cases, the decision of the CVO, or the SVO shall be final and conclusive and shall not be called in question before any court of law. The central/ national government or the State government, as the case may be, will be required to implement the decision of the CVO or the SVO.

The CVO or the SVO while dealing with a case of a public official charged with indulgence in corrupt practices can, on the evaluation of the evidence, either file the proceedings by dropping the charges if the complaint forwarded by the Directorate of Vigilance is frivolous, lacks substance or is malicious in nature; or, if satisfied with the charges framed proceed with the matter in accordance with the established procedure, by examination of evidence, calling the witnesses and passing a speaking order and awarding a minor or major penalty as specified below:

- a) where the default committed is purely of a technical nature, or not of a serious nature, issue a warning to the public official to be careful in future or expressing displeasure over his conduct;
- b) stopping the increments in the salary scale for a specified period or indefinitely;
- c) stopping his promotion to the next scale or his being considered ineligible for promotion for a specified or unspecified period;
- d) where the public official is due to retire, stopping the payment of his retirement dues for a specified or unspecified period with or without stopping the payment of his monthly pension for a specified or unspecified period;
- e) reducing the rank of the public official with or without reduction of salary, or placing the public official in a lower position of responsibility with the lower salary applicable to such lower position;
- f) placing the public official under suspension for a specified or unspecified period coinciding with the period of enquiry into his misconduct or specified

default or as a final decision specifying the period of suspension with or without the termination of his employment. The public official, at the discretion of the CVO or SVO may be provided with a subsistence allowance during the period of his suspension;

g) dismissal of the public official from the public service with immediate effect or at the end of the specified period of suspension, with the full or partial withdraw of pension and/or post-retirement benefits;

h) any minor or major penalty of an administrative nature specified above may be combined with a monetary penalty. In addition, where a public official, through the exercise of corrupt practices, has caused any damage or loss to the government which can be evaluated in monetary terms, the CVO, or the SVO may direct the public official to compensate, wholly or partly, the said government along with interest, if any.

At times, the Penal Code of the country contains provisions for the offences by the public officials, guilty of corrupt practices with specific provisions for punishment for offences of corruption. It would be permissible for the central/national or, as the case may be, State government to proceed against the public official guilty of corrupt practices both under the civil procedure before the CVO /SVO and also under the Penal Code for criminal prosecution.

Where in pursuance of an order passed by the CVO or the SVO, a public official has been dismissed from service, he will be permanently debarred from holding any post under the central/national or state government or any government organization or public enterprise.

In order to give govern the conduct of the public officials during the course of the public service, it would be desirable to lay down guidelines in this behalf in a Code of Conduct laying down do's and don'ts and the information to be supplied in periodic returns for movable and immovable properties acquired or disposed of exceeding a certain monetary value, permissions to be sought for pursuing specified activities, etc. The information supplied by the public official in this behalf to the head of office or head of department should be routinely passed on to the Directorate of Vigilance. Such Code of Conduct can also be made applicable, with necessary modifications, if necessary, to the employees of public sector enterprises, government companies or grants-in-aid organisations.

4. REVENUE ADMINISTRATION

INTRODUCTION

Revenue administration forms an integral part of the overall financial administration. Since mobilisation of financial resources forms the principal function of the revenue administration, it becomes important to harness the administration's human, material and financial resources in an efficient and coordinated manner, to collect the optimum financial resources at the minimum cost. Revenue administration traditionally utilises taxation as the most important instrument for marshalling financial resources. Taxation diverts financial resources from taxpayers to the government which uses them for carrying out the basic functions of the State, maintenance of law and order, defence, foreign affairs and to provide public services. Any excess over current expenditure may be utilized on infrastructure projects or other aspects of socio-economic development. For cost: benefit reasons and to ensure the optimum balance between the private and public sector, some part of the financial resources of the government may be used for projects to be implemented by the private sector.

In an environment characterized by unabating public debt difficulties and by domestic and external financial imbalances, many developing countries and transitional economies have introduced stabilisation policies and structural adjustment programmes aimed at enhancing mobilization of domestic financial resources and streamlining public expenditure, with a view to restoring financial stability and promoting harmonious, well co-ordinated sustainable economic growth. With a view to strengthening domestic resource mobilization, most of these countries have relied increasingly on taxation and sought to raise additional resources by widening of the tax base and strengthening the tax administration.

However, well designed and drafted tax laws may be in theory, they may fail to achieve their purposes in practice, unless they are efficiently implemented and the taxpayers can be induced, if necessary compelled, to voluntarily comply with them. An efficient and effective tax administration is therefore, a basic pre-requisite if a tax system is to fulfil its revenue producing potential, and even the best designed system is only as good as the administration which implements it. Thus, the tax administration is the major tool in a government's

efforts to pursue a sound fiscal policy, achieve an optimum tax effort level and establish an appropriate tax structure. Fiscal policy which constitutes not only taxation but also public spending interacts with tax administration in different ways and may help countries to move from fiscal disequilibrium to fiscal equilibrium, resulting in the promotion of sustainable economic growth. It may happen that higher taxes, although an important part of additional revenue generation strategy, may create a disincentive to production and contraction of consumption.

An efficient and effective tax administration, on the other hand, may generate more revenue without these negative side-effects, thus helping the reduction of budget deficits and curb inflation. Furthermore, the reduction of fiscal deficits may make the governments more conscious of their spending behaviour and give tax administration an additional incentive to combat tax evasion. Improved tax administration may also result in higher levels of capital formation, increased domestic savings rates and reduced public debt; and monetary and foreign exchange policies can be supplemented by tax incentive devices leading to increased exports and foreign exchange earnings.

Efforts to gear a country's tax structure to the capabilities of the tax administration can lead to an increase in revenues by reducing tax evasion and avoidance. A tax structure cannot be merely a heterogeneous collection of taxes administered largely on a piecemeal basis, some of which nullify the effects of others but should, as far as possible, be a harmonious and homogeneous whole; all the constituent taxes should be consistent in their economic impact, and their administration should be self-reinforcing so that non-compliance becomes more unlikely. The tax structure differs from one developing country to another and changes during the process of economic growth. With a view to generating substantial revenues, developing low-income countries are induced to collect revenue from taxes easy to administer, while higher-income countries can rely more on sophisticated taxes, such as, sales and service taxes, whose administration depends upon adequate book-keeping and accounting. In most developing countries, the emphasis on easy-to-administer taxes usually results in a flawed tax structure, consisting largely of narrow-based foreign trade taxes, such as, import and export duties. Hence, administration constraints tend

to determine a country's actual tax structure. Although tax administration cannot by itself change the tax legislation, their input may lead to the amendment of existing tax laws or the adoption of new laws, so as to introduce more broad-based income and consumption taxes, thereby reducing the dependence on foreign trade taxes.

In considering the appropriate tax structure, the strength or weakness of the tax administration is a major constraint, limiting the government's feasible tax options. The weaker the tax administration, the more limited the choice of taxes. Unless the tax administration is capable of enforcing any new taxes, they may not have any significant impact on tax revenues. Moreover, the government's willingness to introduce particular new taxes is closely related to the administrative costs involved. Decisions about particular tax options cannot be made rationally without reference to budgetary requirements and expected revenue yields. If the tax system, whatever its structure, is to yield an optimum level of revenue, a major pre-requisite is the absence of political interference in the process of tax administration.

If the revenue administration is to fulfil its potential as an effective means of mobilising domestic financial resources for development purposes, the tax system must be simple, equitable and neutral, and emphasis must be placed on its role in the pursuit of a sound fiscal policy, the achievement of optimum tax effort levels and the establishment of an appropriate tax structure with a view to fostering economic growth.

EFFICIENCY AND EFFECTIVENESS OF REVENUE ADMINISTRATION

It cannot be overemphasised that an efficient and effective revenue administration can help developing countries and transitional economies to mobilize additional revenue and achieve greater financial self-reliance, not only in facilitating the launching and pursuit of growth-oriented structural adjustment programmes, but also in bolstering the prospects for economic restructuring through privatization, or for more stimulatory policies, with positive effects on both the pattern and rate of growth.

The necessity for introducing higher tax rates or new taxes can be dispensed with altogether by strengthening the capacities of the revenue

administration. It is probable that the latter course of action may involve substantial time lag to produce tangible results of enhanced tax revenues, except for the few specific cases, such as, improved methods in effecting recovery of accumulated outstanding taxes, the results of attempts to generate supplemental revenues through higher tax rates or additional new taxes may prove disappointing unless determined and coordinated efforts are also made to enhance the efficiency and effectiveness of the revenue administration. Incremental improvements in efficiency and effectiveness may also enable the rewriting of the fiscal legislation taking into account socio-economic changes and the expressed need for introducing more simplicity and clarity in the tax codes themselves, so as to render non-compliance on the part of the recalcitrant taxpayers more difficult.

While considering the role of tax policy in the recent Asian crisis, an IMF Policy Discussion Paper (PDP/99/2) observes, as under:

“Taking a broader perspective, the crisis teaches some lessons about setting tax policy. It underscores that tax administration is a particularly challenging task due to the complexity and volume of business transactions in open emerging markets. Just as strengthening financial systems must be a precursor to capital account liberalization, tax administration also requires strengthening in such an environment. At its most simple level, this strengthening is about increasing the effective resources devoted to tax administration.

In another important study on Taxation in Latin America: Structural Trends and Impact of Administration (IMF Working Paper: WP/99/19), it is observed

Modern tax administration is moving forward in leaps and bounds and, as globalization spreads, tax policy and tax administration become even more inter-connected. In this context, the responsiveness of tax administration to ensure that administrative practices closely resemble the underlying principles of taxation, becomes a fundamentally important issue. On their part, tax structures also have to, by necessity, reflect what is administrable, minimizing the number of tax rates and tax concessions, ridding the system of nuisance taxes such as, small excises, and stopping short of changing the tax statute too often. To conclude, the one-to-one correspondence between tax policy and tax administration cannot be

over-emphasized, the hallmark of a developed tax system being, on the one hand, how closely the administration of a tax replicates its original policy objective and, on the other, how cognizant the design of the tax is to make its implementation feasible.

Institutional framework

The institutional framework should be in conformity with the tax structure as derived from the tax legislation and also be attuned to socio-economic, political, geographic and technological characteristics of the country concerned. The tax administration in many developing countries and transitional economies suffers from institutional shortcomings and deficiencies, lack of well-defined systems and working procedures, inadequately trained and insufficient staff, as also lack of proper motivation to act in public interest. The institutional framework of revenue administration would require modifications where necessary, to reflect the evolving changes in international economic relationships and could be dependent upon business concepts and practices in which action orientation and cost-benefit analysis are the guiding principles. The growing influence of multinational enterprises in developing countries, with their transfer pricing mechanisms and distortions to artificially whittle down the aggregate group tax liability, makes it necessary to orient the revenue administration in these countries towards performance of specialized tasks requiring creation or strengthening of specialized tax auditing and tax investigation units to improve taxpayers compliance.

Establishment of a Board of Revenue

Although the fiscal policy formulation is the prerogative of Ministry of Finance, revenue administration should actively participate in the process of evolution of tax policy, so that practical aspects of implementation of tax policy is not lost sight of. For this purpose, there should exist proper institutional framework either as an integral part of the Ministry of Finance or as an autonomous organization to be known as a Board of Revenue or the Revenue Authority which will be exclusively concerned with all aspects of taxation proposals in the fields of direct and indirect taxes, and to oversee the implementation of the tax policy through the Income tax Department, the Excise and Customs Department or the General Sales Tax Department, with clear division of tasks and responsibilities and

hierarchical structure with proper lines of commands and clear-cut demarcation of supervisory, administrative and appellate jurisdictions.

The Board of Revenue would be the apex organization entrusted with the administrative and technical functions of the revenue administration, which will be concerned with assessment and collection of taxes, and all ancillary activities and functions, such as, investigation, audit, litigation, recovery of outstanding dues aspects of all direct and indirect taxes within the competence of the central/national or state governments. Where the State is based on federal principles, there should be clear and unambiguous demarcations regarding tax levying powers of the central /national and state governments. Where a federal structure exists, there is also need to establish well-recognized principles for sharing of the taxes collected by central/national government with the state governments as also consistent accounting procedures to give effect to the tax revenues sharing arrangements.

Ideally, the Board of Revenue should have two distinct organizational structures for direct and indirect taxes although there could be common administrative and vigilance functions regarding the two divisions. The Board of Revenue would be entrusted with the control, guidance and superintendence of all subordinate authorities engaged in the execution of the different forms of fiscal legislation. For this purpose, the Board of Revenue would be authorised to issue circulars and instructions relating to the proper interpretation and explanations of various legislative provisions in the enactments and subordinate legislation dealing with direct and indirect taxes. However, the Board of Revenue should be precluded from giving any such instructions or directions in individual cases or interfering with the discretion vested in subordinate appellate authorities exercising quasi-judicial powers. However, the Board of Revenue would be quite competent to issue instructions or directions on legal issues to lower executive authorities applicable to a class of cases or class of incomes. Since the strict interpretation of legislative provisions in a fiscal legislation can, at times, cause unintended hardships to certain classes of taxpayers, the Board of Revenue should be authorised to reduce the rigours of the strict application of such legal provisions in a taxing statute by passing a general or special executive order, in favour of an identifiable class of taxpayers possessing

common characteristics or geographical location, by modification of some legal provisions of both substantive or procedural nature. In passing such general or special order, the Board of Revenue should be required to bring on record full facts or circumstances justifying departure from application of the statutory provisions.

The Board of Revenue and all executive officers and supporting staff under its administrative control working in attached and subordinate offices, engaged in the administration of any fiscal legislation shall be guided, at all times by the fundamental principle of rule of law, to the effect that no person shall be deprived of his life or liberty or shall not be proceeded against except in accordance with the due process of law.

Directorate of Vigilance

The Board of Revenue should establish the Directorate of Vigilance for both the divisions of direct and indirect taxes for dealing with all matters concerning corrupt practices on the part of public officials, or defaults specified in, or non-compliance with, the Code of Conduct to be made applicable to all public officials, working in the Board of Revenue, its attached or subordinate offices. In view of the vast powers and discretionary authority vested in the public officials in the revenue administration, with the consequent misuse of office or authority for personal advantage, benefit or facility, the Directorate of Vigilance should be suitably strengthened and manned with senior officers with known integrity and balanced judgement, more particularly, because many cases of loss of revenue may arise due to bona fide mistakes of ignorance of law and fact and not necessarily attributable to deliberate wrongful exercise of discretion or exercise of corrupt practices by public officials.

For this purpose, the expression corrupt practices would refer to any activity undertaken by a public official against the express provision of the Code of Conduct or otherwise, whereby such public official has intentionally misused his official position and sought, either immediate or deferred, monetary advantage, benefit or facility or gain, convertible in money or money's worth, for himself or any person related to or connected with him and thereby caused financial or material loss, damage or prejudice to the State. It would be desirable to lay down certain basic norms of good behaviour so as to measure the

performance of any public official engaged in the revenue administration, as specified in the following paragraphs.

Basic norms of good conduct

Every public official in the revenue administration shall, at all times:

1. Maintain absolute integrity in his official and personal life;
2. Conduct himself in a dignified manner;
3. Not behave in a manner unbecoming of a public official;
4. Perform his duties or discharge his functions to the best of his intellectual and physical abilities;
5. Maintain himself and members of his family dependent upon him for support and maintenance within the financial means legally available to him;
6. Not solicit any financial and material assistance, loan or any benefit or facility to which he is not legally entitled, either for himself or any person related to him or dependent upon him for support or maintenance from his superior or subordinate officials or any member of public, business or professional organisation or any other entity, charitable, religious or otherwise, with whom he has or is likely to have official dealings in the future;
7. Conduct himself, perform his duties or discharge his functions in an impartial manner and take decisions strictly on merits of the matter before him without being influenced by extraneous considerations;
8. Neither expect nor solicit any illegal gratification in money or money's worth, reward or personal favour for performing his duties or discharging his functions from any person for himself or any person related to him or any entity connected with him.

In addition to above, every public official in revenue administration would be expected not to utilise his official position, outside his office, to obtain any advantage, benefit or facility or in the form of articles or things or services below its market price or at a concessional rate (unless it is applicable to all members of public without distinction) and in particular, not expect any special treatment or favour, preference or out of turn allotment for himself or any

person related to him, at any educational institution, private medical facility, place of entertainment or place of religious worship. Moreover, such public official shall not accept for himself or any person related to him, any gift, present, souvenir or memento on the occasion of celebration of birthday, wedding, anniversary or other religious functions or festivals from any person who has or is likely to have any official dealings with him.

Every public official in the revenue administration may be asked, within one month of his joining the public service, to file a declaration before the government, of the particulars of all immovable properties and movable properties above a specified monetary ceiling limit (as may be fixed by the government), the date of acquisition, the mode of acquisition and its approximate market value as on the date of declaration. Thereafter, at the beginning of each calendar year, every such public official will be required to furnish a declaration in the prescribed form giving details of all fresh acquisitions in the immediately preceding calendar year of immovable and movable properties above a specified monetary limit, the mode and cost of acquisition and source of funds for such acquisition. In addition, every such public official may be required to furnish a statement showing any expenditure incurred by him in the immediately preceding calendar year, on self and members of his family dependent upon him for support and maintenance, exceeding a monetary ceiling limit on foreign tours, education in a foreign country and medical expenditure. Since the annual property statement constitutes an important source of information having a bearing on the question of integrity of the public official, the supervising authority while writing the annual confidential report of the official should be asked to examine the annual property statement and comment thereon. Where such statement is vague or deficient, the public official may be asked to modify it accordingly. A copy of each such annual property statement may be forwarded by the head of the department to the Directorate of Vigilance within a specified time limit after its receipt.

In addition, before the public official acquires, except by inheritance, any immovable property or movable property above the specified monetary limit, he may be asked to obtain a written permission from the head of the department. The public official will have to state categorically whether

the seller of the property had or is likely to have any official dealings with him and if so, the permission may be refused, unless the transaction takes place at the current market price. The head of the department would have all the powers to call for original property documents, vouchers, cancelled cheques, bank statements, as also to summon witnesses, record their statements on solemn affirmation and require the public official to furnish any supplementary information. Since a number of public officials routinely invest their ill-gotten wealth in immovable properties, the verification of particulars in this behalf is considered extremely important.

Fiscal transparency and good governance

Fiscal transparency which has been defined as public openness in government institutions, fiscal policy intentions, public sector accounts, indicators, and forecasts is fundamental to sound economic policy. Transparency in government operations constitutes an important pre-condition for macro-economic fiscal sustainability, good governance and overall fiscal rectitude. The Declaration on Partnership for Sustainable Global Growth stated that it is essential to enhance the transparency of fiscal policy by persevering with efforts to reduce off-budget transactions and quasi-fiscal deficits . Fiscal transparency is also regarded as openness towards the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. Fiscal transparency makes a significant contribution to good governance practices and enables proper dissemination of information concerning the design and results of fiscal policy, induce governments to be more accountable in the implementation of the fiscal policy and strengthen credibility and public awareness of the importance of government s macro-economic policies and choices. With the advent of globalization, transparency in the process of evolution, formulation and implementation of fiscal policy would promote macro-economic stability and sustainable economic growth.

One of the major facets of fiscal transparency encompasses transparency in government institutions and behaviour. This implies openness in the budget process, tax policy statutes and administration, government s financing operations and the nature and costs of regulatory framework. An important constituent in ensuring transparency in government operations is an independent review agency

responsible for conducting performance audits and studies on selected fiscal issues. With a view to ensuring its effectiveness, such an agency should be answerable to the legislature and to the public at large and should be vested with wide investigative and reporting authority over government operations.

Transparency in **tax treatment** pre-supposes well-defined statutory basis, as also clear and simple administration - assisted by dissemination of all information, including filing instructions. Efforts should be made to avoid, to the extent possible, discretionary tax relief provided to particular selected individuals or enterprises or case-by-case negotiation of tax liabilities between tax officials and taxpayers which may be inevitable in certain circumstances. Exercise of such authority impairs transparency and credibility of the tax system. For greater transparency in tax administration, several countries have adopted taxpayers' rights and obligations as well as code of conduct for tax officials. As a justified departure from transparency, the announcements of changes in tax incentives should be timed to avoid eroding their cost-effectiveness.

Tax preferences can be regarded as amounting to budgetary outlays benefiting specified households, enterprises, sectors or activities. Tax expenditure, that is, revenue foregone because tax preferences are an important input for the debate on annual draft budget or tax reform. There is also considerable scope for carrying out incidence studies which can provide useful information about distributional implications of the tax subsidy system. Although it is a fact that only a few advanced economies may possess technical competence and capacity to carry out such studies, prepare and publish such estimates on a regular basis, even approximate estimates of tax expenditure can facilitate the evaluation of the cost of tax preferences, including alternative proposals.

Non-transparent fiscal policies tend to be destabilising, to create allocative distortions and to exacerbate inequities. These adverse consequences may not be perceived in short-term but may be manifested by severe financial crisis, necessitating much costlier remedial action. For example, non-transparent tax concessions, quasi-fiscal subsidies and off-budget spendings - all contribute to fiscal imbalances.

Transparent tax system

In an ideal situation, a transparent tax system would be characterised by relatively small differences between statutory and effective tax rates on transactions, income and property. The extent of such differences is determined by the extent of tax evasion, administrative inadequacies or tax concessions. Hence, to reduce these differences, the tax base should be well defined and modifications through preferential treatment should be based on clear statutory criteria of eligibility. Also tax administration should be carried out in a clear and simple manner, assisted by dissemination of all the requisite information, including instructions for completing the tax returns. Discretionary tax reliefs provided to particular individuals or enterprises including state enterprises, as per the prevalent practice in most developing countries and virtually all transitional economies should be treated as a departure from transparency. In most of these countries as well as in a few industrial countries, taxpayers may be able to accumulate substantial tax or social security contribution arrear, or overdue obligations, subject to almost endless litigation and, it is believed, in some cases with total acquiescence of the government! Least transparent is the case-by-case negotiation of tax liabilities between tax officials and corporate taxpayers, which has, perhaps, been the exclusive privilege of foreign investors in some of the developing countries. It has been observed that this approach has proliferated in a large number of developing countries and economies in transition.

As a step towards transparency in tax administration, many advanced countries have established statutory provisions specifying taxpayers' rights and obligations (Organization for Economic Cooperation and Development, 1990). Some of the obligations specified in this behalf are: furnishing tax returns and making tax payments by due dates; furnishing information on wages, salaries, interest income and payments for merchandise made by third parties, etc. In the same manner, there is clear specification of the authorities to impose penalties, including the search and seizure of assets, valuables, etc. In many countries, the tax officials are required to strictly comply with code of conduct; taxpayers who desire to protect their right to privacy may have to take recourse to the administration or the courts from being subjected to arbitrary treatment. In some developing countries, the taxpayer aggrieved by

the decision of the tax official can prefer an appeal before a tax referee and is eligible to be reimbursed for the legal costs if the appeal is successful. In most developing countries and transitional economies, such a clear definition and enforcement of rules and regulations is absent.

Tax preferences or special treatment meted out to select taxpayers, can be viewed as equivalent of budgetary outlays benefiting households or specific economic sectors or activities. Accordingly, estimates of tax expenditures, that is, the loss of revenue foregone by the State Exchequer as compared with the amount of tax that would have accrued in the absence of tax allowances, can provide important information to the legislature and the public, more particularly, at the time of the budget debate or during tax reform, although there are difficulties in defining the reference value for each tax expenditure category. It is instructive to know that currently at least a dozen countries members of the OECD are regularly publishing expenditure accounts which reveal the estimated budgetary cost of tax exemptions, deductions, credits, deferrals and reduced rates. Presently, Austria, Belgium, France, Portugal, Spain and USA are legally obliged to prepare an annual tax expenditure report while Australia and Germany are required to present reports twice a year (OECD, 1996).

In the same manner, valuable information about the distributional implications of a country's tax subsidy system can be obtained from incidence studies, although these are at times beset with methodological and measurement shortcomings, as also those associated with those underlying household budget surveys. Australia usually publishes periodically tax subsidy incidence calculations, often prepared under contract by non-governmental organizations. It would always be instructive to estimate the differences among statutory, effective and realised tax rates, more particularly, those relating to corporate taxes and foreign trade.

Legal basis for taxation

It is mandatory that all taxes, duties, fees or cess should have an explicit legal basis. Tax statutes and ancillary subordinate legislation in the form of rules, notifications and regulations should be accessible and intelligible and there should be well laid down guidelines and specified criteria for any

administrative discretion in their application. The Constitutional framework of most countries enshrines the principle that no tax may be levied unless backed by an explicit legal basis, although there may be differences in the application of this principle. More particularly, in the case of a federal structure consisting of a central or national government, and state governments or sub-national governments, there should be clear-cut demarcation of areas of responsibility regarding powers of taxation between them. It is absolutely necessary that taxation should be under the authority of law and administrative application of tax laws should be subject to procedural safeguards.

In most countries there is a statutory requirement for the publication of legislation in the official gazette. It is also necessary that tax laws, regulations, and other documents relating to administrative or official interpretation of tax statutes should be easily accessible to the members of public. Most apex tax organizations routinely issue circulars meant for the general public and departmental instructions meant exclusively for the tax administration officials which should be kept up-to-date. New provisions introduced in the tax statute through budget should be given sufficient publicity so that the taxpayers realise the implications of new tax measures. It may also be a good practice if the tax agency were to make available to the general public the material relied upon by the tax agency in applying the tax laws, such as, manuals and legal opinion.

In addition to being readily accessible, tax laws should be intelligible. This would necessitate following the basic rules of legislative drafting, namely, good organization, including in the law all elements needed to adequately define the tax liability and tax procedure, avoiding ambiguities and contradictions, and the inclusion of all definitions wherever necessary. Proper legislative drafting is the basic pre-requisite to ensure that the legislative intent to raise the necessary financial resources by taxation is given effect to unambiguously. If the fiscal legislation is not properly drafted, the taxpayers will escape tax liability by relying on the imprecise and unclear language.

It is also necessary to watch the judicial decisions given by the tax courts or supreme court in tax litigation. Whenever such courts give their decisions on the legal interpretation of any legislative provision, either pronouncing the legislative

incompetence to levy any tax, or pronounce on the unconstitutionality of any specific provision or provide any legal interpretation in favour of the taxpayer and against the revenue on the ground that the legal language does not accord with the legislative intent, it would be necessary to resort to immediate retrospective legislation by means of an ordinance in case the Parliament is not in session, or by enacting an immediate amendment bill to override the adverse judicial decision or repair the legislative infirmity through a clarificatory amendment.

Widening of the tax base

Effective mobilization of financial resources by way of tax revenues for being utilized for developmental purposes has become a priority for most developing and transitional economy countries. For this purpose, widening of the tax base ensures, to a large extent, realization of full tax potential of the economy. Widening of the tax base has both legislative as well as administrative implications. Despite serious attempts, very few countries have been able to define precisely the concept of income. As a result, in many developing and transitional economy countries, due to the inadequate and incomprehensive scope of the concept of income, large quantities of taxable receipts escape taxation altogether. On the other hand, vague and imprecise basis of charge of taxation creates situations where multiple interpretations of the legislative provisions becomes possible resulting in tax avoidance. Hence, legislative amendments become necessary with a view to plugging the loopholes in the tax legislation as also to broaden the concept of income from time to time to extend the tax net so as to include in that definition receipts of an income character which hitherto were not considered as being taxable. The tax administration will have to be ever watchful over the activities of taxpayers to discover their schemes of tax avoidance as also the adverse decisions of judicial authorities which necessitate amendments of legislative provisions to clarify the legislative intent, sometimes with retrospective effect which generally results in large-scale upsetting of settled assessments of cases of taxpayers with consequent recoupment of lost tax revenue of preceding years.

The second aspect of widening of tax base has administrative implications. No matter how well designed the tax laws may be in theory, they may fail

to achieve their purpose in practice unless they are efficiently implemented and taxpayers can be induced, or if necessary, compelled to comply with them. An efficient and effective tax administration is, therefore, a pre-requisite if a tax system is to fulfil its revenue producing potential and even the best designed tax system is only as good as the administration which implements it. Tax administration is a major tool in the Government's efforts to pursue a sound fiscal policy, achieve an optimum tax effort level and establish an appropriate tax structure. Fiscal policy, which encompasses not only taxation but also public expenditure, interacts with tax administration in various ways and may actually help countries to move from fiscal disequilibrium to fiscal equilibrium resulting in the promotion of sustainable economic growth. For example, higher taxes, although a convenient way of augmenting revenue, may result, inter alia, in a disincentive to production and a contraction of consumption.

Efficient and effective tax administration may generate more revenue without these negative side effects, thus helping to reduce deficits and curb inflation. Furthermore, the reduction of fiscal deficits may make governments more conscious of their spending behaviour and give tax administration an additional incentive to combat tax evasion. Improved tax administration may also result in higher levels of capital formation, increased domestic savings rates and reduced public debt; and monetary and foreign exchange policies can be supplemented by tax incentive devices, leading to increased exports and foreign exchange earnings.

National tax burdens

A country's tax effort or level of taxation, usually expressed as a percentage of gross domestic product (GDP) can be affected by a variety of factors, namely, government spending for consumption and investment, the extent and scope for public debt, the inflow of foreign direct and portfolio investment and the extent of income from public enterprises. These elements constitute a means of determining and comparing national tax burdens. The overall average tax effort level in developing and transitional economy countries is around 20% as against 35% in the developed countries, although in developing countries, it is found to vary from 10% to 30%. While it may not be realistic to compare tax

performance of developed and developing countries, such comparison is instructive to prove that in the developing and transitional economy countries the tax efforts are low in relation to the tax revenue that could be collected on the basis of voluntary taxpayer compliance. Therefore, it would be plausible to conclude that there is scope for an increase in these countries' tax effort. The question, however, of what constitutes a desirable magnitude of that increase cannot be answered with any degree of certitude which would be valid for all countries. There is no simple formula for arriving at the optimum tax effort level. It would be necessary for governments to endeavour to strike a reasonable balance by setting taxation at levels high enough to generate sufficient revenues to meet the necessary public expenditure, but not so high as to discourage investment in business or industry and personal savings and to encourage attempts at tax evasion and tax avoidance.

Tax effort levels reflect the degree to which fulfilment of taxable capacity remains unhampered by non-compliance with the tax laws; consequently, the difference between taxable capacity and tax effort levels could be reduced by improved tax administration. The longer the tax effort has failed to occupy the pivotal role of public finance, the more pressing need there is to enhance the efficiency and effectiveness of the tax administration and more urgent it is to revamp the tax structure. Efforts to gear a country's tax structure to the capabilities of its tax administration can lead to increase in revenue by reducing tax evasion and tax avoidance. A tax structure cannot be merely a heterogeneous collection of taxes administered largely on a piece-meal basis, some of which nullify the effects of others but should be a harmonious and homogenous whole; all the constituent taxes are expected to be consistent in their economic impact and their administration ought to be self-enforcing so that non-compliance becomes substantially reduced.

Constituents of the tax structure

The tax structure of each country differs from that of any other and undergoes substantial changes during the course of the process of economic growth. In the case of countries with low per capita income, there is a tendency to collect more revenue from taxes which are easy to administer, while developed countries can resort to more sophisticated taxes, such as, sales or service taxes whose administration is

linked to proper maintenance of accounts. In most developing and transitional economy countries, the reliance on taxes which are easy to administer leads to considerably flawed tax structure, based mainly on foreign trade taxes, namely, customs duty or export taxes. It would be axiomatic to conclude that the administrative constraints tend to determine a country's actual tax structure. Although the tax administration by itself may not be in a position to change the tax legislation, its inputs may be instrumental in introducing the necessary legislative amendments to the existing tax laws or the adoption of new tax laws, so as to introduce more broad-based income and consumption taxes, thereby reducing the absolute dependence on foreign trade taxes.

While considering the question of mobilization of financial resources by way of taxation, the developing and transitional economy countries should take into consideration the following points, namely:

- (1) the desirability of increasing the percentage of collection of direct taxes, such as, income tax by the medium of withholding taxes on wages, salaries, interest on securities, including bonds and debentures, insurance and other forms of commission, interest on bank deposits including term deposits, dividends, payments to contractors and sub-contractors above a specified monetary ceiling limit;
- (2) the advisability of emphasising indirect taxes, such as, Value Added Tax (VAT), which is levied on goods and services and is largely self-enforcing, although this type of tax requires minimum administrative apparatus but is sometimes cluttered up with many rates and exemption provisions involving considerable administrative difficulties;
- (3) utility of employing presumptive taxation method of assessment, which is applicable to petty traders, hawkers, persons running kiosks selling newspapers or magazines, small restaurants as well as self-employed professionals not requiring serious intellectual inputs, such as, fitters, plumbers, electricians, motor mechanics, carpenters who do not ordinarily maintain any books of account and whose estimated total income from business or profession hovers around the exemption limit which enables the government to collect some additional tax from a large number of marginal taxpayers while simplifying administrative machinery;

(4) the desirability of introducing information technology in the tax administration which facilitates assembling of all relevant information about each taxpayer and creation of a data bank and use of cross checking methods to track down tax evasion and ensure accuracy. The information technology can also help in building statistical data for national income as well as for formulation of fiscal policy in the field of direct taxes.

In determining the magnitude and scope of the tax structure, the strength or weakness of the tax administration will be a major constraint, limiting the government's feasible tax options. The weaker the tax administration, the choice of taxes that can be administered becomes limited. Unless the tax administration is capable of enforcing new taxes, they may not have any significant impact on the tax revenues. Another important consideration to introduce new taxes is the administrative costs involved. Decisions about the particular tax options or introduction of new taxes cannot be made rationally without reference to the budgetary requirements and the expected revenue yields. It would be relevant to mention that if the tax system, whatever its structure, is to yield an optimum level of revenue, a major pre-requisite is the absence of political interference in the process of tax administration.

Difficulties in realization of full tax potential

Generally, most developing and transitional economy countries would experience serious impediments in realization of full tax revenue potential as a result of the interaction of a number of factors, some of which are mentioned hereunder, namely:

(1) The tax laws of most of the developing and transitional economy countries are complex pieces of legislation. The tax codes are, at times, couched in an archaic and incomprehensible language stemming partly from the anxiety on the part of legislature to ensure that the basis of charge is exhaustive and comprehensive so that every potential taxpayer is brought in the tax net as also to ensure that any one not eligible to the tax incentives or concessional tax treatment is not granted unwarranted benefit. Most often, tax laws are treated as vehicles for carrying out socio-economic objectives of the State for awarding concessional tax treatment to special interest groups,

for achieving horizontal equity or for promoting balanced and harmonious interregional development. These considerations, however laudable they may be, inevitably introduce complexities in the tax code with provisions which may have very little or limited nexus with the basic objective of raising revenue. This situation leads to two further difficulties, namely

(a) The complexities in the tax legislation creates avoidable impediment in voluntary compliance with tax laws even by honest taxpayers. Such non-compliance has serious social and economic costs.

(b) Complex and unintelligible tax laws place a heavy burden on the tax administration; more so, where the tax administration is incompetent and inefficient. The complex tax laws is also a boon to unscrupulous and corrupt tax officials who turn these complexities to their own advantage by granting unintended and unwarranted tax benefits to compliant taxpayers to the detriment of the interests of revenue.

(c) One of the basic objectives of tax reform process has to be, inter alia, simplification and rationalisation of tax laws and procedures so as to facilitate voluntary compliance by taxpayers and reduce the scope for corruption.

(2) Complexities in tax laws generate long-winding and needless tax litigation which consumes considerable time and money of both the taxpayer and the tax administration and involves involuntary deferment of tax revenues till the tax dispute is finally resolved. In many developing and transitional economy countries such costly tax litigation is further aided and abetted by a docile and servile judiciary which not uncommonly looks after the interests of taxpayers not without a quid pro quo. At the conclusion of the tax litigation, if the government is ultimately successful, the following consequences follow, namely:

(a) in most cases, the efflux of time creates difficulties in recovery of taxes due since the fortunes of taxpayers undergo drastic changes over a period of time thus jeopardising the chances of full recovery of outstanding demand;

(b) even if after the litigation is over, government is able to recover the taxes due, such tax payment is received after a number of years in a depreciated currency and at a fraction of its original worth when it was initially due. Practically, no developing and transitional economy country has made provision for

indexation of tax payments to take account of the inflation during the intervening years.

(3) In majority of developing and transitional economy countries, there exists rampant and unchecked tax evasion by recalcitrant taxpayers. Where controls and enforcement are minimal, and tax administration is lax and indifferent, these countries lose a large share of their legitimately and legally due tax revenue. Where tax laws are ambiguous and complex and its important provisions are capable of multiple interpretations, there exists scope for tax avoidance which makes a further dent in the tax revenues. Tax evasion and tax avoidance at both national and international levels have serious implications for formulation of fiscal policy. They violate the principle of fiscal equity and undermine the concept of voluntary compliance of tax laws. They can greatly diminish the impact of statutory incentives and consequently affect the allocative behaviour to neutralize distributional programmes, create artificial biases in macro-economic indicators and increase tax burden when tax rates must be increased in order to offset the revenue losses incurred, thereby imposing an unfair burden on taxpayers who cannot shift their tax liabilities. The greater the extent of tax evasion and avoidance, the more difficult it is to finance government expenditure without inflation or to increase tax revenue adequately, so that the excess of expenditure over taxation is positively correlated to the tax burden.

(4) It cannot be overemphasised that an efficient and effective tax administration can help developing and transitional economy countries to mobilize additional revenue and achieve greater financial self-reliance, not only in facilitating the launching and pursuit of growth-oriented structural adjustment programmes, but also in promoting the prospects for economic restructuring through privatization, or for more stimulatory or facilitating policies, with positive effects on both the pattern and rate of growth. The need to raise tax rates or introduce new taxes can be reduced or eliminated altogether by strengthening the tax administration. Such efforts may enable recovery of long overdue outstanding taxes but may not necessarily result in collection of increased revenue. The attempts to generate additional revenue through higher tax rates or new taxes may be frustrated unless determined and coordinated efforts are also made to enhance the efficiency and effectiveness of the revenue administration. Incremental improvement in

efficiency and effectiveness may also facilitate modification or re-writing of tax laws to take account of socio-economic changes and the need for more simplicity and clarity in the tax laws so as to promote voluntary compliance by taxpayers. The extent of corruption in tax administration and the government's ability to deal effectively will also affect the realization of full tax revenue potential. There is very little choice between an efficient but corrupt tax administration and an honest but inefficient and lethargic one. Unchecked tax evasion is generally the result of overt complicity of a corrupt tax administration. Where an inept tax administration neither punishes the corrupt elements nor appreciates the honest and upright, there would be very little scope for realizing the full tax revenue potential.

Impact of international taxation

There has been so far very little discussion about the impact of international taxation on the financial resources mobilization strategies of developing and transitional economy countries. There has been significant and unprecedented growth of international trade and commerce as well as capital movements across national boundaries which have given rise to complex and intricate problems of international taxation and more particularly, of double taxation of the same income by two countries, each trying to assume jurisdiction on the basis of the residence and source principles respectively. While the OECD has formulated its Model Tax Convention on Income and Capital (Revised Edition 1997) primarily on the basis of residence principle, the United Nations Model Double Taxation Convention between Developed and Developing Countries (1980, presently under revision) represents a compromise between the source and residence principles, although it gives more weight to the source principle than does the OECD Model Convention. However, both the OECD and UN Model Conventions have provided the primary right for taxation of dividends, interest and royalties to the country of residence and a subsidiary right (the percentage or tax rate to be applied to such income will have to be established during bilateral negotiations) in favour of the source country but the OECD Model Convention has not given even this subsidiary right to the source country in respect of royalties. The net effect of these provisions is that even though such income by way of dividend,

interest or royalties may accrue to an investor, lender or an enterprise providing a patent, invention or secret formula, such income arises in the source country, which may plausibly be a developing or transitional economy country, yet such income would be primarily chargeable to tax at appropriate rates in the country of residence, normally a developed country and such income would also be taxable at smaller rates of tax in a developing country. No doubt, developing and countries with economy in transition would be willing to provide very concessional rates of tax in respect of such income in the bilateral tax treaties with a view to attract capital, foreign direct and portfolio investment and technology from developed countries.

The concept of permanent establishment is used in bilateral tax treaties principally for the purpose of determining the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. According to that concept, the profits of an enterprise of one Contracting State are taxable in the other only if the enterprise maintains a permanent establishment in the latter State and only to the extent that the profits are attributable to the permanent establishment. However, the definition of permanent establishment under the OECD Model Convention is much more restrictive (compared to that in the UN Model Convention), with the result, unless the duration of project exceeds twelve months, the country in which it is located does not have the primary right to tax the profits attributable to the permanent establishment. The UN Model Convention has laid down a much more comprehensive definition of the permanent establishment including in its scope, furnishing of services, comprising consultancy services as well, and also the restricted period of six months as against twelve months in the OECD Model Convention. The net result of these provisions is that income accruing to foreign enterprises in another country (source country) becomes chargeable to tax in the residence countries, which are normally developed countries, if the duration of the project in such source country is less than that specified in the Model Convention. This artificial jurisdictional demarcation may have prejudicially worked to the detriment of interests of revenue of the developing and transitional economy countries.

Multinational enterprises with their head offices in developed countries and branches or subsidiaries in developing and transitional economy

countries are subject to multiple tax jurisdictions in several countries, with widely differing tax regimes and varying rates of tax. With a view to reducing the aggregate tax liabilities of all the associated enterprises, multinational enterprises are generally prone to adopting various kinds of artificial transfer pricing mechanisms for the sale of goods, services, debt servicing charges, and charges for technology transfers in their dealings with the associated enterprises which are far removed from the arm's length principle. More often, these transactions between the head office and the associated enterprises are further artificially routed through another entity in a tax haven country which provides complete immunity from taxation, whereby huge tax exempt profits are shown to have been made by the tax haven enterprise and negligible profits accrue to the enterprises in high tax countries, generally developing and transitional economy countries. As a result, negligible tax revenue accrues to these countries in which the associated enterprises are situated. Further, many more complexities are involved in the international economic relations through the advent of new financial instruments (worth US \$35 trillion) in the form of derivatives, with their further sub-divisions of swaps, options, forward and futures contracts. The current thinking on the subject suggests that the income embedded in these international financial flows accrues to the country of residence irrespective of the actual situs of the income which may be the source country. Hence, there are strong indications that the income tax attributable to the transfer pricing strategems, tax haven-routed transactions and referable to the new financial instruments or more particularly, incomes generated in international transactions would not ordinarily accrue or arise in source countries, which would normally be the developing or countries with economies in transition, thereby hampering their financial resources mobilization efforts considerably.

Measures to combat tax evasion and avoidance

Tax evasion and avoidance at the national and international levels have serious implications for fiscal policy. They violate the principles of fiscal equity and undermine the concept of voluntary compliance with tax laws. They can greatly diminish the value of codified incentives and thereby affect allocative behaviour to thwart redistributive programmes, create artificial biases in macro-

economic indicators and increase the tax burden when tax rates must be increased in order to offset the revenue losses incurred, thereby imposing an unfair burden on taxpayers who cannot shift their tax liabilities. The greater the extent of tax evasion and avoidance, the more difficult it is to finance government expenditure without inflation or, to put it differently, to increase tax revenues adequately, with the result that the excess of expenditure over taxation is positively correlated with the tax burden. Tax payment has come to be regarded as unfair, since public expenditure has been increasingly perceived as failing to yield commensurate benefits either to taxpayers personally or to their communities.

Tax administrators have adopted various measures for reducing opportunities for tax evasion and avoidance. The scope of these measures varies according to the characteristics of the country concerned, including its legal structure, its political system, its traditions and the psychology of its people. These measures have included reliance on indirect taxes, reliance on declarations and withholding of taxes by third parties, the operation of an efficient system and cross-checking of information, auditing and the unilateral determination of taxable income, the bilateral determination of taxable income (forfeit system) and the use of legislative provisions, administrative rulings and judicial decisions, as well as enactment and enforcement of penalties. International tax evasion and avoidance can be combatted by the conclusion of bilateral tax treaties providing for mutual assistance and exchange of information. One of the major reasons for prevalence of tax evasion is that governments have been tolerant of evasion. Politically, where large taxpayers are few in number and influential, strict enforcement and the imposition of harsh penalties may not be feasible. It may be both expensive and impractical to pursue the real tax liabilities of the self-employed, petty traders and the informal sector, which also requires considerable discretion on the part of tax officials. Where illegal markets constitute a large proportion of the economy, improvements in the formal tax code will be irrelevant to large flows of income.

Concepts of tax evasion and tax avoidance

Tax evasion proper is considered to occur when non-compliance with the laws of the taxing

jurisdiction is the result of a wilful and conscious failure to do so. Broadly speaking, tax evasion also normally encompasses the case of persons who, as a result of carelessness or negligence fail to pay taxes which are legally due although they do not have recourse to deliberate concealment for that purpose.

Tax avoidance, on the other hand, is a less precise concept and one which is not easy to define in terms which would meet general acceptance. Tax avoidance occurs when persons arrange their affairs in such a way as to take advantage of weaknesses or ambiguities in the law to reduce the tax payable below what it would otherwise be, without actually breaking the law. Although tax avoidance may be regarded as immoral, the means employed are legal and the conduct involved is not immoral.

Every person engaged in the revenue administration should consider it his duty to combat tax evasion by recalcitrant taxpayers. For this purpose, tax would include duty, cess, fee or charge payable by any person under a legal obligation. Tax evasion can occur through any of the following means, namely:

(a) Where a person having liability to pay any tax, duty, cess, fee or charge under a statute

1. Does not voluntarily furnish a declaration required to be furnished under the statute and thereby fails to pay his due liability;

2. Furnishes a declaration as required under the statute but omits to declare full particulars of his chargeable income, profits or gains, dutiable goods, articles or things, or presents inaccurate particulars of the basis of charge;

3. Furnishes a declaration as required under the statute but deliberately shows a reduced or nil liability for the tax, duty, cess, fee or charge by claiming a full or partial exemption or a tax incentive or concession which he knows or has reason to believe to be inapplicable to his situation;

4. Furnishes a declaration as required under the statute but knowingly or deliberately claims his personal or residential status to be different or the actual one thereby declining or reducing his liability to the correct amount of tax, duty, cess, fee or charges;

5. Furnishes a declaration as required under the statute but deliberately or knowingly creates false

evidence to reduce or deny his liability to pay the tax, duty, cess, fee or charges; and more particularly, in the case of a declaration of income chargeable to income tax, creates false evidence for expenses incurred or liability for expenses, falsely shows items of income as loans borrowed from third parties for reducing or eliminating altogether his liability to pay tax on his correct income.

(b) Where a person having a liability under a statute to pay any tax, duty, cess, fee or charge either does not furnish a declaration at all as required under the statute or furnishes a declaration containing any of the elements referred above in items 2 to 5, and in either case, with the overt or covert complicity or active support or participation of any public official in the revenue administration is able to reduce or eliminate altogether his liability to pay his statutory dues by offering to the public official or to any person related to or connected with him an advantage, benefit or facility, either immediate or deferred, convertible into money or otherwise, as an illegal gratification for the assistance offered to such person to reduce or eliminate such liability to pay his statutory dues.

In either of the cases mentioned above, there is a failure of the public official to check the evasion of tax through his lack of alertness, diligence or competence and through overt complicity in enabling the person indulging in tax evasion to reduce or eliminate his statutory liability. For either of the causes resulting in loss of revenue to the government, there should be some reprimand or censure of the public official in the first case and some exemplary punishment in the second case of his active involvement. The Board of Revenue and all public officials in the revenue administration should be aware of the primary responsibility to collect all taxes, duties, cesses, fees or charges legally due from every person or entity within the statutorily fixed time limit without fear or favour and thereby performing an important economic function. They may be made aware of the principle of time value of money which clearly shows that any such statutory dues received with a time lag lose its value and is worth much less than its original value. Since any payment of the statutory dues after it became due results in loss to the government, there could be two alternatives to deal with the situation, firstly, by enacting a provision for indexation of all tax payments to guard against erosion in value of money

due to inflation or secondly, through automatic charging of penal interest for late payment of tax or other statutory liability. If the rate of annual inflation is higher than the rate of interest, the government loses on that account but in the reverse case, the taxpayer in default is the loser, more so if the tax laws make an express provision for non-deductibility of such penal interest in the computation of taxable profits.

Informal economy

There is need to undertake extensive outdoor surveys by the tax administration to discover new taxpayers who should be made liable to pay their statutory dues. Many new taxpayers fight shy of approaching the tax administration to fulfil their legal obligation either due to diffidence or ignorance. The survey officials will have to be properly instructed to deal with the new cases with patience and firmness. There should also be strict supervision and control over survey officials to ensure that they perform their duty diligently and honestly so that there is no avoidable loss of revenue through indulgence in corrupt practices.

With the growth of economic activities, in many developing and transitional economy countries, there is an inevitable emergence of the informal economy largely composed of the unorganised underground sector which owes its existence to complex rules and complicated procedures relating to carrying out of the economic activities as also to high tax rates, strict rules for labour welfare and social security contributions payable by employers. In many countries, the informal economy makes significant addition to the Gross Domestic Product without making any contribution to the tax revenues. While the governments should make concerted efforts to bring the informal economy within the folds of the mainstream economy through various means, the Board of Revenue should devise special provisions generally known as presumptive taxation for the taxation of income earned by small enterprises, petty shopkeepers, and self-employed professionals not requiring intellectual inputs, such as, electricians, plumbers, masons, carpenters etc. Most of these persons do not maintain proper books of account and cannot afford professional assistance. There should be rough and ready method to determine income of such categories of taxpayers and public officials should make special efforts to gain their confidence

by showing the necessary leniency and accessibility to them. There should be simplified procedure for determination of tax liability and collection of taxes in these cases.

Appellate procedure

One of the basic pre-requisites of a good administration is the efficacy of the procedure by which any person aggrieved by its decisions can get inexpensive and speedy justice. It would be incumbent upon the Board of Revenue to rationalise the legal provisions and procedures relating to the appellate machinery whereby any taxpayer contesting any decision taken by a public official affecting the ascertainment or determination of his liability to pay any tax, duty, cess, fee or charge, or in any other case, is able to resolve the dispute with the revenue authority expeditiously and at a reasonable cost. For this purpose, the following specific measures would be necessary, namely:

1. Any person contesting his liability to pay any tax, duty, cess, fee or charge should be informed in writing unambiguously the designation of authority to whom an appeal should be addressed and the prescribed form or declaration to be used in this behalf.

2. The appellate authority should be instructed, through administrative directives, to dispose of the appeals expeditiously, within a specified time limit, after providing an appellant with a right of being heard in the matter, in person, or through his authorised representative, giving cogent reasons for the decision with clear-cut directions to the assessing authorities for re-determination of tax liability, if any, in accordance with its decision.

3. The appellate authority should be directed, through administrative instructions, to take up the appeals for hearing in strict serial order and no appeal should be taken up out-of-turn, unless specifically so desired by the supervising authority in writing, either on account of:

- (a) large amount of revenue involved, or
- (b) the appeal involves an important question of law or fact which needs immediate decision, or
- (c) an identical point has arisen in a large number of cases and an immediate decision of

the appellate authority will avoid needless repetitive litigation.

If in any other case, the appellate authority takes up an appeal for hearing other than in a serial order, such action may have to be looked at from vigilance point of view. Moreover, any order passed by an appellate authority after an unconscionably long interval after the last date of hearing should also come for scrutiny from vigilance point of view.

4. There should be as few appellate stages as possible for redressal of grievances for taxpayers but the procedure for successive appeals should be clearly made known to the taxpayers. After the final appellate authority gives its decision, the tax liability should crystallise for payment and be collected expeditiously.

5. Where a taxpayer aggrieved by the decision of an assessing authority contests the tax liability in a first appeal, the assessing authority may allow the taxpayer to keep the disputed demand in abeyance, wholly or partly, or allow him to pay the disputed demand in instalments, with a provision for immediate suspension of the facility if even one instalment is not paid on due date. The assessing authority should exercise this discretion taking into account all facts and circumstances of the case, including the possibility of risk of loss of revenue. The tax liability so determined as payable after the decision of the first appellate authority should be collected promptly, unless the disputed demand further contested in appeal is adequately secured by a bank guarantee or by depositing with the assessing authority title deeds of an immovable property or of any other tangible asset. The assessing authority should closely follow the appellate authority's decision for effecting recovery of taxes due from the taxpayer. Any default or loss arising as a result of recoverableness of disputed amount of taxes should be attributable to the assessing authority and, if necessary, should be examined from vigilance point of view if any collusion between him and the appellant could be proved.

6. Ordinarily, while making selection of officers for manning the appellate functions, care should be taken to ensure that they are persons of unimpeachable integrity and known for balanced judgement. A wholly revenue-minded officer whose only pre-occupation is to protect the interests of revenue is as bad as one with a reputation for lack of

integrity. Any indication of lack of fair-mindedness on the part of appellate authority causes incalculable harm to the reputation of the revenue administration and seriously affects the chances of voluntary compliance by taxpayers.

7. Except for ensuring the prompt disposal of appeals and maintenance of high standard of performance by the appellate authority, there should be no interference in the exercise of the judicial functions by the appellate authority either by the Board of Revenue or any other supervising authority. None of the circulars or instructions issued on the interpretation of the legal provisions issued by the Board of Revenue or any other executive authority should be binding on the appellate authority in any manner. Nor their non-acceptance of the departmental view point may be treated as ground for initiating any vigilance action.

Registration, Assessment, Collection and Audit

The revenue administration's effort to prevent evasion and ensure compliance with the tax laws will involve four stages in the functioning of the tax collecting machinery, namely, registration, assessment, collection and audit.

Registration

The first stage for commencing the proceedings for determination of tax liability is to register the name of the taxpayer in the rolls or the general index of taxpayers. In the case of customs duty, the registration can be effected at the time of first import made by the person liable to pay the duty. For sales tax or central or state excise duty, there would be similar list of persons liable to pay such taxes to be maintained in the concerned office. The first basic requirement is the demarcation of the territorial jurisdiction amongst the assessing authorities on well-identified criteria, such as, geographical areas or industry or profession-wise, or where the taxpayers are salaried employees, on the basis of the names of employers. Whichever basis is adopted, it should be identifiable, distinguishable and intelligible to the taxpayer. Since the tax laws or the manuals for other taxes give authority to assessing officers on the basis of jurisdiction over certain geographical areas or specified attributes, these jurisdictional particulars should be properly spelt out in the manuals or notifications. There should be

necessary statutory obligation on the taxpayers to furnish the declarations within the specified time limit and the consequences following the defaults in this behalf should be high-lighted. Depending upon the size of the taxpaying public and the extent of voluntary compliance, different methods could be evolved drawing attention of taxpayers to their obligation to comply with the statutory requirement of furnishing the declaration, either in the form of general information advertisements in the national or regional newspapers or notices to individual taxpayers or circulars sent to important chambers of commerce or similar organizations. If the registered taxpayers are entered on a properly maintained computerized tax master file, it would help identify unregistered taxpayers through information cross checks. A further refinement can be made by allotment of a unique Taxpayer Identification Number (TIN) through a specific computerisation process to each taxpayer which can be permanent in nature and which can be quoted in specified designated transactions. Such TIN can be quoted on scrolls for making tax payments and facilitate to identify and account for each taxpayer's tax payments.

Assessment

After the declaration has been furnished by the taxpayer, the next stage is the determination of taxable charge and ascertainment of the liability for tax, duty, cess, fee or charge by an assessment procedure in accordance with the legal provisions. Assessment methods for determining taxable income and calculation of the tax due and the mixture of such methods employed, differ according to the legal structure of the country concerned, its political system, its traditions and the psychology of its people. The methods are applied at different stages, prior to the filing of the tax returns or declarations; after the filing of the information return or following audits or similar moves by the tax administration to verify the veracity of the information return. The assessments may be carried out by the taxpayers themselves, by the tax administration acting unilaterally or jointly by tax administration and taxpayers. Where the taxpayers voluntary compliance is significant and the taxpayers are aware of their statutory obligations, the self-assessment procedure may be adopted in a large majority of cases and the tax returns or declarations may be accepted entirely, without requiring the

presence of the taxpayer in the tax office. After verification of the tax payments made by the taxpayers in conformity with the returned income, no assessment as such may be made and after sending an intimation to the taxpayer of the acceptance of the returned income, the proceedings may be filed. Cases involving substantial revenue or important questions of law or fact may be taken up for detailed scrutiny and investigation. The efficiency of the tax administration can be judged on the basis of two criteria, namely, the cost of collection of taxes and the manner in which the assessment procedure is organised so that routine assessments of small and medium income cases are finalised expeditiously and large revenue yielding cases are handled with maximum care and investigation. In most developed countries, nearly 95% to 97% of assessments are finalised on the basis of returned income and only 3% to 5% of cases are selected for scrutiny. With the growth of voluntary compliance, more and more cases could be accepted on the basis of returns furnished. However, cases for random scrutiny and normal scrutiny could be selected on an identifiable fixed or semi-fixed criterion so as to avoid attempts at corruption. As reported earlier, some tax administrations taking a realistic approach to tax evasion, voluntarily waive the right to collect the full amount of taxes for which certain categories of taxpayers are liable, levying the taxes on the basis of a notional or presumptive income, rather than of the income the taxpayers actually receive or to which they are legally entitled

Collection

Information is the most important weapon of the tax administration in its efforts to collect taxes under the law. Since gathering and storage of information is the basis for other steps in the collection process aimed at ensuring timely and accurate filing of returns and the payment of full taxes due at the appropriate time, efficient information systems and specially computerization are of great importance. The process of collection of annually recurring taxes, mainly income tax, excise duty or sales tax should be well phased out so that the payments are made by way of Advance tax in three or four instalments during the income earning year on estimated basis with the final balance payment on the basis of the declared income known as self-assessment tax made at the time of furnishing the return or declaration. The system of advance tax

greatly facilitates ways and means position of the government and also provides important information regarding the general state of the economy. Another important means of collection of taxes is the withholding of income tax at source, from income by way of salaries and wages, commission payments, brokerage, technical know-how fees payable to foreign enterprises, interest, royalties and payments to contractors and sub-contractors. The pre-paid taxes in many developed and developing countries account for nearly 80% to 95% of total tax collections. The balance amount collected after assessments and final appellate decisions clearly reflects the efforts made by assessing authorities in discovering tax evaded income. Concerted and coordinated efforts are required on the part of tax administration in monitoring all pre-paid tax payments by constant liaison with agencies required to deduct taxes at source and ensuring that all taxpayers who are required to pay advance tax do actually discharge their obligations. In regard to recovery of outstanding taxes, they generally represent taxes kept in abeyance till decision in appeal, cases in which instalments are granted and recovery to be made by attachment and sale of assets left by taxpayers who are no longer traceable. Where arrears of taxes are no longer recoverable, bold action would be required to write-off irrecoverable dues. The older the tax debt and more difficult its recovery, a cost-benefit analysis would be required to decide which debts to pursue. If administrative collection proves unsuccessful, various forms of legal action may be pursued depending upon the circumstances, the legal environment, the attitude of the courts and other considerations. The collection machinery should be properly organised with constant feedback and coordination with collecting banks, sub-treasuries or other agencies. It is essential that collection procedures should be prompt and expats.

Audit

Auditing is an essential weapon in combating non-compliance with the tax laws by a careful examination of the taxpayer's records and in the case of VAT or sales tax, the records of the suppliers and customers to determine whether correct tax liabilities have been reported and to ascertain the mis-interpretations as also to detect and punish evasion. The degree of compliance with the tax laws and regulations is closely related to the performance of the audit function and audit operations should be

programmed and carried out to exert the greatest possible impact on the taxpayers. When audit resources are scarce they should be used to the best advantage in terms of revenue collected and deterrent impact, and compliance studies may be desirable to determine which economic sectors or types of business should be targeted. However, the audit coverage of all classes of returns should be maintained to remind other tax-payers in the same class of the presence of the tax authorities when completing their returns, thus helping to encourage long-term voluntary compliance. In some developed countries, the selection of cases for audit is made on the basis of rates of return from the asses of the business and cases of taxpayers who show lower rates of return are taken up for audit. Audit manuals, providing the audit staff, such as, field agents or office auditors with special instructions and guidance on techniques for auditing various types of businesses and situations have proved extremely useful. It has been perceived that audit and investigation are specific areas where developing and transitional economy countries are most deficient.

Personnel management

Recruitment

One of the foremost pre-requisites for an effective and efficient revenue administration is proper recruitment procedure to man posts of higher responsibilities in tax and customs administration. Clear job descriptions need to be prepared setting forth the nature of duties and responsibilities involved, educational qualifications and experience along with salary and benefits offered. The candidates' educational background should be taken into account to determine whether they are likely to become good revenue administrators after suitable training. For this purpose, an entrance examination on a competitive basis, along with an aptitude test may be appropriate, as being done presently by countries in South-East Asia. The recruitment process should ensure that candidates understand the possibilities and limitations of the post and along with the requisite academic qualifications and experience, also possess the qualities as vocation for public service, a sense of responsibility and moral integrity. The difficulty of attracting the right type of candidates for revenue administration is further complicated by the possibility of meritorious candidates being siphoned off by the private sector

offering higher emoluments and perquisites which the public sector cannot match.

Training

Suitable training facilities for revenue administration staff are necessary, both for the newly recruited staff as also for those already in service for acquainting them with new regulations, procedures and legislative modifications made from time to time to upgrade their technical competence and improve productivity. Well-conceived training programmes can enhance their efficiency and motivate them for personal development and career advancement. Apart from technical aspects of their work, training should also lay emphasis on improving communication and inter-personal skills, public relations, and ensure computer literacy. The lack of managerial capabilities seriously hampers the effective functioning of revenue administration in developing and transitional economy countries. There is very little attention paid to developing revenue officials as good managers. This is due to lack of management training facilities and also from lack of awareness of the potential of management tools and techniques with respect to decision-making and problem-solving in revenue administration. Every revenue administration should devise a training plan spanning the entire service career of a revenue officer, including basic and foundational training, periodic refresher courses for technical inputs, specialized training in specific areas of revenue matters, such as, intelligence-gathering, investigation and audit, international taxation and executive and management development programmes. Training is an investment which yields substantial dividends if properly administered and regularly provided; each revenue administration should have, resources permitting, its own training academy or centre or access to an interregional joint training centre. If training is to be effective, good trainers are required and adequate incentives should be provided to attract them. Periodic interregional, regional or sub-regional seminars or training workshops enable revenue officials to interact with their counterparts from different countries or regions and learn from each other's experiences. The use of one country's training facilities by other countries can also make a valuable contribution and increased exchange of information on revenue administration between developing countries essentially neighbouring ones.

Motivation

It is important for revenue administration to retain the services of competent officials with a high standard of integrity. For this purpose, the conditions of service in the revenue administration should be sufficiently attractive, provide adequate motivation, such as, reasonable remuneration, welfare schemes, retirement benefits, job security, job satisfaction, career development opportunities and public recognition of revenue officials' contribution to the revenue administration. Job satisfaction depends on observance by supervising authorities of sound management principles. Decentralisation of authority and proper delegation on clearly understood policies and specific programmes on the basis of qualifications, skills and experience of the staff concerned. Individual officials should feel inclined to imbibe the team spirit and supervising authorities should provide adequate guidance, assistance and encouragement to subordinate officials.

Staff performance should be evaluated at periodical intervals according to objective criteria and awarded standardized ratings. There should be positive efforts to commend excellent performance and suggest remedial measures for removing deficiencies without sounding unduly critical. If defects or deficiencies persist, strict action should be contemplated against erring official. Promotion to higher posts or special positions of responsibility should be normally based on merit cum seniority principles. Promotion prospects, with suitable training opportunities have considerable impact on staff morale. Staff members should be encouraged to suggest measures to avoid waste and improve productivity, with the incentive of prizes for best suggestions. There should be awards schemes for outstanding performance for different fields of activities in the revenue administration.

Motivation and integrity

The question of motivation is inextricably linked with the problem of dishonesty on the part of revenue officials, which is prejudicial to the interests of revenue due to resultant loss of revenue but also for its harmful effects on voluntary compliance by taxpayers and their perception of the revenue

administration. It would be necessary to prevent or punish acts of corruption on the part of public officials in the revenue administration. Such officials may be less inclined to indulge in corrupt practices if they were to receive adequate remuneration. The only strong motives which promote honesty in the face of temptations are: security of employment, likelihood of discovery through internal auditing and the likelihood of receiving exemplary punishment following successful launch and completion of criminal prosecution. Public esteem and approbation of honest officials also constitute an important element in maintaining integrity by revenue officials.

Planning

Planning is of vital importance in efforts to strengthen revenue administration. Planning involves determining revenue administration's achievements, defining its objectives, formulating general strategies and operational plans for attaining those objectives, and allocating resources for this purpose. Planning consists of two elements, namely, strategic and operational. Strategic planning can be considered as a long-term planning process which considers the overall environment in which the organisation operates and intends to anticipate change, in order to avoid negative impacts and take advantage of the positive ones for the benefit of the administration. It is materialized in strategic directions and initiatives, which are the starting-points for operational plans. The latter is a planning process which generally covers a fiscal period, wherein the activities and priorities of the plan are identified. It also shows for each of them the probable dates of initiation and termination, and the human, material and financial resources needed. Generally, operational plans include criteria which subsequently facilitate follow-up and control. In fact, revenue administration requires a formalized operational planning system for optimizing the use of resources, providing the information to justify budget requirements to central government agencies and for reviewing performance with a view to making improvements.

Management Control

Management control is an essential component of efficient revenue administration involving evaluation of performance and the assessment of results in the light of expectations, objectives and plans. The implementation of programmes must be monitored on a continuing basis, so that deviations

from the plan can be ascertained and problems resolved as soon as possible. Similarly, a feed-back system must be in place so that, on completion of project, any corrective action required can be incorporated into the next operational plan. The review and the follow-up function, which is the essence of management control, involves such processes as programme evaluation, internal audit and other management review and information processes.

Special problems of Customs and Excise administration

Generally, customs and excise administrations are handicapped in the effective execution of their duties by a lack of sufficient resources and by a shortage of manpower, equipment and other logistical supports, which negatively affect their performance. Hence, it is necessary that they are provided with adequate funding to meet their requirements. A certain percentage of their collections may be earmarked for that purpose and during periods of financial constraints, cuts may not be applied to these administrations. Within the scope of the resources allocated to the customs and excise administration, it should be given full autonomy to prepare and execute its activities. Heads of customs and excise administrations should be given direct access to the policy-makers, such as, the ministers or finance secretaries and the status of these administrations should be that of a department and not an attached or subordinate office. Consistent with the arduous and hazardous work done by customs and excise officials and their important role in mobilization of resources for the governments, the staff of these administrations should be provided better remuneration and facilities so that they would be motivated to work efficiently, thus enabling the administration to retain the services of competent officials with a high standard of integrity and dedication.

It is common experience that high tariffs and trade barriers generally result in widespread smuggling in developing countries and countries with economies in transition. On the basis of their expertise and experience, senior officials in customs and excise administration should be given a greater role in policy-making, so as to ensure a rational tariff structure. These administrations should also receive extensive and effective logistical support, in the form

of vehicles and communication equipment with a view to enhancing their efficiency and effectiveness in combating smuggling activities. There is need to introduce modern technologies to improve effectiveness of customs and excise administrations, namely:

1. Computers for processing import and export documents and check valuations;
2. Scanners to detect contraband goods in containers and other packaging;
3. Communication equipment to intercept smugglers.

Undervaluation is another major concern of customs administration as it has a negative impact on collections. Countries should organize proper systems for collecting and utilizing evaluation information, and as far as possible computers should be used more extensively in this connection. There should also exist facilities in the form of laboratories, either owned by customs administration or otherwise easily accessible on payment of charges, available for testing chemicals and other substances imported from foreign countries to determine their chemical components and other properties to decide valuation on scientific lines and proper classification for levying customs duty. In some countries, the task of combating drug-trafficking is also entrusted to the customs administration treating this activity as analogous to smuggling. Customs officials would need special training in detecting different kinds of psychosomatic substances and the special treatment needed to apprehend the drug traffickers. It would be desirable to entrust the function of anti-drug trafficking activities to a separate administration, if the country concerned is the origin of the drug traffic, growing different kinds of psychosomatic substances in raw material forms, or possessing illicit processing units or being used as a transit or conduit for other countries with potential for consumption and also depending upon the size of the problem.

Conclusion

The macro-economic conditions of each country, its social structure and priorities, its external debt situation, its administrative capabilities, and other relevant considerations determine its appropriate tax policy, which evolves over time by adapting it to changing political and socio-economic conditions by adjusting tax rates, by fine-tuning or

eliminating existing taxes or by adding new ones, the ultimate aim being to serve the objective of sustainable development. In formulating tax policy, it is necessary to establish fiscal objectives and translate them into tax policy which must undergo pre-enactment evaluation and be administratively feasible. The revenue administration should possess the capacity to interpret the laws and facilitate compliance by those affected, monitor adherence to the laws and ensure their equitable application.

The interpretation of laws and monitoring of compliance are carried out through taxpayer service and monitoring and enforcement programmes deemed essential for income tax administration.

Presently, there are weaknesses in these activities which are **not** achieving requisite results, namely:-

1. Systems to account for revenues assessed, paid and due and to control and finalize returns received and due;
2. A capacity to provide forms and guides to meet the needs of those who had filed objections;
3. A co-ordinated compliance measurement process, extending throughout the revenue administration, to extract data for analysis;
4. Technical enforcement skills to:
 - (i) Screen, monitor and assess the quality of returns;
 - (ii) Collect unpaid accounts;
 - (iii) Conduct auditing of entities with withdrawing, third party filing or similar obligations;
 - (iv) Conduct investigation of evasion cases and obtain convictions in criminal court; and
 - (v) Sustain and develop bilateral and multilateral administrative arrangements consistent with laws for preventing double taxation and identifying avoidance and evasion practices for appropriate action.

There is need to give pointed attention to these inadequacies to bring about improvement in revenue administration.

Developing and transitional economy countries have been facing grave fiscal crisis since

long, with many of them experiencing serious gap between their needs and available tax revenues. While they must rely increasingly on their own resources to finance government expenditures, they must increase the productivity of their tax systems to raise the necessary resources. There are many causes for the shortage of tax revenues in developing and transitional economy countries, namely

1. Their economies are vulnerable to shifts in the world economy. Swings in the prices of certain articles, such as, petrol create hardships in these countries. Way back in 1973, after the sudden surge in oil prices, several such countries found, to their dismay, that nearly 80% of their export receipts would go to pay only the oil import bill. Over the past two decades, commodity exporting countries have also experienced wide fluctuations in the prices of their main products.

2. Increasingly, developing and transitional economy countries have realized that they are themselves to blame for the lack of their economic growth due to their pursuit of wrong and unproductive development strategies.

3. In most of these countries attempts to deal with the debt crisis have been accompanied by inflationary spirals with the consequent fall in tax revenues in real terms.

This fiscal crisis has also coincided with a reduction in the willingness of private lenders to finance government deficits in the developing and transitional economy countries. With a few exceptions, foreign economic aid from developed countries has not increased to fill the gap. The preponderance of evidence from empirical literature on aid effectiveness has pointed out that development aid has not had a significant impact on economic growth in recipient countries. However, there is some evidence that aid has had positive effects when policy environment has been conducive to growth. As regards the main relationship between aid and the main channels through which its impact on growth could flow, namely, investment and domestic savings, the evidence is mixed, with the indication that aid has had a positive impact where adjustment efforts have been sustained. Two findings in a recent study indicate that aid has not been effective when the policy environment has been good, but that aid has not stimulated the adoption of good policies suggest that greater selectivity in aid allocation (in

support of strong policies) might have delivered better performance on growth and poverty alleviation in recipient countries.

The reason why many governments run fiscal deficits can be explained by the rationale for fiscal imbalance being to minimize the distortionary effects of levying non-lump-sum taxes by spreading the burden of these taxes over time, known as **tax smoothing** introduced by Robert Barro in 1979.¹ Tax smoothing has the normative implication that budget imbalances can be optimal fiscal policy responses to anticipated future events, for example, a government anticipating an increase in its own expenditure can minimize the distortionary effects of raising the finance for that expenditure if it brings forward some of the associated tax increase and runs a budget surplus or a smaller deficit in the current period. Tax smoothing approach predicts that tax burden of funding this expenditure will be spread over time (so the government will run a fiscal deficit); conversely, a permanent increase in spending should be financed by raising contemporaneous taxes resulting in no fiscal deficit.

However, there are other intertemporal incentives for running unbalanced budgets. Even if it is assumed that government spending as a share of GDP will remain constant into the future in which case there would be no need for tax smoothing, if the government's discount rate differs from the effective interest rate, then the optimal tax rate will be affected by the government's desire to engage in **tax tilting**. Tax tilting results in a bias towards either budget deficits or budget surpluses. Tax tilting could occur, for example, if the current government is unsure of its re-election prospects and would favour higher current debt levels than are implied by tax smoothing in order to exert an influence of the future spending activities of rival political parties who assume office. The intertemporal tax-smoothing model is successful in explaining the behaviour of the fiscal deficits of one developing country so that the central government was able to keep its tax rates relatively constant (smooth) in the presence of temporary shocks to expenditure.

It could be argued that the traditional inability of the central government to satisfy its intertemporal

budget constraint from conventional tax and non-tax revenue sources raises the likelihood of public borrowing being its preferred response to shocks to government spending- behaviour which is consistent with the tax-smoothing hypothesis. Moreover, this same inability to garner sufficient receipts from conventional revenue sources results in tax tilting behaviour by the central government, with quasi-fiscal activities, such as, seigniorage and financial repression being important sources of net revenue, through the implicit taxation of financial intermediation. In the ultimate analysis, formulation of fiscal policy in a developing or transitional economy country is a delicate exercise which may have financial implications for the future budgets as well.

Many developing and transitional economy countries have taken steps to control the need for tax revenue. Some have enacted user charges for government services while others have made progress towards controlling the growth of their public sectors by exerting fiscal discipline during periods of economic expansion. Most of the developing countries cannot, however, escape the need to raise more tax revenue. The recent tax reform efforts in many developing countries reflect a new pragmatism in their approach to taxation. In many countries, there has been a movement toward tax systems that are more effective in raising tax revenue and away from tax systems designed primarily to promote certain economic and social objectives. This has been also found to be widely prevalent practice in developed countries. While the developing and transitional economy countries can benefit from experience of developed countries, they need not blindly copy them in formulating their tax policies or organizing their tax administration. It would be necessary to take the economic and social circumstances of the country into account, as the tax laws can be more easily adapted to national customs than *vice versa*. It is essential that taxpayers should understand the tax system and find it compatible with conditions in their country. Successful tax reform depends upon the formulation of a tax policy that will result in a tax structure that can be administered adequately with the available resources while making the best possible use of those resources from a long-term standpoint.

The IMF's involvement in tax reforms in developing and transitional economy countries, is

¹Robert Barro (1979): On the determination of Public Debt (Journal of Political Economy, 87)

essentially a case-by-case approach responsive to its existing conditions, consisting of firstly, surveillance activity, secondly, through its lending operations, and thirdly, through requests by member countries for technical assistance. While examining the question of fiscal reforms in low income countries, IMF has observed that improving the structure and administration of tax systems requires significant tax policy reforms, such as, simplifying and rationalizing tariff and tax rates and introducing broad-based taxes on consumption, for example, value-added taxes (VAT). Reform strategies should also seek to modernize tax and customs administration, keeping in mind that these reform measures take time to produce needed revenue gains. Some countries with low initial revenue effort failed to improve revenue performance as rapidly as envisaged. This result could imply that the programme designed to raise revenue over time in low income countries must reckon with administrative constraints. Generally, low income developing or transitional economy countries with low revenue to GDP ratios (around 10%) should emphasize efficient revenue mobilization as a key element in rectifying fiscal imbalances. On the other hand, at much higher revenue-to-GDP ratios, (generally more than 20%), persistent macro-economic imbalances would call for shifting fiscal consolidation efforts towards containing expenditures.

During 1980s, tax reforms have taken place in a number of countries at all levels of development. In virtually all these cases, concludes Sven Steinmo,² these tax reforms have meant lowering income and profits tax rates, cutting back tax expenditures, and broadening the tax base. Tax reform has now come to mean the redistributing of existing burdens downwards. Specific policies may vary from country to country, but observable trends have been towards a more inclusive and less progressive (flatter) income tax with fewer rates, and more reliance on VAT. In any case, tax reform has included and required changes in tax administration and redistribution of administrative resources.

²Sven Steinmo (1993): *Taxation and Democracy: Swedish, British and American Approaches to Financing the Modern State* (Yale University Press).

According to Parthasarathy Shome,³ globalization is also likely to lead to significant changes in other areas of tax systems and arrangements in the twenty-first century, particular features being - (1) international cooperation despite the sacrifice of some fiscal sovereignty; (2) the introduction of global taxes, such as, an environment tax, rather than one on financial transactions which would adversely affect financial flows; and (3) an international tax organisation focussed on international tax policy and related tax administration issues which would reduce the hold of tax havens, increase international exchange of tax information, develop multinational conventions, and reduce the prevalence of bilateral treaties.⁴

The criterion for improvement is progress towards closing the compliance gap, the gap between actual and potential revenues, as observed by Bird and Casanegra de Jantscher.⁵ Whatever policies are adopted, they will be negated if there is a large compliance gap. Roy Behl and Jorge Martinez-Vasquez⁶ explain, Because low-income countries do not efficiently administer the systems they have in place, they fail to collect the true amount of revenue due, the efficiency objectives of the tax structure are not realized, and both the horizontal and vertical equity intent of the nominal tax structure are compromised.

The strategies for tax administration are not in doubt. The first principle is simplification. For example, the number of tax brackets in the income tax should be reduced and exemptions and deductions

³Parthasarathy Shome (1999): *Taxation in Latin American: Structural Trends and Impact of Administration* (IMF Working Paper: WP/99/19)

⁴Tanzi, Vito (1998): *The Impact of Economic Globalization on Taxation* (Bulletin of International Bureau of Fiscal Documentation, August-September 1998, pp 338-343)

⁵Richard Bird and Milka Casanegra de Jantscher (1992): *The Reform of Tax Administration in Improving Tax Administration in Developing Countries* - International Monetary Fund, USA.

⁶Roy Behl and Jorge Martinez-Vazquez (1992): *The Nexus of Tax Administration and Tax Policy in Jamaica and Guatemala* in *Improving Tax Administration in Developing Countries*.

as far as possible eliminated. However, Roy and Martinez-Vasquez argue that development which brings about a more complex economy may require more, and not less, complex tax structure. The second principle is the need for a clear strategy for reform rather than *ad hoc* measures. It is necessary to evaluate the current tax system so as to understand where the revenue presently comes from, the uses of administrative resources and how they relate to revenues and the number of cases handled, actual and potential tax bases, and existing problems. The third principle is a high level of commitment to reform, particularly at the highest levels, but also embracing all concerned. The way a tax system is viewed depends on perception - of the extent of evasion, fairness, complexity, arbitrariness, and the burden of administration on taxpayers. The final principle is technical competence. Tax administration consists of routine tasks, such as, withholding of taxes, maintenance of accounts and collection of revenues, as well as more discretionary ones, including audit of returns. The methods for improvement are well-known: they include well-trained and well-compensated officials, tight control over cash, monitoring of information, systematic checks, internal security, close involvement of operating administrators and researchers, and timely and reliable operations.

Before concluding, it would be necessary to take into account development of national corporate tax policies in the context of the internationalization of business activity. The main idea is that internationalization will induce governments to seek new cooperative methods of taxing businesses, including allocation methods for attributing income to different tax jurisdictions. In fact, the necessity of using formula allocation at the international level as businesses become increasingly global in their operations cannot be underestimated. Although existing corporate tax regimes are introducing allocation methods on a piece-meal basis, the necessity of doing so will become stronger overtime as governments maintain their desire to levy income taxes on business activity. Even though there are limitations to allocation methods, it appears that continued international integration of business activities with new forms of organization and transactions will require governments to cooperatively seek a new arrangement for corporate income taxation. Allocation methods may facilitate such cooperation by providing a desirable trade-off

between allocative and cost efficiencies with national autonomy and flexibility. It is important that countries participating in allocation would need to agree to a reasonably common base for determining corporate income. While the federal government's corporate income tax base may help as a starting point for determining state or provincial government tax bases, at the international level, no similar institution would provide an opportunity to generate a common method of defining corporate income. However, the development of tax treaties and other international tax arrangements provide an excellent lesson for policymakers. For the development of a globalized corporate income tax according to Dr Vito Tanzi, it would be useful to create a formal body, such as, the World Tax Organization or provide powers to an existing international organization that would facilitate multilateral cooperation for developed and developing countries. To start the process, a smaller group of countries could provide leadership to encourage the development of multilateral discussions that would ultimately lead to new arrangements for tax coordination. This could be facilitated by, say, G-7 countries, which account for a significant share of multilateral trade, to initiate discussions and develop a broad set of criteria as basis for multilateral negotiations among developed and developing countries.

In conclusion, it would be pertinent to mention that the success of revenue mobilization over the medium term depends significantly on the implementation of comprehensive reforms in tax administration, more particularly, through strengthening institutional capacity, improving systems and procedures, and giving greater autonomy to tax administration. Reforms of tax administration typically include elements, such as, wider registration of taxpayers, simplification of procedures for taxing the informal sector, establishment of large-taxpayer units and staff training and computerization. Tax administration reforms typically have long gestation lags and, therefore, cannot be utilized as short-term revenue measures. Appropriate sequencing of tax reforms is important for the overall success of the reform strategy, given the limited administrative capacity in many low income developing countries.

A significant feature of tax administration reform in many developing countries would be the establishment of an autonomous tax administration

separate from the Ministry of Finance or Treasury and, in some cases, outside the regular civil service. Separating tax administration from the regular civil service and providing more flexibility in setting salary levels of tax officials and hiring and firing staff, if supported by political commitment and reinforced by organizational reforms has been found to enhance productivity and contribute to substantial revenue gains. Along with granting greater autonomy to revenue administration, the change often created opportunities to make organizational changes that supported implementation of more efficient and modern procedures. Further, technical assistance, when well designed and implemented in accordance with growth in local capacity can play an important role in tax administration reform, more particularly, for building institutional capacity and reorganizing tax administration along functional lines.

In recent years, a number of industrialised and developing countries have sought to adopt fiscal policy rules which impose a permanent constraint on fiscal policy in terms of summary indicators of overall fiscal performance. The rationale for fiscal policy rules, in the form of various balanced-budget rules, borrowing rules and debt rules, rests primarily on the need for macro-economic stability, support of other financial policies, long-term sustainability, reduction of negative spill-overs and overall policy credibility. Fiscal policy rules can be implemented under a variety of institutional arrangements. However, an effective and efficient revenue administration would be one of the most important pre-requisites for ensuring the success of the operation of fiscal policy rules.

5. PUBLIC EXPENDITURE ADMINISTRATION

Introduction

There is a growing realization that developing and transitional economy countries which face particularly difficult problems of economic adjustment are often found to be burdened with economic structures and institutions which hinder rather than accelerate the achievement of economic growth. It is necessary that international organizations should promote and implement action-oriented responses aimed at enabling these countries to enhance financial resource mobilization capabilities and their efficient, effective and rational

utilization to reduce inequalities in incomes and wealth as also achieve sustainable economic development with social justice.

The deterioration in fiscal performance arising primarily due to unabated and uncontrolled growth of public expenditure has resulted in an important remedial measure, namely permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance. Several developed countries face a major difficulty in managing a sustainable fiscal policy over medium to long-term, having regard to uncertainties in macro-economic outlook, structural rigidities and growth in the aging population. On the other hand, in the case of developing and transitional economy countries, continued vulnerability to macro-economic imbalances prevent realization of full growth potential.

Over a third of the population of developing countries, or about 1 billion people, is considered to be living below the poverty line according to the yardstick currently applied, namely, annual per capita consumption of less than US \$ 370. These are the forgotten people in the development process, having received little or practically no benefits from the economic growth over the past decades. The extremely difficult living conditions of the poor coupled with low life expectancies, malnutrition and high levels of illiteracy can be attributed, to a large extent, to gross public financial mismanagement and imperfect macro-economic policies. The most effective means of reducing poverty and inequalities is the adoption of national development strategies which encourage sustainable economic development which increase income-earning opportunities with better access to the education, health and family planning services to the under-privileged sections of the population.

The utilization of public financial resources to improve education and health of the poor has proved to be an investment that benefits the economy as a whole, since a healthy and educated work-force means higher productivity and rapid economic growth. Generally, the free-market reforms and prudently implemented privatization programmes in the post-cold war era were intended to result in increased foreign direct investment, streamlined public sector and reduced inflation with a view to bringing about a significant level of stability and economic prosperity. However, in many developing

countries and transitional economies, the objectively justified reforms have been marred by crony capitalism and nepotism, and without a concomitant commitment to social justice, stability of national currency, competitive markets and establishment of democratic institutions and practices, resulting in unbridled mercantilism with vast sections of population being denied the opportunities and benefits of economic growth. In many cases, dishonestly implemented privatizations have resulted in public monopolies being replaced by private monopolies. In some countries, the populist opposition has emerged in protest against free market reforms which are perceived simply as a subterfuge for further enriching the haves at the cost of have-nots. Improperly implemented free-market reforms have, at times, given rise to populist opposition to structural adjustment programmes backed by important international financial organizations, which, while often necessary, are looked upon with suspicion, as harmful and prejudicial to the interests of the poor.

It is against this background that developing countries and transitional economies will have to make efforts to maximize the mobilization of financial resources from both domestic and foreign sources while at the same time ensuring that those resources are used in the most efficient and productive way so as to benefit all classes of the population, including the poor, and that public financial operations are reliably accounted for so as to inspire confidence among both citizens and foreign donors and investors.

To this end, the governments of developing countries and transitional economies, with the active assistance and participation of international financial organizations will have to strengthen their capacities in the following areas, namely

- I. Enhanced resource mobilization:
 - A. Enhanced mobilization of domestic financial resources
 1. Enhanced mobilization of government revenues;
 2. Enhanced mobilization of private (business and personal) savings;
 - B. Enhanced mobilization of private foreign investment.

- II. Improved government financial management (public expenditure planning, budgeting, performance evaluation and accountability).

- III. Public enterprise reform and private sector development.

In this background, it is proposed to examine the various constituents of public financial management with an accent on public expenditure policies, implementation and controls, and the role and impact of Supreme Audit Institutions in this behalf.

PUBLIC FINANCIAL MANAGEMENT

Developing countries and countries with economies in transition have a special responsibility to organize an effective financial management system for implementation of policies with a view to promoting national socio-economic development goals. Public financial management constitutes all or part of the processes and functions of planning, programming and budgeting, budget execution and accounting, auditing and evaluation. All these activities are aimed at ensuring that, to the maximum practical extent, the government's financial resources are utilized in accordance with law, efficiently, effectively and rationally to yield optimum results, and with transparency and accountability to the legislature and the population at large.

The Group of Experts on the United Nations Programme in Public Administration and Finance in their Report on the Twelfth Meeting (A/50/525 - E/1995/122) observed:

In many countries, financial management capabilities have been eroded by the pursuit of financial populism, ineffective and distorted budgetary mechanisms and the breakdown of the existing financial management institutions.

A central concern for all countries is how to harmonize methods of strategic management and control of aggregate financial variables with processes for changing expenditure priorities and enabling effective and innovative management of service delivery institutions.

Further, the Secretary-General in his Report to ECOSOC (E/1997/86 dated 27 June 1997) on the Thirteenth Meeting of the Group of Experts on the United Nations Programme in Public Administration and Finance, observed:

“The Governments of developed and developing nations alike are transforming their governance and administration systems. The need to reform public financial management in developing countries and economies in transition appears to be more pronounced than ever. Traditional approaches have failed to produce sound, efficient and effective systems of resource mobilization, budgeting and financial management. For several decades, centralized planning and resource allocation were characteristic of many governments, giving expression to national blueprints for development and growth. Budgeting was subordinated to planning, and that caused gaps between development policy planning and resource allocation decisions. The result was unrealistic national economic and fiscal policy-making, compounded by the poor administrative capacity of many governments to collect revenues. New policies, moving from a statist orientation to a more restricted role for government, are placing heavy demands on public financial management systems in developing countries and economies in transition. These changes involve strengthening capacity in three areas : guidance of the economy through central fiscal policy-making; public expenditure management and accountability; and revenue mobilization.

Centralized fiscal policy-making institutions should be pro-active in medium- and long-term investment planning, budgeting and financial management of the economy. Macro-economic management should replace short-term crisis management, especially with regard to public debt ceilings and deficit management. Governments should undertake more effective oversight, using performance management standards, supported by regular monitoring and effective audits, for all the programmes of government. Traditional separation of current and development budgetary processes caused duplication and confusion. Planning and budgeting need to be integrated. In fact, all components of the financial management system should be integrated in a smooth flow of information, decisions, funding appropriations and auditing/ evaluation. All parts of the system should cooperate, and strong agency planning, budgeting, cash and debt management, accounting, reporting, auditing and evaluation should complement central policy-making. Asset management, procurement and personnel are also parts of this integrated system. Critical problems, such as labour market instability and possible social

unrest, arise from the need to change and transform while also downsizing the workforce. Reforms may require significant training and retraining components in new skill sets, especially where the use of new technology is involved.

Many developing countries and economies in transition rely heavily on external financial resources, including donated funds and loans from international organizations, bilateral programmes and non-profit organizations, on which there needs to be a clear government policy. Heavy debt burdens in such countries indicate the importance of regular, stable and adequate flows of domestic revenue. External loans and grants carry strict conditions aimed at altering the economic nature and fiscal policies of recipient nations, resulting in loss of freedom in making independent fiscal choices. Developing countries and economies in transition have seen a need to reorient their tax systems and strengthen their administrative capacities for revenue estimation, tax collection and tax administration. To be effective, the tax structure should be based on the two principles of efficiency and equity. These must be balanced to avoid counterproductive consequences, such as, loss of investment and social displacements. A broad-based tax is both efficient and equitable.

Public financial management reform typically incorporates the following components, namely:

- (i) use of structured planning and programming as means of evaluating and selecting ways of achieving desired objectives;
- (ii) taking resource allocation decisions within the framework of a unified budget;
- (iii) integration of budgeting and accounting;
- (iv) use of accounting principles that match service delivery with service costs;
- (v) encouragement of financial accountability;
- (vi) measurement of outputs as well as inputs; and
- (vii) preparation of consolidated reports.

Budgeting

In view of the limited buoyancy of revenue mobilizations, the financial resources obtained,

whether from foreign or domestic sources, will have to be used rationally and optimally if development goals or planned fiscal adjustments are to be attained. Accordingly, a number of developing countries and transitional economies have been re-examining their expenditure priorities with the dual aim of curtailing their fiscal deficits and ensuring that the available financial resources are put to the most effective use. Budget administration and expenditure monitoring and control procedures must be improved. Reduction in the overall budget deficit tends often to be achieved by expenditure containment measures rather than revenue-increasing measures. Indeed, in the short-term, the possibility for substantial increases in revenue is limited. More emphasis should be placed on controlling expenditure growth, given that the expenditure base is generally larger than the revenue base. Budgeting is the entire system or process of planning, proposing, authorizing, measuring, controlling, and reporting the conduct of national fiscal activities and related transactions, such as, management of cash balances, borrowing and debt management. Good budgeting is a pre-requisite, which ideally involves:

- (a) The appraisal of various governmental activities in terms of their contribution to the national objectives;
- (b) The projection of government activities over an adequate time period;
- (c) The determination of how these objectives can be attained with minimum resources; and
- (d) The revision of the budget, in the light of changing circumstances and experiences.

While traditionally budgets have been seen as vehicles of legislative authorization and accountability, they are clear and unambiguous manifestation of the financial expression of government's goals and strategies, and written expression of government's sense of purpose, intended to achieve the following objectives, namely :

- (a) provide a basis for accountability to citizens, taxpayers and creditors of government
- (b) ensure the financial viability of the government sector within an overall fiscal framework; and

- (c) maximize economic welfare in the domestic economy by appropriate prioritization of activities and allocation of resources.

The evolution of budgetary systems and structures in terms of five broad paradigms that determine budget management approaches in different countries are : traditional, central planning, fiscal balance and performance budgeting. The current dominance of fiscal balance approach has been the result of technical development of macro-economic and fiscal management tools and techniques and the growing belief in recent years that increasing fiscal imbalances were a primary cause of economic instability. The performance or results oriented budgeting embodies most of the precepts of fiscal balance approach with two significant points of contrast. Firstly, performance budgeting derives directly from and has long been considered as logical development of budget management and secondly, rather than viewing government primarily as a potential source of economic instability, Government is assessed as a producer of services - among which would be included that of aggregate management of the economy. The key elements of performance budgeting aspects of which are currently being introduced in several OECD countries (notably New Zealand, UK, Australia and some Scandinavian countries) are as follows:⁷

- (a) decentralization of resource management authority to agencies - somewhat along the lines of the Swedish Model;
- (b) appropriation in relation to contracts for specific services or outputs rather than as estimates of input needs;
- (c) adoption of an accrual rather than a cash basis for budgeting and accounting; and
- (d) an emphasis on transparency and accountability (both at the aggregate and individual agency level) supported by legislation specifying these responsibilities in policy statements and forecasts, accounting and audit.

⁷William Allen (IMF) (1997): Budget Structure and the Changing Role of Government in Budget Reform in Developing Countries (United Nations, 1999) (ST/TCD/SER-E/60).

These changes to the extent that they are widely adopted, will have far-reaching impacts on budget structures and processes and possibly on the appropriate measure of fiscal balance to apply in assessing macro-fiscal management. They imply a highly decentralized budget structure with correspondingly less emphasis on detailed item-level controls. The adoption of accrual accounting and budgeting suggests a greater emphasis on balance sheet rather than cash and debt-oriented assessment of a government's fiscal position. According to William Allan, many of these changes are contentious and are yet to be fully proved in practice. The experience of New Zealand, which has gone furthest down this track, appears promising but needs to stand a longer test of time. Application of these reforms in other countries with a different tradition of budgeting is another test that has not yet been made to any great extent.

While all budgets are plans, not all plans are budgets; but both are companion processes. A plan is aimed at identifying and defining the policies best calculated to achieve objectives; it provides guidelines for policies through the translation of these guidelines into physical targets and specific tasks. There exists a close relationship between planning and budgeting since both are instruments for realising national development goals and strategy; formulation of goals and ordering of priorities; mobilization, allocation and utilization of resources; review, revision and monitoring of performance. However, there are possibilities of friction between planning and budgeting due to divergences of horizon, scope and attitude, which necessitates building of institutional and consultative links between the two processes. Mutual collaboration can be particularly helpful in identifiable areas, such as, project identification and preparation; formulation of short-term policies within the long-term context; preparation of annual plans; review and revision; and in monitoring performance. Qualitative improvement in budgeting as companion process of planning entails reforms in budget structure and classification; budget preparation and execution; and in government accounting.

Government accounting

Government accounts of developing countries have frequently been characterized as inadequate. Government accounting, according to Peter Dean

may be defined as : the process of recording, analysing, classifying, summarizing, communicating and interpreting financial information about government reflecting all transactions involving the receipt, transfer and disposition of government funds and property.⁸

Accounting systems should provide information to a variety of users. Accounting should be accurate and reliable, responsive and timely, verifiable and relevant to the needs of those who use it. A recent analysis by Peter Dean has found a wide variation in the quality of accounting practices among different countries, and a clear correlation between per capita income and higher education, and better accounting. Clearly, if government capacity is to improve, good accounting is a basic pre-requisite.

Government accounting deals with the collection, measurement, classification, processing, communication, control and stewardship of receipts, expenditures and related activities in the government sector. It is an integral element of the financial management function concerned with

- (a) proper recording of all receipts and expenditures of agencies and other organizations of the government;
- (b) maintenance of records that reflect the propriety of transactions and give evidence of accountability for assets and other resources in public use; and
- (c) classification of data in a way that provides useful information for control and for efficient management of programme operations.

Timely preparation and presentation of government accounts is essential for sound financial management. Mechanised systems of accounting, properly installed and employed can have profound influence on the accuracy of accounting records and their speedy production and can generate comprehensive information which can be utilized for number of purposes, including the formulation of national budget and review of performance in relation

⁸Dean, Peter (1996): Government Accounting in Developing Countries in Naomi Caden (ed.), Public Budgeting and Financial Administration in Developing Countries : pp. 45-68.

to goals and objectives. Mechanization cannot be a substitute for a sound accounting system. Installation of a mechanized system should be preceded by careful consideration and streamlining of existing systems, feasibility studies to ascertain the suitability and cost-effectiveness of the proposed course of action and the consequential training of the requisite staff for the manning and operation of the system.

The scope of public accounting systems may need to be extended to define and introduce new accounting concepts and to establish multiple accounting structures to generate the various kinds of data required for managing public affairs and measuring the cost, performance and productivity of government programmes and projects. The strengthening of accounting at the project level can improve management of the project and also throw light on the efficient use of resources and on optimum resources mix. The UN Manual on Government Accounting specifies three types of accountability objectives, namely:

(1) Fiscal accountability, which via the accounting system ensures that applicable laws and regulations are followed; that financial records and reports are accurate and represent a fair result of government operations; that the accounts and reports are issued in time, and that expenditure is within legislative appropriations;

(2) Managerial accountability which stresses the need to provide essential information for the use of managers ensuring efficiency and economy of operations, avoidance of waste;

(3) Programme results accountability which demands the evaluation of programmes in terms of effectiveness, to find out whether a programme or activity is achieving the intended goals.

Sound financial reporting is significant for both those within and outside the government who are concerned with its financial affairs. Within a government, the effective management of its financial affairs calls for well-founded strategic, managerial and operational decisions in order to avoid any waste and mismanagement of financial resources. In order to make such decisions, policy-makers and managers require relevant and reliable information, appropriately reported to enable them to meet their responsibilities for strategy, management and operations. The significance of sound financial reporting is therefore to enable well-judged decisions

to be made and thereby to facilitate the effective management of its financial affairs and the efficient use of its financial resources.

Accrual accounting

23. The movement towards measurement of outputs has necessitated a parallel movement towards measures of expenditure which faithfully record the cost of input resources used in the production of outputs. Traditionally, the system of government accounting has been cash, which measures only what is disbursed in a twelve-month period, which includes payments early in the year for some of previous year's resources and payments in advance for later years, and excludes resources delivered late in the year for which bills are outstanding at the end of the year. Prudent financial management was often equated with the balanced cash position. The case for cash system of accounting was succinctly put by Seymour Harris⁹. Its strength lies in its comprehensiveness, in its tie-in with operating statistics, and its relevance for revealing economic effects of the budget. Over the years, considering the importance of fund control and measurement of costs incurred in rendering government services, two other systems, namely, obligation and accrual, were advocated and applied in government accounting. Accrual accounting is a system where revenues and expenditures are recognized as they are earned or regardless of when payment of expenses is made or when income is actually received. Accrual accounting adjusts cash data so as to show the true resource cost of programmes, projects and activities. This information would be needed for the following purposes, namely:

(1) comparing the cost in-house production with contracting out (a need surfacing in developing countries);

(2) comparing alternative methods of production (i.e. cost control);

(3) setting user fees where cost recovery is government policy (which is also on the increase); and

⁹Harris, Seymour E. (1963): Budgetary Concepts: A Symposium ; Review of Economics and Statistics, Vol. 45 (May, 1963)

(4) comparing the cost of resources with outputs so as to improve expenditure allocations.

Accrual accounting still provides all the traditional cash data (which is still needed since legislative appropriations and account-ability continues to be cash), and it assists cash projections and better liquidity management by providing data on liabilities. The IMF Government Finance Statistics system is switching to an accrual basis as the standard to which all Governments should aspire at least for IMF reporting purposes, though it is not expected to happen soon. Till 1997, only New Zealand Government had fully converted to an accrual base and had a consolidated government balance sheet. Many other OECD countries are fairly well advanced, for example, Canada has consolidated Federal balance sheets and is currently moving toward including capital assets at the department and programme levels.

In several developing countries, there is no urgent need felt for conversion to accrual system of accounting primarily because the accounts are in arrears and there is need to streamline the existing systems. Moreover, with few professional accountants in the public service, the conversion to accrual accounting should proceed cautiously, after proper planning over a phase of five to ten years, which is the minimum time required to professionalize the government accounting staff and for training the non-financial managers in the use of accrual accounting information. Developing countries which are still struggling to meet traditional cash accounting requirements should go slow in changing over to accrual accounting system if the existing accounting cadre is under-staffed, under-skilled and under-motivated. Any moves to accrual accounting system should commence with strengthening the cash based system in ways which would facilitate future accounting developments. Even in developed countries the progress in the introduction of accrual accounting has been slow for a variety of reasons, namely, implementation problems, cost of the systems and the growing influence of demand management as a policy goal, etc. The accrual system also engendered some tricky conceptual issues, for instance, for corporate income taxes, the accrual system could be more volatile and a time lag between accrual and actual payment of taxes could produce sharp differences between their actual and apparent impact. Moreover, in some cases, the

recording of taxes when due, generates a degree of false complacency and induce new items of expenditure. When actual payment of taxes fell far short of the accrued estimates data, there was need to resort to deficit financing to balance the budget, but with serious consequences. Further, the accrual basis had limited applicability for the bulk of transfers to other branches of government where services accrued to the grantees. It also posed problems in the assessment of work done (in lieu of delivery) for which progress payments were made over a period of time. For this purpose, the commonly adopted technique is constructive delivery under which expenditures are reported with reference to the work actually performed to government specifications. However, this presupposes resorting to imputations which, by their very nature, cannot be consistent and cannot be free from controversy. Since the introduction of accrual accounting entails significant additional cost and deployment of skilled manpower, the system was not always accorded overriding priority. More specifically, the induction of accrual accounting suffered a major setback due to the increased emphasis on the measurement of the budget impact and the advantages the cash system had in this behalf.

Several governments have moved to, or are investigating, a shift to accrual measures. International Federation of Accountants (IFAC) has noted that the accrual accounting system is used by governments in the United Kingdom, Australia and New Zealand, by central government agencies in Sweden; and by local governments in many countries, e.g. Malaysia, Switzerland and Italy. Canada uses the modified accrual and is moving towards a full accrual system. Countries as diverse as France, Mongolia and Chile are seriously investigating a shift to a modified accrual or full accrual system. It does not, however, mean that the accrual system is feasible for many countries in the near future. Accounting system design should be particularly conscious of both financial and fiscal objectives, whatever basis of accounts recording and reporting is used.

Transparency of government operations

The recording of government transactions, namely, cash and accrual - has important implications for the transparency of fiscal performance. Reliance solely on the cash-based approach, although helpful

for assessing the impact of government borrowing on inflation and the external balance, can result in a misstatement of the magnitude and timing of fiscal operations. By comparison, the accrual based approach is indispensable for gauging the macro-economic repercussions of fiscal policy, especially over the medium to long-term.¹⁰ There has been a growing recognition of the serious shortcomings of pure cash-based measures for both fiscal and financial reporting. Expenditure arrears, transactions-in-kind, contingent liabilities and other non-cash operations have an economic impact before they are reported in cash or modified cash-based reporting systems. These effects are recognized in accrual basis systems and also need to be taken into account in macro-economic policy-making. It is proposed that the Government Finance Statistics (GFS) prepared by IMF be changed from its present cash basis to an accrual basis of fiscal reporting. For those countries that also adopt accrual basis accounts, financial reports and fiscal reports will converge in some respects. **Accrual basis accounts, though introducing additional demands in terms of recognition of transfer of ownership, will also help governments assess their effectiveness and efficiency in utilizing the resources at their disposal.** Cash measures have serious limitations from this perspective, including the inability to capture the effects of non-cash items.

Many governments have embarked on the ambitious project of improving accounting and financial reporting standards. The work of IFAC and the proposed revision of IMF's GFS Manual together with the Code for Fiscal Transparency are further steps towards development of standards which will help improve international comparison of data and contribute to improved fiscal transparency. It is important to distinguish the different objectives of these initiatives and coordinate work in all these areas. The Public Sector Committee (PSC) of IFAC has released a draft Guidelines for Government Financial Reporting aimed at primarily helping national governments prepare financial statements. The Guidelines will not be an accounting standard but a statement of principles which will be a basis for international public sector accounting standards

¹⁰Kopits, George and Jon Craig (1998): Transparency in Government Operations: IMF Occasional Paper No. 158, pp 8-10.

developed by the PSC. The Guidelines have defined the bases of accounting used by governments in terms of four spectrum: cash; modified cash; modified accrual; and accrual. Although most governments operate cash or modified cash basis accounting systems, at least certain aspects of accrual standards could be applicable to financial reporting of most governments even though their underlying system may remain predominantly cash-based.

The International Monetary Fund is proposing to change the GFS from its present cash basis to an accrual system of reporting. This change recognizes the growing importance of accrual concepts for government accounting and aims at harmonising GFS with other international financial statistics systems, namely SNA that use the accrual concept. The proposed revision will not require that countries adopt an accrual accounting system : a staged transition is envisaged, and countries could adjust data from their cash accounts or, in many cases use, cash data where differences between cash and accrual are not substantial. IMF's Code for Fiscal Transparency aims to support the application of GFS and inter-national accounting standards emphasizing that, firstly, all countries report on financial assets and liabilities - introducing some elements of a modified accrual standard; secondly, all countries should aim to have an accounting system that can produce reliable reports on arrears. Such reports could be produced at a memorandum level by a cash system. The need to extend this system to a modified accruals system where accounts payable are automatically recorded as expenditure should be determined by each country on a cost : benefit basis. These changes will also facilitate the development of more reliable fiscal reports for macro-economic analysis.¹¹

It would be instructive to mention specific recommendations of the Code for Fiscal Transparency on government accounting matters:

The accounting basis

3.2.4 The annual budget and final accounts should include a statement of the accounting basis (i.e. cash or accrual) and standards used in the preparation and presentation of budget data.

¹¹International Monetary Fund (1998): Manual of Fiscal Transparency pp 44-46.

Specification of Procedures for Budget Execution

3.3 Procedures for the execution and monitoring of approved expenditures should be clearly specified.

The accounting system

3.3 A comprehensive, integrated accounting system should be established. It should provide a reliable basis for assessing payments arrears.

An effective accounting system is the basis for timely and reliable information on government activities. Accounting systems should be based on well-established internal control systems, allow for the capture and recording of information at the commitment phase and thereby generate reports on arrears, cover all externally financed transactions in a timely way, maintain records on aid-in-kind, and encompass balance sheet transactions, such as, debt issued in connection with bank recapitalization.

Internal control systems

As observed in the Manual of Fiscal Transparency, sound control systems can make an important contribution to the reliability of fiscal and financial data, and are the starting point for ensuring the integrity of the recording and reporting process. While government systems vary widely, standards for internal control vary less. Broadly defined, internal control is the management tool used to provide assurance that management's objectives are being achieved. Under this broad definition, internal control also covers administrative controls (procedures governing decision-making processes) and accounting controls (procedures governing the reliability of financial records). Responsibility for internal control, therefore, rests with the head of each individual government agency. However, a central government agency might be assigned responsibility for developing a government wide standard approach to internal control.

As defined by the International Organization of Supreme Audit Institutions (INTOSAI), the objectives of internal control systems are to promote orderly, economical, efficient, and effective operations; to safeguard resources against loss due to waste, abuse, mismanagement, errors, fraud; to adhere to laws, regulations, and management directives, to develop and maintain reliable financial

and management data; and to disclose these data in timely reports. To be effective, internal controls must be appropriate, function consistently as planned throughout the period, and be cost-effective. The set of guidelines for internal control standards issued by INTOSAI are summarized below

INTOSAI has issued a set of general and detailed standards defining a minimum level of acceptability for a system of internal control:

General standards

1. Specific control objectives are to be set for each activity of the organization, and are to be appropriate, comprehensive, reasonable and integrated into the organization's overall objectives;
2. Managers and employees are to maintain a supportive attitude to the standards at all times, and are to have integrity, and sufficient competence to meet the standards;
3. The system is to provide reasonable assurance that the objectives for an internal control system will be met;
4. Managers are continually to monitor their operations and take prompt remedial action wherever necessary.

Detailed standards

1. Full documentation of all transactions and the control system itself to be provided.
2. Transactions and events should be promptly and properly to be recorded.
3. Execution of transactions and events should be properly authorized.
4. Key responsibilities at different stages of a transaction should be separated among individuals.
5. Competent supervision is to be provided to ensure control objectives are being achieved.
6. Access to resources and records is to be limited to authorized individuals who are accountable for their custody or use.

An innovative other example of government wide approach to internal control is that adopted in France and in other Francophone countries based on the French administrative system, where there is a clear distinction imposed by law between the public

agency requesting the payment, a special unit of Ministry of Finance that approves all expenses, and the accounting department of the Ministry of Finance that makes all payments. Other systems also separate the power to authorize commitments from that of making payments, but are more decentralized and emphasize the responsibility of management of each individual government agency for setting a sound control environment.

Auditing

The Manual of Fiscal Transparency has observed (para 3.3.3) that budget execution should be internally audited and audit procedures should be open to review. Effective internal audit by government agencies is one of the first lines of defence against misuse and/or mismanagement of public funds. Internal audit is defined as internal to the executive branch of government as external audit is external to the executive. Internal audit, therefore, covers both an audit of an agency by the staff of the agency itself (ideally reporting directly to senior government management) and an audit of an agency by another agency (e.g. by an audit body under the control of the Ministry of Finance or Prime Minister). It should be based on a sound internal control environment and not seen as a substitute for one. Examination by internal auditors also provides valuable material for review of financial compliance by external audit agencies. The existence and effectiveness of internal audit should be assured by requiring that internal audit procedures be clearly described in a way that is accessible to the public, and that the effectiveness of these procedures should be open to review by the external auditors.

At times, the function of traditional audit, which is to verify the legality and financial accuracy of transactions is not effectively performed, owing to the weaknesses of the accounting systems that provide the basis of audit, the lack of trained personnel, the insufficiency of financial resources allocated to audit, the absence of clearly defined audit standards and, in some cases, the less than adequate independence enjoyed by audit authorities. Several measures are essential to enable audit systems to participate with other relevant agencies in evaluating the efficiency and effectiveness of government projects and programmes. Primarily, budgeting has to provide a foundation for audit of performance. Planning and budgeting have to formulate clear

targets and specify efficiency goals, and target efficiency-related reporting and analysis needs to be developed to facilitate the audit of performance and link it more closely with programme and project implementation. Agencies engaged in planning, budgeting, accounting and auditing have to collaborate in jointly defining the underlying concepts and units of measurement. They have to agree on their respective roles in performance audit and on the linkages between internal and external audits.

The importance of public sector auditing can be examined from the following perspectives, namely:

1. Audit assists in the accountability process. The people's right to know and even control how their taxes are spent is one of the cornerstone of democratic government. In parliamentary democracies, this control is exercised by the elected representatives of the people, the parliament. After it collects and spend tax money, the government must also show that it received and spent the correct amounts, in accordance with the approvals and purposes set out by parliament. The public accounts, in the form of budget and estimates, provide sufficient information to the parliament, the governing body, for holding the government to account for its stewardship and management of public resources. An important link in the accountability process is an independent assessment of that information. A Supreme Audit Institution (SAI) audits government operations and provides information which helps parliament to hold the government to account for its stewardship of public moneys.

2. Audit contributes to the change and reform process. Developing countries and transitional economies are undergoing dramatic internal reforms while addressing broad issues such as globalization, technological advancement, and environmental protection. Many SAIs are still heavily involved in traditional compliance, financial, and transactional auditing and have not yet adopted broader-scope auditing, such as, performance or value-for-money auditing. Many have not yet adopted technological tools into their audit practice, such as, Computer Assisted Auditing Techniques (CAATs), statistical sampling, and risk-based approaches. As governments computerize their operations, it becomes increasingly important for

public sector auditors to keep pace and to likewise improve their capacity to audit such computerized operations.

3. Audit contributes to improving public sector management. Audit reports identify and highlight instances where laws and regulations have not been complied with, where financial systems need strengthening and in some cases, where value-for-money has not been achieved. SAIs not only report weaknesses but increasingly recommendations are included on what actions need to be taken by government officials to rectify reported deficiencies. The advantage of including recommendations is that they serve as a basis for subsequent follow-up, to help ensure that reported weaknesses do not recur. By reporting weaknesses found, and their impacts and consequences, SAIs serve to inform and improving appropriate management practices, particularly as regards accounting and financial management systems. While the deterrent effect is difficult to measure or prove, the fact that the work will be subject to review will tend to contribute to greater care being taken.

In its resolution A/RES/50/225 adopted on 19 April 1996, the General Assembly:

Invites Governments to strengthen their public administrative and financial management capacities through public sector administrative and management reform, with emphasis on enhanced efficiency and productivity, accountability and responsiveness of the public institutions, and encourages, where appropriate, decentralization of public institutions and services;

Public financial management, through which Governments manage public financial resources according to established legal provisions, is aimed at ensuring that such resources are accounted for and administered efficiently, effectively and transparently. A public financial management system must be supported by an appropriate audit system which will determine how public resources have been used, evaluate the results achieved with those resources and verify compliance with legal accounting and administrative provisions and procedures. In fact, an adequate integrated public financial management and audit system is essential to sustainable long-term economic growth and the strengthening of democracy. Accordingly, the role of SAIs and their audit work is of considerable

importance not only as a means of improving government systems and practices but also for strengthening accountability and transparency.

The increasing size and complexity of government transactions enhance the importance of audit and place a special responsibility on the audit institutions to maintain and improve the quality and coverage of audit. The extent and quality of audit make a significant contribution to enhancing accountability, efficiency and effectiveness in the public sector. The importance of formulating and adopting audit standards systems from these considerations, since audit standards represent broad but basic principles and conditions related to the professional and personal conduct expected of auditors, the planning and performance of audit and the reporting on the audit results. They are influenced by the legal, political and administrative environments. Audit standards help to assure the quality and consistency of audit and enable proper projection of the credibility of audit institutions to the legislature, executive branches of governments, the public and international lending agencies. The necessity for laying down comprehensive and unambiguous audit standards cannot be overemphasised, since they serve four purposes, namely:

- (1) Audit standards specify the personal qualifications that an auditor must possess and the quality of work performance that must be achieved;
- (2) The standards establish the criteria by which the work of an auditor may be evaluated;
- (3) Audit standards establish the communication between the auditor and others utilizing his work;
- (4.) Audit standards reflect the maturity of the auditing profession and promote the development of the professional.

Evidence shows that in fighting corruption and mismanagement, the SAIs were employing primarily *a posteriori* audits. Their activities comprised the investigation of corrupt associations and criminal systems, for example, where award of contracts processes or subsidies were concerned, the reporting of corrupt practices, provision of support to the prosecution in criminal proceedings and investigation of the causes of corruption and mismanagement with a great emphasis on preventive

action. Further responsibilities included examination of compliance with regulations, suggest practical approaches to improvement of institutional framework, investigation of weaknesses in public administration systems, the enforceability of audit findings (possibility to impose sanctions), devise strategies to check improper use of discretionary powers and remedial measures to prevent corrupt practices and recurrence of mistakes resulting in loss to the Exchequer This requires a very high degree of integrity and ethical standards on the part of SAIs.

Procurement and tendering

The Manual of Fiscal Transparency has laid down that procedures for procurement and employment should be standardized and accessible to all parties (Para 3.3.2). Contracting for goods and services, particularly where large contracts are involved, must be open and transparent to provide assurance that opportunities for corruption are minimized and that public funds are being properly used. Similar considerations should apply to contracting out government service or management processes, and to privatization. It is essential that appropriate tendering mechanisms are set up for contracts above a threshold size, and procurement regulations should give independent authority to a tender committee or a board and require that its decision should be open to audit. Where services formerly provided within government are contracted out to the private sector, these procedures should be subject to the same or similar procurement regulations. In this area, OECD and the World Bank helped many countries to establish modern procurement systems, and good progress has been made in the transitional economy countries towards establishing sound and transparent procurement systems.

The SAIs generally highlights defects in the process for procurement of goods and services, for example, incorrect estimation of requirements, non-competitive tendering, incorrect analysis of bids received, undue favours to specific bidders especially during negotiations, defective contract clauses prejudicial to the interests of the government, absence of penalty clauses for delayed or defective deliveries, etc. While it is practically impossible to eliminate corruption or favouritism in procurement contracts, SAIs can contribute to preventing corruption in several ways, namely:

(1) The important fact that the SAI actually exists and is endowed with an effective mandate to audit procurement has a preventive effect. Only if the SAI performs procurement audits on a regular basis that the procurement agencies will expect such audits.

(2) SAIs should encourage the implementation of appropriate framework conditions which prevent corruption in procurement.

(3) The legal framework that fosters competition is certainly conducive to substantially diminishing the potential for corruption and favouritism. The European Union has set up tendering procedures in which several companies are invited to submit tenders for a particular contract. In some other countries, there is an open procedure in which even the intention to award a procurement contract must be made known publicly. Tenderers who apprehend that they have been treated unfairly in this process may, in the given circumstances, have the procedure reviewed and even annulled by an independent body and claim damages.

(4) SAIs should ensure that similar rules are implemented wherever the law does not stipulate a public invitation of tenders. In some countries, this position applies to contracts below a certain amount of value, or to military contracts in the interest of safeguarding confidentiality. As a matter of principles, such contracts should be awarded by competitive tendering (public or at least limited invitation for tenders). Discretionary awards without an invitation of tenders should remain the exception and be tied to strict requirement.

(5) The contract-awarding agencies should operate within an adequate organizational framework. SAIs should ensure that agencies reporting and establishing a need for a particular asset are separated organizationally from those units which are responsible for the search of tenderers and for laying down the contractual arrangements. With large-scale contracts it would be desirable to have a separation between those units which plan for the basic requirements and those which define the detailed specifications. The two units should communicate smoothly to prevent undesired effects but no unit should be bound to the instructions issued by the other.

(6) In the ultimate analysis, the SAIs should seek to strengthen internal concomitant control

mechanisms and on-site oversight (in building and construction) in the organizations concerned. Concomitant control and oversight functions, if they occupy a significant position within an organization and are directly involved in the majority of operations and transactions, generally tend to exert a high preventive effect.

Audit for irregular procurement practices

In the experience of an SAI from a developed country, there are key elements by which the unbiased delivery of a procure-men process and the presence of corruption or favouritism can be virtually ruled out. However, the audit may not be limited to these key elements alone, but may include other priority areas as well. Some of the following are of particular importance. The award of contracts is basically divided into the following steps, namely:

- (1) Planning identification of requirements and substantiation of the established needs.
- (2) Selection of suppliers public invitation of tenders or direct discretionary award without invitation of tenders.
- (3) Award of contracts placement of an order
- (4) Delivery and quality control
- (5) Invoicing and payment.

These steps are considered in the following paragraphs

1. Planning

In the experience of the country concerned, two of these functions, namely, planning and the selection of suppliers, particularly encourage the preferential treatment of a company in the awarding process. In-built pre-selection mechanisms could reside especially in the planning phase, which would result - as the natural outcome of the other functions- in the desired result, namely a particular company.

When auditing the planning phase of procurement audits, the following should be taken into account, namely:

- it should be possible to infer the type, amount, and time of procurement of a particular asset from the strategic planning documents. For example, Coordinated timing of a tendering process when procure-men of an asset is concerned, which may give the beneficiary company a price advantage for

operational reasons, which permits it to submit the lowest bid in a public invitation of tenders.

- The first specific planning steps in procuring an asset (tender documents) should include only the practical specifications. For example, In the procurement of heavy-duty vehicles, the specified requirement of a rated engine output instead of a load capacity could give preference to one product and preclude others.

- The functional or constructional specifications resulting from the first concrete planning steps should always be drawn up without the involvement of a potential supplier. Also the specifications should not refer to any one specific product.

The technical specifications lend themselves particularly for giving unjust preference to one particular product or supplier. The specified requirement for one constructional element may lead to the exclusion of all other products, which would be equally suited to meet the specified requirements, in the following awarding process.

- In auditing the planning step, auditing staff with the required technical knowledge are absolutely necessary.

- It is equally important that the required quantities and assessment criteria for the individual items are laid down. The main criteria should be included in the invitation of tenders and brought to the attention of the tenderers.

2. Selection of suppliers

As stated above, the the European Union stipulates that the intended award of contract must be made known to the public, or to an interested group of prospective tenderers. Although publicity will not fully or automatically prevent unlawful or corrupt behaviour, it is an instrument that guarantees competition and avoids that individual companies are treated on preferential terms. In the general experience of the exerts in this field, there are formal and material aspects which need to be considered in auditing the selection of suppliers, namely:

- Formally, it would be essential to document all processes as comprehensively as possible. A complete documentation would prevent the substitution or unjustified non-consideration of individual tenders. The concurrent opening of tenders

by a panel will avoid the frequently voiced criticism that any particular company has been given an advantage because it has previous information on the quoted prices of its competitors, or that submitted tenders are modified or suppressed.

- The audit of material aspects should focus in particular on the unbiased assessment of the submitted tenders. Special attention should go to tenders which were eliminated because they purportedly did not meet the requirements. Tenderers should only be contacted for clarification, and not for an amendment of their bids. A considerable divergence in the quoted price for individual items maybe indicative of intentionally incorrect estimates of required quantities, especially with building contracts. In exceptional cases, contracts may be awarded directly to companies without previous publication. Such an exceptional procedure may be followed only in the cases of urgency, confidentiality, or when there is only one company which can render the required performance. However, in such cases, a note should be kept in the records explaining the reasons for adopting such a procedure and should be brought to the attention of the head of the organization or the competent authority for its information. It is only natural that discretionary awards harbour a strong potential for favouring individual companies for whatever reason.

- With discretionary awards it is absolutely essential to verify whether the stated reasons actually exist. Often, it will be necessary to give a close look to the planning side of the procurement process. For example, it would be unfounded to invoke urgency, if the preliminary planning documents indicate that the need for a particular asset has been known for a longer period of time.

- With discretionary awards, the auditor should always look whether a price/performance ratio was established by a comparison of prices.

- If the public was consciously excluded from an award because there is only one company that can render the required performance, the awarding process should include a documentation on market research that was performed.

3. Awarding of contracts

Contracts for the supply of goods or services are awarded on the basis of the preliminary planning and selection of suppliers. Even though the preceding

steps may apparently have been conducted correctly and do not give rise to any criticism, contractors may be favoured in the awarding phase to the detriment of the State and rival competitors. According to the common experience, the following situations call for attention, namely

- The contract is inconsistent with the planned and specified quantities or schedules for the delivery of goods or services. For example, if a favoured company, due to a secret agreement, could expect larger quantities to be ordered than stated in the tendering documents, it may have probably quoted lower prices than its competitors.

- Repeated alterations of the original contract due to changes of the actual situation. For example, with the building contracts in particular, repeated changes may be an indication that the incorrect quantities were specified intentionally. Contractors with knowledge of the actual situation could therefore bid at very low rates, since they could expect the contract to be altered.

4. Delivery, quality control, invoicing and payment

Although these steps are the result of the awarding of the contract, they should nevertheless be considered a part of the process and looked at during an audit. However, a differentiation may be made between the supply of goods or the rendering of services, for example, in construction, when assessing whether any of the bidding companies was unduly favoured.

- From previous experience, it is known that deficiencies in the procurement of goods with regard to delivery, quality, control, invoicing and payment are often the result of public officials being negligent, rather than acting wrongfully by intent. This might be due to the fact that biased or prejudicial action in this phase is easily detectable by the controlling bodies and attributable to those who are responsible. However, systemic deficiencies in this phase, such as, inadequate documentation of the movement of goods, or lacking control mechanisms, could open up possibilities for wrongful behaviour, which is very difficult to reconstruct or associated with a low risk for the official.

- It is again common experience that the possibility of intentionally prejudicial or corrupt behaviour is greater when it comes to the

performance of services, in particular with a construction contract performed. In contrast to the delivery of goods, it is - quite obviously - much more difficult to verify whether a delivered performance is consistent with the agreed performance. Such verification, if at all possible, demands a considerable commitment of technology and time, and the in-depth study of the documents by an experienced auditor.

On the basis of complexities of a contract, the audit of these key areas by the SAIs increasingly requires the use of teams. These teams should be composed of technical experts and of auditors with the required experience.

These foregoing observations and reflections outline some of the major experiences commonly noticed in auditing public procurement. Although it is difficult to prove corruption in a fool-proof manner, SAIs are well equipped to develop findings which suggest corrupt behaviour. By raising the risk of detection, repeated audits of procurement processes have a preventive effect. Another important task of SAIs is to urge the development of framework conditions in procurement which stifle corruption. In a time of rapid technological progress and growing competition on the markets, SAIs will be confronted with ever-growing challenges. They will have to optimize the employment of their manpower and financial resources to adequately fulfil their role in fighting corruption.

Corruption and mismanagement in projects financed outside the national budget

Notwithstanding substantial amounts of aid received by many developing countries during the last twenty to thirty years, the original expectations of early supporters and pioneers of development aid - that it would boost investment and growth in low-income countries by supplementing domestic savings or relaxing foreign exchange constraints - have not been fulfilled. In fact, the common criticism is that, far from taking advantage of aid to achieve high and sustained growth, thereby reducing the need for further assistance, many countries have become more dependent on aid. Some commentators¹² have even

¹²Harvard Institute for International Development (HIID) (1997): *A New Partnership for Growth in Africa* (Cambridge, Massachusetts)

suggested that aid flows have allowed governments to postpone needed reforms. For example, in a recent proposal to the US government, on a new partnership for growth in Africa (HIID, 1997), the authors emphasise that by being open-ended, foreign aid has failed to put pressure on governments to make the policy choices needed to mobilize domestic resources for development. Evidence regarding the relationship between aid and the main channels through which its impact on growth could flow - investment and domestic savings - is mixed, with some indication that aid has had a positive impact on domestic saving and investment in countries where adjustment efforts were sustained.¹³ Two specific findings in a recent study¹⁴ conducted in the World Bank, that aid has been effective when the policy environment has been good, but that aid has not stimulated the adoption of good policies - suggest that greater selectivity in aid allocation (in support of strong policies) might have delivered better performance on growth and poverty alleviation in recipient countries. Although there is considerable evidence of fungibility, it is difficult to believe that aid does not add to investment at all in recipient countries, in the light of the dominance of project aid in ODA. Although there is little evidence about the possible Dutch disease effects of aid - that is, erosion in export competitiveness, the studies have highlighted the importance of an appropriate macro-economic policy mix to address issues of competitiveness and the crowding out of private investment.

The common criticism regarding the insufficient and insignificant impact of foreign aid on economic growth in recipient developing countries is attributable to gross financial mismanagement of donor-aided projects. Funding projects outside the national budget appropriations process occur where donors find that programme delivery is constrained by inadequate government implementation mechanisms. As a result, donors may direct their funds to a Non-Governmental Organization (NGO) or independent project

¹³Tsidi M. Tsikata (1998): *Aid Effectiveness: A Survey of the Recent Empirical Literature* : IMF Paper on Policy Analysis and Assessment (PPAA/98/1)

¹⁴Burnside, Craig and David Dollar (1997): *Aid, Policies and Growth* , Policy Research Working Paper No. 1777 (Washington: The World Bank, June 1997).

implementation unit. Donor financing for these projects may be provided by making direct fund transfers into commercial banking accounts. Further, major donors may also convince the government to make its counterpart payments in support of care projects in the form of monthly direct transfers to the commercial banking accounts.

The definition of public monies in public finance legislation of the host governments is generally limited to funds appropriated by the national budget. The civil service legislation or regulations that require civil servants to be prosecuted or proceeded against for misappropriation or abuse of public funds adopts the same definition. Civil servants are generally aware of this limitation to public prosecution, more so as it applies to the donor funds held in the commercial banking accounts of project implementation units and NGOs.

Civil servants who are assigned as direct counterparts to project implementation units and NGOs and who misappropriate funds know that public prosecution is unlikely. There is strong circumstantial evidence which suggests that these civil servants and others in the Executing Agencies do in fact divert funds. Fungibility makes the analysis of whose funds are misused, donor's or government's an impossible task.

In most cases, the office of Comptroller and Auditor General is legally bound to audit government's counterpart contributions. Most often, that office is understaffed and competes for qualified personnel with a large number of donor-financed project implementation units where salary differentials can be very large, in favour of employment in a donor-financed project. Moreover, the Comptroller and Auditor General's staff mostly relies on financial statements and access to records that can only be provided by non-government staff who are outside their jurisdiction, or counterpart civil servants who may have little motivation or inclination to assist.

In this limited case, there is no need to extend the role of the Supreme Audit Institutions. In fact, there is need to reduce the use by donor countries and institutions of the transfers which do not go through the national budgeting process. It is true that in many developing countries, donor development programmes exceed the absorptive capacity of weak governmental institutions. Although it may be

desirable to raise the delivery and implementation of donor programmes by directly transferring funds into the private banking accounts, ultimately the end result is likely to be counterproductive. Financial and material resources which are intended to support national development objectives may be diverted by unscrupulous civil servants towards private ends and the civil society may be deprived of the benefits to the extent intended. There is a distinct possibility that future development programmes could be jeopardised where misappropriation by civil servants in the host country becomes evident to taxpayers in the donor countries, thereby potentially denying the civil society access to such development resources in the future. Because of the constricted ability of the Comptroller and Auditor General's office to audit government counterpart funds and the significantly reduced possibility of prosecution of erring civil servants who misappropriate such funds, donors should avoid transfers of funds outside the host country's Governmental appropriation process.

Aid as specifically considered by OECD as official development assistance (ODA) comprises grants, concessional loans and debt forgiveness. In order to qualify as ODA, the assistance would have as its main objective the promotion of sustainable socio-economic development and welfare, and if in the form of loan, should have a grant element of at least 25%. On the basis of this definition, the annual net disbursements of aid to developing countries (excluding transitional economies) rose from US \$18 billion in 1975 to a peak of nearly US \$56 billion in 1990 and then declined to US \$51 billion in 1995. In real terms, the total net disbursements to these countries fell sharply after 1990. The coverage of the ODA data expanded in the 1990s to include the assistance to the transitional economies - countries in Central and Eastern Europe as well as the successor States of the former Soviet Union. The share of total ODA that went to these countries increased from 4% in 1990 to 11% in 1991 and to 16% in 1995. Aid from bilateral sources far outweighs multilateral aid which accounts for 70 to 80% of the total. Within bilateral aid, project aid predominates, with its share of total bilateral aid commitments rising from an annual average of 60% during 1976 - 80 to 75% during 1991-95. Over the same period, the share of debt relief in bilateral aid also rose from 6% to (%), while the share of food aid and other programme aid declined. Programme aid may have become more important for multilateral agencies but overall,

project aid is the predominant form of aid. It would be relevant to state that the aid effectiveness from the point of view of its impact on economic growth in the host country is largely dependent on proper and effective aid resources management.

Programme or project administration

One of the major deficiencies noticed in public financial management in developing countries and transitional economies is the lack of professionalism and inefficiency in carrying out programme or project administration. The lack of administrative abilities, inadequate managerial capacity and authority, insufficient knowledge of financial regulations and general incompetence to take decisions are some of the apparent factors for poor programme or project administration. In most developing countries, the SAIs routinely bring to light cases of non-achievement of physical and financial targets, along with reasons for shortfalls, non-realization of social and economic objectives, time and cost overruns and their linkages, over-staffing and idle personnel, idle plant and equipment and non-utilization of installed capacity of costly plant and machinery, excessive inventory holdings, absence of proper pricing of industrial goods, etc. There are major indictments of the managerial inadequacies in the lack of proper inventory management, resulting from improper or deficient maintenance of inventory records, excess holdings well above annual requirements, non-conducting of periodical physical verification, non-performance of ABC analysis of stores, lack of adequate efforts to weed out surplus/ obsolete / dead stock, in fructuous expenditure on account of carrying cost of excess stores, etc.

In most developing countries, the ministries or departments of the government are entrusted with the task of running industrial or commercial enterprises or establishments which are not carried out through the public or state enterprises because of considerations of national security, secrecy or otherwise considered to be of strategic importance, such as, ordinance factories for manufacture of products for defence purposes, atomic energy, even railways establishment, building of dams, tunnels, bridges for civilian or military purposes, building of roads on border areas, setting up printing presses for currency notes, coins or security press for government bonds or printing of budget or other secret works, etc.. These enterprises are required to

undertake projects for commencement of production facilities of different kinds, establish factories for manufacture of strategic goods or articles and at times, expand the existing facilities. All these activities require establishment of a project or work programme for construction, manufacture or production purposes.

Time and cost over-runs

It has been common experience that most programmes or projects of government activities generally suffer from time and cost over-runs as compared to the estimated cost and period of completion schedules fixed therefor. Apart from the general administrative inefficiency and slackness, there are several contributing factors for this phenomenon, namely :

Instances of Time over-runs

1. Delay in appointment of project personnel;
2. Delay in placing orders for purchase of plant, machinery, equipment due to delays in approval procedure;
3. Delay in installation of plant, machinery or equipment;
4. Break-down of plant, machinery or equipment due to mechanical defects or external hazards, such as, fire, floods, other natural calamities, etc;
5. Strike or lock-out of employees;
6. Non-receipt of essential spare parts for machinery or equipment in time thereby stoppage of construction activity;
7. Delay in receipt of financial sanctions for essential plant or equipment in case of change of scope of the project or additional facilities required during the construction phase.

There are many other factors which could also cause time over-runs which can be enumerated.

Instances of Cost over-runs

1. Change of scope of the project;
2. Devaluation of national currency resulting in unforeseen increased cost of imported plant, equipment or machinery;

3. Increase in import duty on imported plant, equipment or machinery;
4. Increase in wage component due to increase in minimum wage or wage settlement during the course of the project implementation;
5. Other unforeseen expenditure required to be incurred;
6. Change of contractor entrusted with the part or whole of the project contract due to disputes or litigation, his abandonment of contract arising from bankruptcy or liquidation;
7. Time over-runs resulting in increase in interest liability or payment of compensation to aggrieved parties.

It should be the responsibility of authorities in-charge of programme or project execution or implementation to ensure that time or cost over-runs are avoided or at least minimized so as to adhere to the cost and time schedules to the maximum extent possible. It should be possible to pin-point responsibility for the cost and time over-runs and hold the person accountable for the loss caused to the Exchequer.

Till the project is under construction, all revenue expenditure incurred is required to be capitalized. Hence, all current expenditure incurred till the commercial production starts will be capitalized and will be attributed to the different capital assets on certain identifiable basis. One of the important items to be dealt with is the interest during construction (IDC). Wherever the project is financed through budgetary resources, including loans specifically attributable to the project, IDC comes into play. Traditional accounting practice favours utilization of the own resources in the first instance and thereafter the loan component. Even amongst loans, the loan carrying the lowest rate of interest is utilized first and thereafter the loans in ascending order of interest so that the loan with the highest rate of interest is utilized last. The main purpose of this strategy is to ensure that the aggregate IDC is the lowest. However, this is possible only if the loans are received in ascending order of interest or there is the flexibility to avail of loans in the manner that the loan with the lowest rate of interest is utilized first and thereafter the loans with the higher rate of interest and so forth. The basic idea of lowest IDC is that the IDC which is capitalized till the date

of commencement of commercial production enables to keep the total project cost at lowest level and hence, wherever depreciation is chargeable, to show it at the lowest figure possible.

It is necessary to devise a reporting system for projects at pre-construction or construction stage. In the case of projects at the pre-construction stage, the monitoring will commence from the time the project is sanctioned by the competent authority with a view to initiating corrective action so that the target dates for various activities could be achieved. For projects under construction, there should be reports on the following areas, namely:

1. Project time schedule;
2. Project Cost and expenditure till the report date;
3. Manpower required and available (categories);
4. Scarce resources;
5. Inter-related activities; and
6. Problems and action areas.

It would be desirable for the Ministry/department of the government under which the project is undertaken to maintain a master network for major projects. In the case of projects involving inter-related activities, administrative ministries concerned should collect information on the inter-related activities/projects from the concerned agencies and develop a total coordinated picture of not only the projects under review but of all related projects so that the total status of the project was clear. The administrative ministry/department should institute adequate organizational arrangements for receipt, storage and retrieval of data received as also expert analysis of the data. For the purpose of monitoring and improving the project performance during the construction stage, the ministry/department should hold quarterly performance review meeting with the chief executive in charge of the project. There would also be a separate meeting for considering the problems of operating units.

There is need to evolve an early warning information system for performance appraisal both for project under construction and operating units to create awareness, both at the project /operating unit level and the government level, primarily with a view to take corrective measures at appropriate time. There are three segments of the early warning reporting

system - (1) Analysis of the trend of financial performance; (2) Analysis of the trend of physical performance; (3) Review of progress of projects and under construction. An attempt is also made to identify the reasons for high levels of performance or sharp deterioration. If extraneous factors, such as, administered prices, market fluctuations etc helped the buoyancy, these are duly noted.

The analysis of physical performance, in the case of operating units, covers details of production and capacity utilization and inventory (work-in-progress, finished goods and spares) during a quarterly period under review, as compared to the position in corresponding period of the previous year. The comparative position of inventory should be properly examined to see the build up of inventory. The physical performance also analyses productivity trends in terms of capacity utilization, identifying reasons for low utilization. Shortfalls against the targets set for the given period are also covered in the analytical report which is prepared on the basis of the review. The desegregated analysis of financial and physical performance endeavours to establish a direct correlation between the deteriorations in financial and physical performances.

As part of "early warning" reporting system, progress of projects under construction is also reviewed. The report highlights, *inter alia* the progress of projects under construction, indicating the cost escalation over 50% of the original cost and slippage over 6 months of the original schedule, identifying the reasons therefore. The proforma covers details of the name of the project, capacity of major product, approved cost - original and revised, anticipated investment, actual expenditure incurred up to the latest period, cost over-run over original and revised cost estimates, date of approval of project, original schedule of completion, revised schedule of completion, delay in years/months over original schedule and remarks. The early warning reporting system is intended to provide alarm signals to the decision-making competent authorities in government. Any coordination and decision needed at the government level is facilitated through the periodical reviews placed before highest decision making levels of government. This facilitates the follow-up action to effect "correction" wherever deficiencies are detected in the "early warning" reports.

A development project has been defined as a discrete package of investments, policy measures, and institutional and other actions designed to achieve a specific development objective or set of objectives within a designated period. Systematic selection, formulation, and implementation of projects are crucial for optimum utilization of resources and for realization of overall socio-economic objectives. Accounting system of a development project has to respond to the information, monitoring and control needs of various parties, namely, government ministry/department, public accountability institutions, project managers and external financiers, such as, banks, aid donors, and international financial institutions. Most developing countries accounting systems are inadequate, with the following defects, namely

- (1) lack of timeliness in recording data, inaccuracy in its compilation, inability to prove the accuracy of accounts, unreliability of the information produced and failure of financial controls;
- (2) cumbersome government financial management systems create delays in disbursement, slow collection and poor control of receivables, delays in claiming reimbursement from foreign lenders and donors, delays due to time-wasting procedures, e.g. for the award of contracts, and poor coordination between government agencies;
- (3) the financial management systems of developing countries are frequently dominated by concerns of legislative accountability and budgetary control. In contrast, they are not well adapted to the needs of managers and decision-makers. In particular, in the present context, they fail to provide adequate information to those responsible for project execution and monitoring;
- (4) under-developed financial management system often fail to integrate cost with performance, and budget with plans. Such failures hinder effective project management.

Pricing of goods and services supplied by government

Generally, any goods or services supplied by government should be priced at short run marginal cost if the objective is to maximize welfare. Many governments, however, regard short run marginal cost pricing as being the exception and not the rule and is resorted to only where there was persistent

excess capacity. Most of the times the non-adoption of short run marginal cost pricing is due to the fear of excessive financial burden on the national Exchequer, and the demand forecasting would become overoptimistic. However, the short run marginal cost is opposed on the more theoretical ground that most consumers investing in long-lasting assets do extrapolate current price levels or price movements into the future. If current prices do not reflect their longer-term trend, there is a danger of wrong investment decisions being made. While it may be desirable to give information to consumers about likely trends in costs, there are practical difficulties in its implementation. If the more prevalent system of cost-plus is to be adopted on the basis of actual cost of production of the goods or services plus the expected return on investment, there may be some practical difficulties arising due to the imperfect state of government accounting system which may not convey correct information about actual cost. Any defective procedure adopted in pricing of goods or services supplied by government may usually lead to hidden, unconsciously given unjustified subsidies to the consumers.

Subsidies and transfer payments

Subsidies and transfer payments represent an important constituent of public expenditure in most developing countries and transitional economies. They are generally intended to benefit identified specific sections of the population which deserves special treatment. Although laudable as an effective measure for ameliorating the conditions of living of the targeted population, subsidies and transfers, at times, fail to achieve their objective due to a variety of reasons, amongst others, the administrative failure and inefficiency resulting in corrupt practices as also difficulties in identifying and reaching the targeted beneficiaries in the population. Another problem associated with the subsidies is the failure to ascertain the actual cost of the goods or services provided to the consumer and therefore, the exact cost of such subsidies to the Exchequer. Most often, governments provide essential goods or services to the targeted population either free of cost or at a concessional rate. It is absolutely necessary for government to ascertain the actual cost of the goods or services so provided free or at a concessional rate and then to decide whether the economic cost of the subsidy so given is worthwhile or not. In a majority of cases, it may be desirable for government to

charge the beneficiaries at least the short run marginal cost of the goods or services so as to remove the subsidy element altogether. There should be a programme to reduce the subsidies and transfers by a specified percentage of GDP over a period of years, reflecting in part a lower transfer to public enterprises and a better targeting of consumer subsidies. In transitional economy countries, the reduction of subsidies and transfer payments should be given high priority because such spending played an especially large role in pre-transition period. Generalized consumer subsidies are considered an inefficient means of increasing the consumption of the poor and budgetary transfers to public enterprises often sustain inefficient state-owned firms.

Since 1970s, major industrialised countries have seen rise in share of government in economic activities with consequent widening fiscal imbalances, with the rise in public expenditure not matched by commensurate improvement in revenue receipts. Fiscal performance of the developing and transitional economy countries was characterized by larger fluctuations: the substantial growth in public expenditure was superior to the taxation efforts at a far lower level, in view of the relatively larger informal sector and lower administrative capacity. Moreover, in these economies, expenditure programmes and tax revenues were subject to large upheavals, reflecting terms-of-trade shocks and relatively limited decision-making visions of short-term, unstable governments, further compounded by rapid shifts in consumer and investor confidence. In developing countries fiscal adjustment programmes undertaken at the behest and under the aegis of international financial organizations, generally as a sequel to the external payments crisis, has usually included structural fiscal reform and financial and trade liberalisation. The transitional economy countries, in their market-oriented transition have undergone considerable fiscal stress as a result of collapse of production capacity, waves of privatization, lack of administrative and institutional framework, and growth of informal sector resulting in fall in tax revenues. On the other hand, the spurt in public expenditure caused by building improved infrastructure and social safety-nets, and supporting enterprise and bank restructuring was partially financed by reduction in price subsidies. Their fiscal disequilibrium was further accentuated by large,

inherited public-debt servicing obligations which was partially carried outside budgetary accounts.

Measuring the efficiency of government expenditure

Developing and transitional economy countries incur public expenditure in providing certain goods and services to their populations, to achieve various socio-economic objectives. The efficiency with which these goods and services are provided is very important in macro-economic stabilization and economic growth. Governments are treated as producers, engaged in the production of different outputs by combining labour along with other inputs. Governments which produce more of these outputs while spending less on inputs will be considered as more efficient than those governments which produce less outputs and use more inputs, other things being equal. Using a regression analysis, that relates government consumption to the rate of economic growth, the optimal size of the government would be estimated at an average of 23 percent of the GDP in a study carried out by Georgios Karras.¹⁵ This study also finds that government services are over-provided in Africa, under-provided in Asia and optimally provided elsewhere. On the other hand, Tanzi and Schuknecht¹⁶ find that the increase in public spending in many industrial countries since 1960 has been excessive in relation to its impact on social welfare, as measured by certain economic, and social and economic indicators. Another important study carried out by IMF regarding a cross-country comparison of the efficiency of government expenditure on education and health in 38 countries of Africa during 1984-95 proved that increasing budgetary allocations for education and health may not be the only or most efficient way to increase education and health output, and more attention

¹⁵Georgios Karras (1996): The Optimal Government Size: Further International Evidence on the Productivity of Government Services, *Economic Enquiry*, Vol. 34, No. 2 (April), pp 193-203.

¹⁶Tanzi, Vito and Ludger Schuknecht (1997): Reconsidering the Fiscal Role of Government: The International Perspective *American Economic Review*, Vol.1. 87, No. 2 (May), pp 164-168.

should be given to increasing the efficiency of expenditure.¹⁷

Several approaches for measuring the efficiency of government expenditure have been devised in economics literature along four lines. First, studies have concentrated on gauging and enhancing efficiency in practical applications, often focussing on certain types of government spending in a specific country; second, the efficiency of government has been addressed in quantitative terms, using data on inputs of government spending but not on outputs; third, some studies have assessed the efficiency of public spending using outputs but not inputs; and fourth, other studies have looked at both inputs and outputs. But these studies have not made a consistent comparison of the efficiency of government spending among countries. The interest in gauging and enhancing government efficiency led to initiation of wide-ranging institutional reforms by the Government of New Zealand in the late 1980s aimed at improving the efficiency of the public sector. The central theme of these reforms was to separate policy formulation from policy implementation, create competition between government agencies and between government agencies and private firms, and develop output-oriented budgets using a wide array of output indicators. One reform objective was to transform government institutions to reflect the distinction between outputs - the goods and services produced by the government and outcomes the goals that the government wants to achieve with the outputs. Elements of this approach have been adopted by many countries and the theory and practice of result-oriented public expenditure management has generated a wealth of information on how to control production processes within the government and how to enhance their efficiency.¹⁸

Rather than concentrate on either inputs or outputs, the analysis of efficiency may use

¹⁷Gupta Sanjeev, Keiko Honjo et al (1997): The Efficiency of Government Expenditure: Experience from Africa IMF Working Paper: Wp/97/153.

¹⁸OECD (1994): Performance Management in Government: Performance Measurement and Results-Oriented Management Public Management Occasional Paper No. 3 (Paris, OECD)

information contained in both inputs and outputs and consider the question whether the same level of output could be obtained with less input, or equivalently, whether more output could be generated with the same level of input. In considering the question of efficiency of government expenditure on education, it was found in most studies of developing countries, teacher education, teacher experience, and availability of facilities have a positive and significant impact on education output, and that the effect of expenditure per pupil is significant in half the studies, the pupil-teacher ratio and teacher salary have no discernible impact on education output.¹⁹

Recently, a study was conducted to assess the incremental impact of public spending on social and economic indicators, for example, real growth and the mortality rate, in industrial countries. From a comparison of social indicators in countries with varying income levels, it concluded that higher public spending did not significantly improve social welfare. The IMF study revealed that improvements in educational attainment and health output in Africa and the Western Hemisphere are feasible by correcting inefficiencies in government spending on education and health. For example, relatively low allocations for primary education or relatively high allocations for curative health care, or directing most benefits of such government spending to high income groups is symptomatic of expenditure inefficiencies. There is need to exercise caution in increasing budgetary allocations for education and health. The efficiency ranking of countries including those eligible for relief under Highly Indebted Poor Countries (HIPC) initiative in the short-term indicates that the level of government spending alone is not sufficient for achieving higher social indicators.

Fiscal policy rules

The role of the public expenditure administration has to be examined in the context of the fiscal policy rules which a number of developed and developing countries have adopted or are planning to adopt. These rules impose a permanent constraint on fiscal policy in terms of summary

¹⁹Ralph Harbison and Eric Hanushek (1992): *Educational Performance of the Poor: Lessons learnt from Rural Northeast Brazil* (Oxford: Oxford University Press).

indicators of overall fiscal performance. Many fiscal consolidation programmes undertaken to correct persistent budget deficits in the past have not known significant success, which suggests that though discretionary policies may be theoretically superior, well designed fiscal policy rules may offer second-best solution to counter political pressures on fiscal policy-making. The major balanced-budget or deficit rules²⁰ are broadly as follows:

1. Balance between overall revenue and expenditure, that is, prohibition on government borrowing, or limit on government deficit as a proportion of GDP;
2. Balance between structural or cyclically adjusted revenue and expenditure; or limit on structural or cyclically adjusted deficit as a proportion of GDP;
3. Balance between current revenue and current expenditure, that is, borrowing permitted only to finance capital expenditure.

A critical feature of the fiscal rule is that regardless of the statutory instrument (international treaty, constitutional amendment, legal provision, or policy guideline) or local terminology, such as a budget norm in the Netherlands, reference value in EMU, guideline in Indonesia, etc it is intended for application on a permanent basis by successive governments in a given country, at the national or subnational levels. The traditional rationale for fiscal policy rules is macro-economic stability. The best-known fiscal policy rules involve balance between government revenue and expenditure. This could be specified as overall balance, the current balance, or the operating balance to be met each fiscal year, or over a longer period, in terms of a structural balance or a cyclically adjusted balance. Specialized fiscal rules applied to certain categories of government revenue or expenditure have their own rationale. A limitation on primary expenditure at constant prices or on the share of primary expenditure to GDP is ordinarily intended to contain or limit the size of government in the economy. Rules which require the earmarking of revenue for any specific purpose or for mandating a certain composition of expenditures over time, for example, limiting defence outlays, are

²⁰International Monetary Fund (1968): *Occasional Paper No. 162*, page 2

usually pre-determined on macro-economic grounds and cannot be maintained over an extended period.

Although rules on composition of primary expenditure may be considered as arbitrary or inconsistent with rules encompassing aggregates, their adoption could be justified in certain circumstances. Rules which require balance between complimentary outlays, for example, primary and secondary education, or between current (operations and maintenance) and capital expenditures on health care facilities or highways have generally certain economic justification and consequences. At the same time, earmarking of certain user charges for provision of specific services, e.g. for toll roads, or of payroll contributions for specific social insurance fund may be useful in creating both support and accountability for such programmes. In short, the strict conformity with fiscal policy rules would be extremely important for developing and transitional economy countries that are particularly vulnerable to macro-economic imbalances which prevents realization of their full growth potential, especially in the absence of predictable and sound fiscal policies.

There has been phenomenal growth in public expenditure since the end of World War II for a variety of reasons, namely, social and political factors, growth of democratic institutions, canons of distributive justice, social insurance and social security systems, public education and health, growth and age structure of the population, increase in the demand for public services with rising individuals incomes, greater outlays following spurt in oil prices, working of relative price effect, that is, prices paid by public sector rising faster than inflation, etc. However, the social forces which have moulded the forms of government and economic forces operating through the political and organizational processes have resulted in continuous growth in public expenditure. While dealing with the economic adjustment programmes intended to improve economic management in low-income developing and transitional economy countries, it is generally experienced²¹ that reductions in recurrent expenditure

²¹Nashashibi, Karim, Sanjeev Gupta, Claire Liuksila & others (1992): The Fiscal Dimensions of Adjustment in Low Income Countries IMF Occasional Paper No. 92, pp. 12-13

have proved difficult to achieve. On the one hand, needs for health, education, maintenance of infrastructure, and delivery of other public services for rapidly growing population are increasing; on the other, government employment often tends to be excessive, and manpower utilization inefficient, leaving substantial pockets of underemployed civil servants. Structural measures designed to curtail the growth of the civil service and to weed out areas of inefficiency are difficult to implement and take time to take effect. Moreover, public employment becomes a vested interest and it becomes difficult for the government to scale down its size. Wage drift, pressures to increase government employment in the face of rising population and inadequate growth in employment opportunities in the private sector, automatic recruitment from civil service schools and guaranteed job security have been systemic structural factors that have impeded the reduction and restructuring of the public sector wage bill in several low-income African countries. In many such countries, the government is still perceived as the employer of the last resort.

In examining the implications of Enhanced Structural Adjustment Facilities programmes, the IMF has found that the structural measures to improve overall fiscal management and the composition of expenditure may also limit, at least in the short run, the scope for significant reduction in expenditure. The liberalization of interest and exchange rates, civil service reforms, recapitalization of public enterprises, and the provision of safety nets for the poor during the adjustment process entail additional costs that tend to increase recurrent expenditure. While some savings may be obtained from reducing non-productive expenditure, these tend to be deeply entrenched and can only be significantly reduced over time. Therefore, emphasis on public expenditure management can be very important in making best use of public resources, cutting wasteful spending and scrutinizing the composition of public expenditure. (op. cit. pp. 26-27).

In a recent study to identify key arrangements that create incentives consonant with and supportive of achieving better expenditure outcomes, institutional arrangements are categorized according to their relative impact on three levels or categories of expenditure outcomes - aggregate level of spending and the deficit, that is, aggregate fiscal discipline, the composition of expenditure, that is,

strategic prioritization for allocative efficiency and equity, and the technical efficiency in the use of budgeted resources²². The conceptual framework of government financial management and public expenditure controls would be examined in the context of the criteria laid down in the World Bank study.

The Report of the Secretary-General to the Commission on Sustainable Development (E/CN.17/1997/2/Add. 23 dated 22 January 1997) observed:

43. With respect to domestic resource mobilization for sustainable development, it may be necessary to consider a wider range of instruments and mechanisms, and **to discuss reforms in such areas as public expenditures (subsidies, military spending, and unproductive public expenditures). Furthermore, policy guidance is needed on how to redirect financial resources through macro-economic and structural reforms.** In addition, it will become increasingly important to discuss how greater private sector participation in the financing of sustainable development can be achieved. (Emphasis supplied.)

Budget deficits representing the yearly excess of government expenditures over revenues and government debt being the deficits accumulated over the years have soared in many developed countries over the last 20 years and most of them are trying to bring them back. The persistence of budget deficits during the long period of peace when governments traditionally pay off debts and save for the future should set the alarm bells ringing. Moreover, the projected increases in the cost of government programs as populations age and economic growth lags give cause for further apprehension. Large deficits emerged after the oil crisis in mid-1970s and widened drastically after 1980, mostly as a result of government over-spending rather than meagre tax receipts. Government expenditures in industrial countries rose sharply from 28% of GDP in 1960 to

50% in 1994. These deficits have sharply increased the public debt (the accumulated burden of yearly budget deficits) which jumped from 40% in 1980 to 70% in 1995, weakening government finances and draining resources from the economy. Aging populations and sluggish economic growth add urgency to this wearisome trend. Governments have now little choice except to restructure their spending programmes.²³

Budgetary issues in developing countries differ from those in developed countries. Fiscal policy in developing countries faces unique challenges, with smaller budgets, lower personal incomes, large informal economy, inefficient financial markets and erratic tax collections. As a result, with lower government revenues, they have lower public expenditures with the developing countries in Asia and the western hemisphere spending the least and those in Africa, Middle East and Eastern Europe the most, as follows :

Large and persistent deficits push up interest rates, reduce investment, crowd out private investment and create a crushing and unbearable burden of indebtedness. Deficits interfere with the effective functioning of markets everywhere and compromise the living conditions of present and future generations. Given the high levels to which taxes have risen and the danger of stifling growth by raising taxes further, apart from adverse political fallout therefrom, it is reasonable to suppose that reducing government expenditure offers the best means, if not the only means, of eliminating the fiscal imbalance.²⁴ Most developing countries do not spend on social security, such as, pensions, health care and unemployment insurance as much as developed countries do. However, governments will have to adjust their budgets to the inevitable aging of the populations, although they have sufficient lead time than developed countries which they may utilize for designing more sustain-able public pension and welfare programmes than in the developed countries.

²²Ed Campos and Sanjay Pradhan (1996): Budgetary Institutions and Expenditures Outcomes: Binding Governments to Fiscal Performance: World Bank Policy Research Working Paper 1646.

²³Rozlyn Coleman (1997): Confronting Budget Deficits IMF Economic Issues No. 3 (Based on Paul R. Masson & Michael Mussa (1995) IMF Working Paper 95/128).

²⁴McDermott, C. John and Robert F. Westcott (1997): Fiscal Reforms that Work: IMF Economic Issues No. 4.

Government Finances of Developing Countries, 1993 (In percent of GDP)			
Region	Revenue	Expenditure	Balance
Africa	21.9	31.3	--9.4
Asia	15.4	17.8	--2.4
Four newly industrialized Asian Economies	18.3	17.6	0.7
Middle East and Europe	29.3	36.3	--6.7
Western Hemisphere	17.3	17.4	--
Countries in Transition	24.6	31.4	--6.8

International Monetary Fund : Structural Adjustment Facility and Enhanced Structural Adjustment Facility

Since 1986, IMF has supported the adjustment programmes of low-income member countries with loans on highly concessional terms through Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF). These facilities are based on two premises, namely, firstly, that macro-economic stabilization and structural reform of economic systems and institutions complement each other and secondly, that both are needed for economic growth with external viability. These programmes envisaged relatively modest adjustments in the overall fiscal balance, the fiscal deficit was slated to decrease by about 1% of the GDP from the pre-programme year. During the programme period, significant progress was achieved with fiscal consolidation, with fiscal deficits falling significantly in countries where, on average, the initial deficits were highest (i.e. countries with deficits greater than 10% of the GDP). In these countries, the average overall fiscal deficit shrank from 13.8% of GDP in the pre-programme year to 9.5% of GDP in the most recent year. The results of the adjustment programmes varied considerably by region: transitional economy countries outperformed expectations although from excessively high initial deficits, economic performance in Asian and African countries fell slightly short of expectations and performance in Western Hemisphere countries fell significantly short of targets. The annual targets in SAF/ESAF programmes have aimed, on average, to maintain total expenditure as a share of GDP while shifting the composition from current to capital expenditure. Relative to average spending in three years prior to the programme, these adjustment programmes envisaged that capital expenditure should rise by an average 1.4% of GDP and that current expenditure would fall by an average of 2.2% of GDP. According to initial three year-ahead targets, SAF/ESAF countries sought to reduce non-interest public expenditure by 1.9% of GDP.²⁵

During the typical adjustment programme period, SAF/ESAF countries succeeded in changing the composition of expenditure in the direction envisaged. The share of capital expenditure in the

total increased and that of current expenditure decreased, although the changes were of lesser magnitude than that expected. Within current expenditure, the share of wages and salaries in GDP was, on average, slightly higher than envisaged but substantially lower than in the pre-programme period. The overall decline in wages and salaries as a share of GDP was due more to real wage shrinkage than to employment curbs envisaged in civil service reforms. The allocation of outlays by function changed significantly, with less expenditure on military, general public, and economic services (essentially subsidies and transfers) and more outlays on education and health. One positive gain of adjustment programme was expenditure management improved in a number of SAF/ESAF countries, aided by extensive technical assistance from IMF. However, shortcomings in expenditure management have continued in many countries, which have impeded fiscal adjustment and structural reforms. Those countries with no programme interruptions generally had lower expenditure to GDP ratios than programmed. Education and health expenditure rose in real terms and in relation to GDP after the initiation of the first programme in SAF/ESAF countries. Real annual expenditure per capita on education and health rose by 3.8% and 4.8% respectively. However, in both cases, the results varied considerably among countries.

General lessons of expenditure reforms under SAF/ESAF

The actual experience of carrying out SAF/ESAF programmes since the last decade has led to the following specific recommendations concerning public expenditure reforms, namely:

1. As regards public employment, programmes should lay down explicit monitorable quantitative targets based on actual numbers of workers rather than positions. Moreover, the programmes should focus on medium-term plan, instead of one-shot reductions, and on strengthening or creating institutions that ensure control over recruitment and the civil service payroll.
2. Considerable scope exists for increasing the level, efficiency and benefit incidence of social expenditure. Progress in this area is presently constrained due to limited data on functional categories of social expenditure. It would be desirable to prepare comprehensive and timely data on expenditures by function and made available so

²⁵ George T. Abed and others (1998): Fiscal Reforms in Low Income Countries - Experience Under IMF-Supported Programmes: IMF Occasional Paper No. 160

that adjustment programmes can incorporate targets which are realistic, easy to monitor and supported by underlying analysis.

3. The reform of budgeting and expenditure control systems should place greater emphasis on improving the quality of human capital, providing the appropriate incentives for officials charged with carrying out reforms and ensuring transparency and accountability.
4. Since revenue shortfalls often adversely affect expenditure composition and the accumulation of arrears, contingency measures on the expenditure side need to be considered systematically and specify a core-budget of high priority allocations which would be protected from *ad hoc* cuts.
5. Capital expenditure targets should be based on realistic expectations of the capacity for projects implementation, and care should be taken to protect essential public investment from budget cuts.
6. Social safety net measures are highlighted in programmes, but information concerning their impact on the target population groups is scarce. Greater effort should be made to follow up on these measures, particularly to ascertain whether programmes are reaching their intended beneficiaries.

Civil service reforms

As shown by the experience from SAF/ESAF adjustment programmes, civil service reforms constituted an important element of programme design, with the World Bank mostly taking the lead. In most programmes, nearly half of the savings in current expenditure was expected from wages and salaries which were targeted to fall by an average of 1% of the GDP. In general, the reforms typically involve some combination of reducing the excessive numbers of public sector employees, eliminating ghost workers, maintaining competitive wages (in particular, for high-skilled employees), eliminating distortions in the wage structure by increasing the differentials and reducing non-wage benefits, restructuring ministries and rationalizing their functions. These would often be accompanied by civil service surveys or efforts to otherwise improve the personnel database and personnel management systems. There should be clear and unambiguous enumeration of functions of each employee and effective performance appraisal at the end of each year to ascertain his functional utility for the organization.

The growing size of the public service is a matter for concern in most developing countries. While this is mainly a policy issue, it necessitates appropriate tools for budgeting personnel. Systems and methodologies for personnel management should aim at fostering efficiency in delivering public services, which covers wide set of issues like, compensation and measures for increasing mobility. Personnel budgeting methods should take into account performance issues but the balance between fiscal discipline and efficiency-performance strictly depends on the context of each country. There is a broader set of measures to make personnel management flexible and reduce the scope of the government through, for example, flexible personnel procedures, covering both compensation and recruitment and increased pressures on agencies to downsize their activities through market-testing systems or efficiency dividends.²⁶

Most developing countries maintain expenditure ceilings by budgeting personnel expenditures under a separate line item, and limiting transfers between personnel and non-personnel items. This is considered as insufficient. Personnel expenditure ceilings are more of a floor than a limit and rules concerning transfers in effect protect personnel expenditure from overruns in spending on goods and services. Although this system has a certain degree of flexibility, it tends to increase in the personnel expenditure. There is a need for a system permitting governments to monitor and control their legal commitments and not only cash payments and obligations more closely.

Most countries utilise the staff-ceilings in terms of the full-time staff equivalent and are subject to internal or external controls or both. Where it becomes apparent that the size of the civil service must be reduced substantially, it becomes necessary to prepare personnel plans to ascertain which sectors may be pruned, lay down an incentive policy, work out the aggregate amount of redundancy payments, etc. Staff ceilings would then be the annual implementation targets corresponding to these personnel plans. The inclusion of staff ceilings in the budgetary process would identify the risks of over commitment of personnel expenditures at the budget

²⁶Salvatore Schiavo-Campo and Daniel Tommasi (1999). *Managing Government Expenditure* Asian Development Bank, Manila. pp 169-170.

formulation stage itself. Where the size of the civil service is not unduly large and methods of determining personnel expenditure do not present difficulty, it would be sufficient to keep personnel expenditures and other current expenditure under separate budgetary line items and adequate control may be exercised on personnel expenditure by regulating transfers between these items.

Many of the ESAF countries trimmed public sector employment through different means, including limits on recruitment, early retirement or more strictly enforced retirement rules, voluntary departure programmes, and retrenchment resulting in substantial employment reductions. It would be necessary to ensure that the retrenchment programmes are not more costly than envisaged. In some cases, the compensation packages tended to be unduly generous and poorly designed with severance payments often increasing too rapidly with years of employment, which at times, encourages the most senior or skilled civil servants to leave the public sector, increasing the fiscal cost of the reform. In some cases, efforts to generate financial savings through retrenchment are negated by hiring at the highest end of the wage scale while reducing lower level positions. As clearly laid down in SAF/ESAF programmes, there should be a definite target specified for reduction in the wage bill over a period of years.

Conclusion

The basic objective of public expenditure management is effective utilization of public financial resources to enhance the socio-economic welfare of the population by making rational and intelligent choices of competing claims and projects to yield optimum results. Certain coherent and universal principles laid down for this purpose are as follows:

1. Strengthening four pillars of governance : Accountability, Transparency, Predictability and Participation;
2. Reinforcement of their foundation in civil society through efficient and responsible fiscal decentralization and encouragement of citizens participation;
3. Effecting improvements in public expenditure management to reduce opportunities for corruption, both domestic and imported;

- 4 Utilizing the direction provided by objectives of public expenditure management: expenditure control, strategic resource allocation, good operational management and due process;

5. Multi-year approach in budget formulation to adopt long-term objectives, systematic reflection and dialogue.

Although the capacity to incur public expenditure is severely constrained by the availability of revenue receipts, it would always be prudent to maintain the level of expenditure as a percentage of GDP, while shifting the revenue or current expenditure to capital expenditure. The usual form of ensuring harmonious public expenditure management is to effect budgetary savings in annual targets through cuts in public sector employment as also inefficient subsidies and transfers with a view to utilizing them for increasing the capital expenditure on basic infra-structure and social sectors. It is always possible to achieve gains in expenditure productivity through the reallocation of resources to basic health care and primary education, improvements in the targeting of basic services to the under-privileged sections of the population, and a reduction in excessive military expenditure. Capital expenditure would be generally perceived as potentially more efficient at the margin than current expenditure but this conclusion would be incorrect if the investment turns out to be relatively unproductive. In short, it is imperative that public expenditure should be made more efficient and productive through improvements in budgeting and expenditure management.

Transparency in government operations is regarded as an important pre-condition for macro-economic fiscal sustainability, good governance and overall fiscal rectitude. In this context, fiscal transparency is manifested by openness towards public at large, about government structure and functions, fiscal policy intentions, public sector accounts and projections. It involves ready access to reliable, comprehensive, timely, accurate, intelligible, and internationally comparable financial information on government activities - whether undertaken inside or outside government sector - so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government's activities, including the present and future economic and social implications. Transparency in government's operations consists of many dimensions, firstly, the provision of reliable

information on government's fiscal policy intentions and forecasts; secondly, detailed information on government operations, including publication of comprehensive budget documents containing properly classified accounts for the general government and estimates of quasi-fiscal activities conducted by the government; and thirdly, behavioural aspects, including clearly defined conflict-of-interest rules for elected and appointed officials, freedom of information requirements, a transparent regulatory framework, open public procurement and employment practices, a code of conduct for tax officials and published performance audits. These aspects of fiscal transparency are closely associated with the successful implementation of good governance.

Public expenditure management has to be considered in the context of the role of the State, good governance, macro-economic policy and the changing environment with reference to the information and communication technology. Public expenditure management approaches and recommendations are solidly anchored on the economic, social, administrative and implementation capacity realities of the specific country. In fact, public expenditure technology will have to be specific in terms of local factor endowments, local institutions, and real local needs. Moreover, the important factors for the analysis of applicability are the evaluation of the country's institutional framework, availability and reliability of the relevant data and appropriate skills.

The efficiency of public expenditure management is vitally dependent upon the strength and capacity of the institutional framework. The institutional dimension of the budget process is very important, since budgetary outcomes are profoundly affected by budgetary institutions. In developing countries, the stock of institutions is larger than visible on the formal service which leads to the following basic points, namely

1. A design failure to take into account key informal rules is likely to lead to a failure of the budgeting reform itself.
2. Durable institutional change, in general and in public budgeting in particular, takes a long time to be implemented successfully.
3. One way to improve the overall institutional framework is to make the informal rules more visible.

4. Although budget organizations and new units can be merged, restructured, recombined and recreated, but no change in behaviour will result unless basic rules, procedures and incentives also change.

Corruption, often identified with large procurements and major public works programmes, is closely associated with public expenditure management which necessitates improvement in the quality of governance through reduction in opportunities in the process. Corruption weakens fiscal discipline, distorts allocation of resources, harms operational efficiency and effectiveness and is antithetical to the due process. Corruption which is increasingly being seen as neither beneficial, nor inevitable, nor respectable, is bad for economic efficiency and growth and hurts most the disadvantaged and under-privileged sections of the population. When corruption is associated with organised crime, legitimate business is discouraged, the allocation of resources is distorted and political legitimacy is compromised. Corruption has a pervasive and troubling impact on the poor since it distorts public choices in favour of the wealthy and powerful, and reduces the State's ability to provide a social safety net.

Since the extent and scope of public expenditure is closely interconnected with the availability and predictability of all forms of public revenues, Supreme Audit Institutions (SAIs) operating in developing countries and transitional economies have to examine whether all types of government revenues are duly collected in accordance with the due process of law. SAIs also have to ensure that the verification of public expenditure proceeds in accordance with the auditing standards. The efficiency and effectiveness of the SAIs depends upon a variety of factors, namely, support from lawmakers, strength of the legal mandate, extent of availability and adequacy of human and financial resources, degree of independence from executive, access to information, and sufficiency of institutional support in the form of trained personnel and professional accountants.

The three key objectives of good public expenditure management are: fiscal discipline, or expenditure control, allocation of resources consistent with policy priorities or strategic allocation and good operational management. Most important, fiscal discipline requires control at the

aggregate level; strategic resource allocation requires good programming and entails appropriate inter-ministerial arrangements and operational management is largely an intra-ministerial matter. Fiscal discipline results from good forecasts of both revenue and expenditure; strategic allocation has counterpart in tax incidence across different sectors and effective and efficient tax administration is the revenue aspect of good operational management of public expenditure. In essence, good operational management requires efficiency or minimizing the cost per unit of output and effectiveness or achieving the optimum output and the outcome for which the output is intended. In short, efficiency in public expenditure management ensures to the increased socio-economic welfare of the population.

6. REGULATORY FRAMEWORK

Introduction

During the 1990s, international capital flows grew significantly. Transactions in bonds and securities grew rapidly in both developed and developing countries. Moreover, the composition of these flows has changed both in substance and form foreign direct investment and portfolio capital flows have fast replaced commercial bank lending as the main sources of international capital flows. The factors which have accounted for this spurge in international financial transactions include : the remarkable technological change that has reduced the costs for the market participants; privatization of state assets; deregulation of financial markets in key developed countries; growth of institutional investors; and macro-economic and structural reforms in developing countries. This environment has encouraged institutional and private investors to acquire a wide variety of international securities. However, the advent of innovation financial instruments consisting of derivatives with their sub-components, and international competition have made it extremely difficult for most countries to control international financial flows. Hence, the liberalization of domestic and international capital markets has implications for the nature and kind of economic policies that governments will find it useful to follow.

Globalization has mostly been represented in terms of the duality of national-global where the global gains power and advantages at the expense of the national. And it has largely been conceptualized in terms of the internationalization of capital and then

only the upper circuits of capital, notably finance.²⁷ In the context of evolving international economic environment and globalization, it has become necessary to explore ways and means, for expansion of international trade and capital movements across national boundaries, to promote financial resources mobilization for achievement of sustainable economic growth.

During the past decade, globalization has given rise to three highly beneficial global trends but which have, unfortunately, involved distortions which were neither anticipated nor adequate steps taken to reduce their influence. These are the distortions which have been partly responsible for the crises suffered by several developing countries during the last few years. In the first place, the growth of capital markets, facilitated by high technology and sophisticated innovative financial instruments led to an unprecedented proliferation of capital flows to emerging markets; however, the decisions were, in most cases, based on inadequate and sometimes hasty risk assessment by the investors. Secondly, many emerging markets tried to open their capital accounts to reap benefits of competition and the increase in international finance. However, the sequence of liberalization was not wholly appropriate and the supporting policies were found to be weak. The liberalization of more stable, longer-term flows lagged behind the rapid *de facto* freeing of short-term flows, as domestic borrowers competed to avail of the new financing arrangements.

Thirdly, most countries have attempted to steer their economic policies towards freer markets, a restricted role for the State and the use of indirect instruments of macro-economic management. However, these countries failed to strengthen public sector governance, as also corporate governance but there was also widespread corruption and uncontrolled nepotism, or cronyism which abrogated the positive effects of good policies. Globalization requires that each country ensures that its policies are sound and endeavours to guard against the possibilities of abrupt changes in its external environment.

Role and size of government

In performing its economic functions, government uses many policy instruments, and

²⁷Saskia, Sassen (1998): Globalization and its Discontents. (The New Press)

thereby allocates resources, redistributes incomes and influences economic activities. The normative role determines the guidelines, principles, or norms for intervention in the economy for welfare-enhancing purposes and may differ from its actual or positive role due to differences between the interests of the governed and those who govern. According to Vito Tanzi,²⁸ apart from historical developments, the other factors which influence the role of government are the following, namely :

1. Social attitudes, which may be determined by the cultural heritage or religion;
2. The level of economic development, which depending upon the sophistication of the market and of private institutions, may call for more or less state intervention;
3. The degree of openness of the economy;
4. Technological developments, which may create or destroy natural monopolies or may create or increase the need to regulate certain new activities, such as, financial markets, communication or transportation; and
5. The quality of public administration, which may impose limits on the scope of effective government intervention.

Although the developing countries and transitional economies have the greatest need for an expanded public sector, they are least prepared to play efficiently such a role. Moreover, the evidence presently available points to a greater need for governmental action in developing countries and transitional economies as compared to developed countries; but the developed countries seem to exhibit a much larger role for the government when that role is measured in terms of levels of taxation and public spending. On the average, the levels of taxation and of public spending, measured as share of GDP is at least twice as large in industrial countries as in developing countries. For most of the time, increases in government spending were largely financed by tax increases. However, as the levels of taxation increased, there was substantial resistance from taxpayers which led to recourse to public borrowing which, in its turn, led to growth of public debt and interest payments. The situation became unbearable

²⁸Tanzi, Vito (1997): The Changing Role of the State in the Economy: A Historical Perspective IMF Working Paper: WP/97/114. Page 7.

when the public debt as a percentage of GDP became unconscionably high and affected the level of interest rates at which government could borrow. The situation arose due to these countries' difficulties in raising tax revenue. It has been observed that governments that cannot raise a desired level of tax revenue do not scale down their role in the economy, but they pursue that role through non-fiscal instruments, such as, quasi-fiscal activities and quasi-fiscal regulations. Although these activities are not connected with the budget but they have effects, similar to those of fiscal actions²⁹.

A quantitative impression of what a minimalist state might imply in terms of public spending is provided by the historical statistics, for the 1870 - 1913 period (Table 1). This shows that the government expenditure, as a share of GDP, was much lower a century ago than in later years, by societies that were quite advanced and sophisticated. But the state did not engage in activities, such as, higher education, health services, social security and public welfare on a large scale, etc. The Table 2 also shows that for some advanced industrial countries with an extended role of the public sector, total spending in 1990s exceeded 50% of the GDP and for some, even 60% of GDP. For certain centrally planned states of Eastern Europe, this percentage was even higher.

Globalization has brought about growing divergences between relatively static legal jurisdictions, such as, nations and highly dynamic markets. This process has resulted in reduction in the power of national governments over some economic actions by individuals and enterprises. In all its ramifications, globalization has created or contributed to many cross-border externalities which has led to an increase in the number or in the functions of the international and regional organizations. According to Vito Tanzi, such an increase may be seen as an effective reduction in the discretionary authority of national governments. For example, with the creation of the World Trade Organization to deal with cross-border externalities connected with trade policies, the power of national government to interfere in the matters of trade through tariffs, subsidies, quotas, or other quantitative restrictions has been considerably reduced. Recently, the Interim Committee of IMF has

²⁹Tanzi, Vito (1995): Government Role and Efficiency of Policy Instruments: IMF Working Paper: WP/95/100.

endorsed a “Code of Good Practices on Fiscal Transparency” that would encourage member countries to conduct fiscal policies which in conception, implementation and results are as transparent as possible. If such a Code were practised and monitored, it might limit the discretion of the countries in the use of non-transparent instruments, namely, quasifiscal activities, to conduct the fiscal policy. The earlier formulated Data Dissemination Standards Initiative may limit the discretion of countries to generate indifferent data or to keep data confidential that may be useful to international capital markets in making decisions as to where to allocate financial capital. Further, the G-7 countries’ decision has created the Financial Action Task Force developing standards for banking and other activities aimed at reducing money-laundering, which will act as a restraint on the freedom of countries. In short, formal or informal international agreements, understandings, reached between heads of State or governments, or codes of conduct will, in future, guide the actions of governments or will have the effect of limiting the discretionary actions of governments, more so when they affect other countries in a negative way. Moreover, globalization is reducing the degrees of freedom that national governments had in the past, thereby representing a transfer of some powers or functions from the policymakers of national governments to market forces. The net effect appears to be the reduction in the relative role of national governments and in the *raison d’être* of the nation state.

In short, the economic role of national governments will be reduced because of the effect of globalization on tax revenues. The long-term effects of globalization and the resultant tax competition on taxation will be two-fold, namely, that it will lead to lower tax revenues and that there will be major changes in the tax structure. Since revenue from income taxes is likely to fall significantly, the ability of governments to sustain high levels of public spending will be reduced. According to Vito Tanzi,³⁰ the taxes that will fall most will be those of the National governments, for whom it will be difficult to replace those losses because their other major revenue sources, namely, value-added taxes and social security taxes, will also be substantially

³⁰Tanzi, Vito (1995): Government Role and Efficiency of Policy Instruments: IMF Working Paper: WP/95/100.

reduced. Hence, there will be a reduction in the ability of national governments to pursue particular policies.

A large share of production was carried out by state-owned enterprises and traditionally, governments provide a large share of education, health services, road construction and maintenance as also run essentially commercial enterprises selling goods and services. This type of non-financial government activity accounted for a weighted average of 4.9% of GDP in 8 industrial countries during 1978 -91, while for 40 developing countries, the average was 10.7%. Even amongst developed countries, there was considerable variation, with 18.2% for Portugal and 1.2% for the USA. After the fall of communism, the erstwhile Eastern European countries in the Soviet Bloc have strengthened the movement towards privatization since it yields efficiency and welfare gains.³¹ Several studies have shown that state-owned enterprises perform substantially worse than similar private firms.³²

There are a range of productive activities which can be performed by the government or by the private sector. The activities differ in relative efficiency with which government and the private sector can carry them out. Some activities tend to give more output for given inputs when carried out by government and vice versa. The comparative advantages which the private sector has in carrying out certain activities, depends upon, *inter alia*, the production externalities, the public goods nature of the output, the feasibility of contracts in the private sector and the market structure that prevails in the private sector scenario. The government can alter the range of a government activities by privatization or take overs. The optimal range of government activities is dependent upon the relative efficiency (or wastefulness) of government production as well as distortions created by the investment tax which is applicable to private production.

³¹Huizinga, Harry & Nielson, Soren Bo: (1997): Privatization, Public Investment and Capital Income Taxation World Bank.

³²Boardman, Anthony E. And Vining, Aidan R. (1989): Ownership and performance in competitive environments: a comparison of the performance of private, mixed and state-owned enterprises: Journal of Law Economics 32, pp 1-53

Presently, many economists and political activists are re-defining the role of the state in a world where technological advances have made major strides and many countries' economies are getting closely integrated. In this new globalized world, the state will have to play a more significant and intelligent regulatory role: the private sector will have to carry a greater burden in areas that have traditionally been the responsibility of the governments, such as, the provision of infrastructure and of services traditionally provided by public utilities, and in areas such as, pensions, education and health.

The question, whether in the face of globalization, the role of the government will undergo any conceptual and strategic change, has been answered by the Secretary-General of the United Nations in his Report A/ 52/428 to the 52nd Session of the General Assembly, as below:

The Government's activities can be re-defined and reduced in scope as it withdraws from the direct provision of services and manufacture. Experience has shown that Governments can continue to play a vital role in creating an effective legal and regulatory framework in which the private sector is enabled to operate. As those in countries moving towards a market economy keep pointing out, the private sector cannot develop fully unless the Government institutes a legal framework that guarantees and protects private property, governs business relationships and enforces the commitments involved in business contracts. Suitable enforceable legislation is needed as related to the personal liabilities of owners and the bankruptcy of businesses as well as the obligations of those involved. An adequate legal framework is vital in developing an enabling environment in which business creation and operation can function successfully.

Privatization

The advent of privatization brought to the fore in the 1980s, following the British experiments initiated by Margaret Thatcher has resulted in a renewed interest and enthusiasm for private enterprise and market economy and led to rolling back the economic frontiers of the state. Privatization involves two distinct concepts; in the broader sense, it implies shrinking the welfare state or simply associating the private sector with areas hitherto reserved exclusively for the public sector. Or, in

other words, privatization involves the transfer of certain responsibilities, activities and assets from the collective realm to the private realm, which may include the introduction of private insurance, funding of health services, contracting out certain services in hospitals, schools etc, running public transport systems on competitive basis and replacement of state redistribution with voluntary organizations. It refers to the sale or leasing of assets in which the state has majority interest, contracting out publicly provided functions, substitution of user charges for tax finance and liberalization measures aimed at more operational and competitive efficiency and wider choice.

Privatization and private sector development are two distinct concepts, with different ideological connotations but both have been adopted by developing countries and transitional economies as excellent means for economic and social transformation and as the preferred modality for introduction of more commercially applicable approaches into activities undertaken in public owned entities. Many of the privatization exercises in developing countries were rapidly undertaken without due review, for the most part, of the structural and fiscal objectives of such programmes. Mostly, under the urgency of structural adjustment, privatizations were carried out en masse in many of these countries with the active support and assistance of multilateral institutions, often with such speed that the emphasis on fiscal objectives for which the privatization programmes were being carried out, in the first place, become diluted. While most developing countries and transitional economies would conceive well designed, complex and committed privatization programmes, with higher than average implementation rates, and more difficult than average economic circumstances, it was observed that in the area of absorptive capacity, management modalities and valuation that stumbling blocks had arisen in the processes.

In the absence of alternative models of efficient functioning, many countries have seized upon the option of privatization as a means of pursuing the goals of modernization, restructuring, and rehabilitation of public enterprises. Since the early 1980s, a number of countries (about 80) had undertaken the comprehensive privatization programmes as per the UNDP: Human Development Report, 1993. All over the world about 11,332 state

owned enterprises were privatized from 1988-1994, as per the Table 2.

Fiscal implications of privatization

In the case of public enterprises under state ownership, government may finance the operations of public enterprises through subsidies, loans and capital transfers. On their part, the public enterprises may contribute to the government revenues through taxes, dividends and debt service payments. Once the public enterprise is privatized, the financial flows between the budget and the public enterprise will cease and the government will receive the sale proceeds and taxes on the enterprise's profits.

Privatization is often motivated by general fiscal considerations where the government is keen to increase its revenue receipts. The immediate and direct effect of privatization is felt through the privatization proceeds. Where the privatization proceeds successfully, then the initial fiscal impact is positive and it can create additional possibilities for incurring expenditure on social infrastructure or programmes. On the other hand, if the fiscal impact is negative, government will have to adjust the budget by raising taxes or cutting expenditure. The impact of privatization on the government finances has many facets. If the sale price received by the government for a successful and profitable public enterprise is equal to the discounted stream of profit remittances that would have been received if the enterprise had continued to remain in the public sector, the impact can be treated as zero. In such a case, the only effect of the privatization will be on the structure of government net wealth but not the level. If, on the other hand, if the privatization proceeds exceed the existing discounted income stream, on the expectation that the income stream will improve after privatization, the fiscal impact will be positive. Some methods of privatization will offer better chances of producing a positive fiscal impact than others.

Mass privatization - also known as voucher or coupon privatization - has been frequently applied in the transitional economies. This method does not generate any revenues for the government, because the shares are distributed to the population free of cost or at for a nominal fee. Although the mass privatization or restitution do not generate any sales proceeds, they can nevertheless produce a positive fiscal impact if the privatized public enterprise had been a net drain on the budget. A negative fiscal

impact can occur if profitable enterprises are divested. The risk of underpricing is probably the largest if the privatized enterprise had undergone negotiated sale to strategic investors and management/workers buyouts, although the risk can be lessened if there are transparent mechanisms for establishing the sale price. In contrast to public auctions and sales, negotiated sales enable the government to influence the divestiture to achieve its social objectives or to exclude unwanted buyers, for example, foreign investors. However, these constraints on the new owner can lead at times to a lower sale price, reducing the revenues that the government can use to finance social safety nets. On the other hand, under management/employee buyouts, which were common in a number of Eastern European countries, there is neither infusion of fresh capital nor of new ideas, with the result, employment, average pay, wage differentials, output structure, output prices, and productivity levels change only gradually. Although this approach apparently offers the greatest chance of minimizing the adverse impact on employment, the benefits of privatization are also delayed.

Different technical methods have been employed in transitional economies for mass privatization. In some cases, the shares were distributed directly to the population, while in others, the population received vouchers for shares of the privatized enterprises, which could be pooled in investment funds; in another transitional economy, the population received vouchers for shares in the investment funds. All these methods produce, at least initially, a dispersed ownership providing a potentially widespread distribution of the benefits of privatization. It is quite likely that the advantages in terms of income distribution may disappear if the beneficiaries are able to resell these shares too soon; in fact, in one country, the shareholders sold their shares literally for a negligible price and did not benefit from the potential gains from privatization in increased efficiency and productivity. Where small shareholders lack the capacity to manage their portfolio or to monitor the management of the enterprise, the advantage will accrue to better-informed and better-placed shareholders. In the transitional economy referred to above, this danger is mitigated where individuals hold shares in the investment funds. The concentration of share holding in the investment funds ensures effective corporate governance and where the funds are well-regulated, the individuals' interests are protected.

Privatization through restitution which results in the return of the nationalized properties to their original owners has been prominently used in certain transitional economies as also in an African country. Under this form of privatization, the adverse effects on workers and consumers are likely to be as significant as in the case of public sales and auctions. The “restitutio” approach is often governed by judicial and legal considerations, which remains outside the policymakers’ discretion, the options for pre-privatization restructuring and for incorporating social concerns in the transfer of ownership to the private sector are quite limited. While restitution does not generate any revenues, in the case of loss-making enterprises, the budget does not have to cover the losses.

It has been observed that among the several economic changes which have taken place in recent years, privatization has most closely been associated with corruption. There is no doubt that public or state owned enterprises have been a major source of political corruption, as they enable the politicians to finance political activities and provide opportunities for creating employment potential to their followers. Privatization of non-natural monopolies is, therefore, a necessary step to reduce this form of corruption, because it eliminates an instrument often used particularly in political corruption. However, the very process of privatization of public or state-owned enterprises is known to create situations whereby some influential persons, such as, ministers or high-ranking officials possess the discretionary power to make the basic decisions while their associates or lower functionaries possess information not available to outsiders which they can use for enriching themselves. In fact, the abuses of privatization processes which have been witnessed in a number of developing countries and transitional economies have made many right-thinking citizens rather wary and even suspicious of the virtues of a market economy.

It would be instructive to see the observations of UNDP in *Corruption and Good Governance* in this context

Privatization of state-owned enterprises can improve the performance of the economy and, in the process, reduce corruption. But the process of turning over state assets to private owners is fraught with opportunities for corruption and self-dealing. The sale of a large parastatal or public firm is similar to the process of tendering for a large public

infrastructure project. Thus the incentives for malfeasance are similar. Corruption may undermine the efficiency rationale for privatization. If firms pay to preserve the monopoly power of the enterprise after it enters private hands, the result may simply be a transfer of profits from the state to new owners. The employees of the newly privatized firm may then face demands from suppliers and customers seeking to share in the monopoly benefits.

Strategy for deterring and detecting corruption

The basic pre-requisite for privatization is the existence of adequate legal framework to establish and protect property and contract rights. The state of development of law relating to contracts denotes the level of socio-economic development of a country. While many developing countries and transitional economies have passed laws to establish property rights and govern contractual relationships, there are many gaps and the judiciary is not yet fully trained in their application. It has been the experience that complexity and ambiguity in the privatization procedures and regulatory framework lead to administrative discretion in its application, which leads to indulgence in corrupt practices. If laws, regulations and procedures are unambiguous, clear and comprehensible, there would be less scope for corruption, since the politicians and civil servants have no grounds for discretion or delays as also less flexibility to interpret the regulations to their own advantage. On the other hand, administrative efficiency is increased by accent on innovative management systems which allows greater flexibility and reduction of red tape to public officials in the means of achieving better performance in exchange for commitments to higher targets. There are trade-offs between corruption and flexibility which needs to be explored in each situation.

One of the commonest source of corruption to be avoided in privatization procedure is to reduce the number of levels through which the proposal has to pass till it is finally sanctioned by the competent authority. Each separate approval by an official in the chain of command constitutes a rent-collecting opportunity. If the number of officials in every single transaction is unnecessarily increased, far from constituting an internal check, it may provide more opportunity for corruption and dilute accountability, as also slow down the process. Procedures should be simplified to make fewer officials more responsible,

decision criteria should be more clear, known to all parties, ensure less and less discretion at each level and lay down time limits for reaching a decision at each stage involved. As recommended by Rose-Ackerman³³, in some cases, it may be possible to destroy bureaucratic monopolies by providing alternative service points to the public or overlapping service jurisdictions. In the context of disinvestment, however, it may not be practicable to have more than one agency with the competence to dispose of each individual enterprise, but it may be practicable to separate authority to evaluate bids and announce the winner from the authority to negotiate the contract of sale.

In most developing countries and transitional countries, bribery or extortion by public officials for a private benefit is a punishable offence under national criminal code. It may also be possible to charge an errant public official under the law of fraud if the corrupt intent is difficult to prove. In some countries, the laws need to be made more clear and specific to cover bribery committed in a foreign country. There are international model laws covering this subject. It may also be possible to a losing bidder to get the corrupt contract set aside under the competition laws, such as, anti-trust, restrictive trade practices or business regulations. Prosecutions can also be brought under regulations covering foreign exchanges or under tax laws where the income from corrupt practices is not declared for tax purposes. It is common knowledge that corruption raises the cost of doing business and makes outcomes less certain.

In several countries, the matters connected with privatization are so politically sensitive, that the traditional civil service secrecy is intensified. Even after a privatization is completed, the public may not come to know of it and it is only the unsuccessful bidders to bring it to the general attention. Good governance requires that all such decisions should be transparent and in fact, decisions on the operation of tenders, award of contracts, licences and franchises, allocation of shares, etc should be open to the public scrutiny. In one developed country, the Freedom of Information Act (FOIA) substituted the concept

³³Rose-Ackerman S. (1994): Reducing bribery in the public sector in Duc V. Trange (Ed) *Corruption and Democracy: Political Institutions, Processes and Corruption in Transition States in East Central Europe and in the Former Soviet Union*

right-to-know for the need-to-know. This applied to all federal executive government agencies which could refuse to release a requested record or a part of a record only if it falls within any of nine statutory exemptions, such as, documents classified on grounds of national security, defence, or foreign policy, tax returns and other such documents prohibited from release, confidential business information, information which could undermine crime prevention or prosecution, and communications between departments where the related decisions have not yet been made.. The FOIA has been widely used and has had a significant impact in making the federal government more open and transparent. Several other developed countries have tried to follow in the footsteps of this legislation.

The exemption of documentation prior to the decision implies that the privatization process may still be kept completely secret till the final decision is taken. In such a case, the critical decisions are, firstly, whether a given public enterprise is to be privatized, secondly, to whom such an enterprise is to be sold or actively contracted, and, thirdly, the terms and conditions of the contract or regulatory licence.

In the same manner, the public also has a right to know whether the government's objectives in privatization and regulation are being achieved. It is unfortunate that very few governments would sponsor a systematic and impartial enquiry or evaluation of the impact on efficiency, equity, investment, fiscal balance or any other relevant criteria. In most cases, such an evaluation, if ever made, is always an in-house exercise, often by people involved in the process and who, naturally, have an interest in showing only the positive aspects and moreover, the results are not published. In most cases, there is no attempt to sponsor any systematic and independent evaluation of the impact on efficiency, equity, investment, fiscal balance or any other relevant criteria. Independent evaluation of impacts is absolutely necessary, with arrangements for feed-back for policy-makers and other stakeholders.

29. Whenever there are unambiguous declarations of policy goals, applicable laws or regulations, an aggrieved bidder who, in his opinion, has been unjustifiably discriminated against, can challenge the decision on the ground of irregularity. Not only should there exist and be accessible information

regarding standard through public pronouncements and publicity campaigns, but that there should be means to acknowledge and investigate public complaints, including anonymous complaints against incorrect decisions. A free and competent press which can investigate and bring out in open impropriety in government decisions is an important constituent of the democratic process which can also act as a deterrent against corruption and a source of information in rooting it out.

Most governments rely on the unsuccessful contractors or suppliers, and citizens groups to report the cases where corruption has allegedly taken place, since they are primarily the aggrieved parties and would gain by challenging the wrong decision about award of contract through colourable exercise of authority. Rose-Ackerman (op.cit) has proposed an international forum to review cases of suspected corruption in privatization matters or contracting cases brought before it by frustrated unsuccessful bidders. There should be possibility of re-bidding if the Tribunal or the forum discovers the selection process mala fide or suffering from gross impropriety. The Tribunal should have jurisdiction to decide such cases originating from countries which sign an Integrity Pact in return for technical assistance.

As observed by Cooter,³⁴ only chambers of commerce or trade associations with strong ethical overtones or moral standards can prevail upon members to uphold principles of integrity in business dealings. The level of corruption in a country is often a function of its cultural and social norms and may be affected by changes in these norms as a result of, for example, a strong leadership.

The increasing awareness of corruption in the leading industrial countries has been the main catalyst for actions attacking the supply side of corruption. The international corporate bribery scandals exposed by the Securities and Exchange Commission and US Senate Finance Committee's Subcommittee on Multinational Corporations created the stimulus for passage of the Foreign Corrupt Practices Act, 1978. The Act makes the payment of

³⁴Cooter Robert D. (1997): The Role of the State Law versus the Rule of Law State: Economic Analysis of the Legal Foundations of Development in Proceedings of the Annual World Bank Conference on Development Economics, 1996, Washington D.C World Bank.

foreign bribes by United States firms a crime. On 17 December 1997, the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions was signed by representatives of the 29 member governments of the Organization for Economic Cooperation and Development (OECD). It calls upon each of these countries to enact legislation in 1998 to criminalize foreign bribery. This initiative is expected to have global impact. Corporations headquartered in OECD member countries undertake the overwhelming bulk of foreign direct investment and large-scale international official contracting. Moreover, there are indications that many of the governments of leading emerging market economies will adopt similar legislation once the OECD convention has been made effective - Argentina, Brazil, Bulgaria, Chile, and Slovakia all have signed the convention at the formal OECD ceremony in December 1997.³⁵

Audit offices, anti-corruption agencies, ombudsman offices and *ad hoc* commissions of enquiry are vital constitutional checks on corruption. In many developing countries and transitional economies, they have very limited independence and face difficulties where ministers or powerful bureaucrats are involved. In many countries, audit offices are still struggling with inadequate staff to extend the coverage and effectiveness of simple regulatory audit: this has led to donors instituting their own accountability regimes with respect to aid disbursements. In fact, all these agencies should have powers which go beyond the access to records and books of account. Since bribes do not show up in the official books of a government agency nor revealed in conventional audit checks, auditors and investigators have to be more enterprising in their methods. Since the audit of privatization requires non-traditional skills, the SAIs should consider using outside specialists, even on long-term contracts to cover the likely period of a privatization programme.

The INTOSAI Working Group on Privatization has issued guidelines to the effect that an SAI should become involved in the privatization process as soon as constitutionally possible, consistent with maintaining its independence. Thereafter, it should examine whether adequate safeguards are in place to ensure that a sale is

³⁵Vogl, Frank (1998): The Supply Side of Global Bribery: Finance & Development (June 1998)..

properly and honestly carried out. The guidelines suggest that all parties to a transaction should know that the sale may be subject of an independent and searching enquiry and examination by the SAI, and that its findings are likely to be published in the public interest. The time factor is of the essence since many of the key people involved in the process may disperse, after the sale is completed without leaving any trace.

Unfortunately, relatively little work has been done in the areas of accountability, transparency and corruption in the field of privatization and regulation, despite its high profile in international and national developmental agendas. Corruption in the implementation of privatization programmes has been a major hindrance in the realization of the potential benefits. This is associated with the lag in development of effective regulation of private operators in a privatized environment. Moreover, there have been no recent guidelines on how to ensure absence of corrupt practices in each of the major modalities of privatization or regulation.

In particular, there has been little attention paid to accountability and transparency guidelines in government sales of enterprises. This gap could be filled by formulating guidelines on procedures and standard documentation, based on existing standards for government procurement, and their adaptation and adoption should be insisted upon in countries, generally in receipt of loans or technical assistance. The most direct improvement in transparency may be gained by routine public disclosure of details on each major privatization, including bids, scoring systems for multiple criteria, ranking of bids, and final contracts. Exemptions from disclosure, such as, commercially confidential data, should be pre-defined, as in the freedom-of-information legislation in some countries. The onus should be on government to prove that any data not disclosed is so done in public interest. General strategies to improve accountability and transparency include

1. Reduction of administrative discretion, even at the cost of reduced flexibility, efficiency or equity. The rules of the game should be made public.
2. Watchdog agencies should be strengthened and made independent of the executive and the judiciary.
3. Privatization programmes should be taken out of the hands of line ministries and managed by expert

agencies which use external consultants as necessary, but remain politically accountable.

4. Civil service codes of conduct, including regular declaration of assets, should be introduced and made effective, with sanctions for non-compliance. This would be assisted by greater international action against money laundering, and controls on financial havens.

Widespread privatization without real reform

The large budgetary deficits in many developing countries and transitional economies, combined with huge investment requirements in infrastructure sector have necessitated private sector participation. Moreover, the poor performance of most public enterprises and their incapacity to offer a quality service and meet demand have encouraged many governments to approach private sector for the provision of infrastructure services, leading to the need for reforms. However, many large companies in developing countries and transitional economies that were privatized were most often sold as monopolies or quasi-monopolies. Instead of creating greater competition in the concerned sectors *before* privatization, what has been accomplished is substitution of a private monopoly for a public one. As pointed out by Guislain,³⁶ the privatization of the East German electricity industry in 1994 came under sharp criticism as competition was limited and vertical integration was maintained. The public sector's monopoly was merely shifted to the private sector, thereby enlarging the area of domination of the private West German power utilities instead of breaking up the sector and introducing competition. After all, the efficiency impact of privatization depends on the quality of government regulation and its ability to harness competition for sectoral reform.

There is general consensus that private ownership leads to a spurt in productivity, Stiglitz³⁷ has observed that an enterprise's efficiency is

³⁶ Guislain, P. (1997): *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience*, The World Bank, Washington D.C.

³⁷ Stiglitz, J.E. (1998): *Knowledge for Development Economic Science, Economic Policy and Economic Advice* Address to the World Bank's 10th Annual Bank Conference on Development Economics.

determined not so much as by its *public* or *private* ownership, as by the regulatory structure and the degree of competition under which it operates. By considering the example of China as compared with former socialist economies, he concludes that effective competition and regulatory policies are important, rather than privatization *per se*. China had shown that an economy might achieve more effective growth by focussing first on competition, leaving privatization until later. In contrast, competition remains thwarted in many of the former socialist economies that pursued privatization first, demonstrating that without effective competition and regulatory policies, private rent-seeking can be every bit as powerful, and perhaps even more distortionary, than public rent-seeking. Moreover, there have been cases where public enterprises have operated at a level of efficiency comparable to, or greater than, that of similarly situated private enterprises; typically these are associated with firms subjected to competition, either in exports as in the case of Korea's steel industry or domestically as in Canada's railroads.

In actual practice, although privatization of traditional natural monopolies has become widespread in many developing countries in over the last decade, their policies towards real sector reform have often been rather ambivalent. It is true that there is considerable privatization achieved during this period, yet the actual degree of commitment to competition-based reform and the measure chosen vary substantially among countries and industries. Some alternative measures to introduce greater competition have taken root in the developing world. Table 3 summarizes different modes of privatization and sector reform measures in some network industries. A measure to introduce competition for the market via competitive bidding of concessions, for example, has taken root in power, communications, railways, and water enterprises in developing countries as diverse as China, Guinea, Hungary, and Mexico. Countries like Argentina and Chile not only actively introduced competition in the market through vertical disintegration of their telecommunication or electric power enterprises, but also adopted yardstick competition measures in several industries to supplement their sectoral reform efforts. Nevertheless, the *breadth*, *depth*, and *methods* of the private participation as well as the sectoral reform remain highly uneven among countries and industries. For example, Argentina and Hungary have chosen to unbundle the gas sector

before privatization, introducing greater competition, whereas privatization has not yet been accompanied by unbundling or greater competition in the gas industry in Russia.

Better regulation of natural monopolies : Some Policy Lessons and Regulatory Experiences

Guislainh (op.cit) has observed that the efficiency and behaviour of a monopolistic enterprise, whether public or private, depends substantially on the framework in which it operates, and especially on the existence of performance-enhancing incentives and penalties. Neither the superior performance of a public monopoly to a private monopoly, nor the contrary has ever been proved empirically. The nature of the specific approaches and techniques to be applied is important in devising natural monopoly regulation policy. Some regulatory practices and experiences of developing countries and transitional economies are examined hereunder.

A. Competition as an efficient form of regulation.

Where privatization has proceeded with strong competition in the market, the outcomes were positive, as proved by the case of Argentine electricity where full competition and vertical disintegration was introduced in electric power industry. In Argentina, the power sector was restructured radically in 1992 by unbundling generating, transmission and distribution activities and organizing them under different companies. This was considered as 'big bang' approach³⁸ in which privatization, restructuring and introduction of competition were all accomplished in single big step. On the other hand, although Chile was also a fath-breaker of privatization in the developing world, in the electricity sector, the restructuring of enterprises prior to privatization fell short of what was needed to ensure competition. Hence, whenever possible, harnessing competition in the market for regulation should be a priority.

B. Organize competition for the market .

³⁸Joskow, P. (1998): Regulatory Priorities for Reforming Infrastructure Sectors in Developing Countries The World Bank Annual Conference on Development Economics, April 20-21, 1998.

Where competition in the market is not possible, for example, in water industry, the sector should be organized to take advantage of opportunities for competitive bidding. In the water industry, the network-related costs are a higher proportion of total costs than in gas, electricity or telecommunications, and the gains to be made from introducing competition by splitting up ownership of the system are relatively small. Hence, most water will be supplied monopolistically for the time being, and franchising appears as a way of encouraging efficiency despite the monopoly.³⁹ In the railway industry, franchising is also a preferred practice. The success of the early concessions and the lack of credible alternatives have caused a snowballing of such franchise-based reforms in Latin America, spreading also to other regions. So far, the experiences in Argentina, Brazil, Burkina Faso, Chile, Côte d'Ivoire and Mexico are encouraging. The Introduction of competition for the market requires supplementary regulation.

(1) It requires a substantial government investment in the initial design of the concession. This entails government's fundamental decision concerning the degrees of flexibility of the concession agreements to be allowed and price regulation.

(2) In addition, over the course of the concession, it inherently requires continuing government involvement in regulating safety, monopolistic behaviour and compliance with the pricing and service requirements of the concession.

C. Regulating monopoly price : *Cost-based or price-based formula ?*

Setting an optimal price for natural monopolies at the time of the concession is not an easy matter. Difficulties about monopoly pricing results from, firstly, from the problem of regulators not having access to good information regarding demand and best practice cost conditions⁴⁰ and secondly, difficulty in designing a system of price controls that

³⁹Klein, M. & Irwin T. (1996): Regulation in water companies in Public policy for private sector, March 1996.

⁴⁰Bradburd, R. (1992): Privatization of Natural Monopoly Public Enterprises: The Regulation Issue Policy Research Working Papers - WPS 864, The World Bank.

give a strong incentive for the regulated firm to invest more and to improve its efficiency. In particular, main purpose of tariff regulation in most developing countries should be to foster investment rather than to control the level of prices *per se*. If the tariffs are kept at higher level, an enterprise could self-finance a large part of its investment programme and contractual or regulatory mechanisms could compel it to re-invest the excess tariff in the sector to meet demand. Three basic issues are involved :

- the rate level issue - making sure that the total earnings of the firm are appropriately related to the costs;
- the rate structure issue - the determination of the proportion of earnings between different services and different customers;
- the quality issue, to ensure that price controls do not create incentives for firms to reduce the quality of products and services.

Of the various methods of monopoly pricing regulation, those applied often to concessions in developing countries are described below:

1. Rate of return (or cost-based) regulation

This cost-plus-fair rate of return regulation method (based on *average cost* pricing) allows tariffs to rise subject to a pre-determined rate of return. Prices are adjusted so as to keep the company's rate of return on capital at a constant level. If the rate of return falls below that level, the regulator allows prices to rise. Under this approach, the tariff is calculated to cover the regulated firms operating costs, plus a rate of return on the investment. The problems with this price regulation are as under:

- One must estimate cost of building capacity. The basis of the calculation may be inflated by means of unrealistic or spurious costs or investments. Under this approach, the utility calculates and the regulator reviews the expected operating costs for a normal year. (*Information problem*)
- It is considered to provide very little incentive for the regulated firm to reduce costs and improve technology. This does not encourage firms to minimize costs. But it often encourages firms to overinvest in capital. (*Incentive power problem*)
- It is complicated to administer. It requires

extensive research into an enterprise's accounts - and thus plentiful human resources - to determine which costs should be included in the rate base, and which should be disallowed. It requires constant monitoring of management and continued negotiation between the two sides.
(*Regulation cost problem*)

Due to its tendency to distort input choices, as well as its administrative difficulties this method of regulation has become increasingly unpopular. Particularly, in most developing countries where professional skills are scarce, the opportunity cost of scarce human capital devoted to regulation is too high to recommend its use.⁴¹

2. Price Cap (or price-based) regulation

This method emerged during the privatization of Britain's utility industries in the United Kingdom in the mid-1980s and is now used in developing public utilities in countries, such as, Argentina, Brazil, and Chile. Under a price cap, prices are allowed to rise by means of a formula, known as RPI-X, that increases the tariff by the increase in the retail price index adjusted by an efficiency factor, X to account for the expected productivity gains and other changes. Under this method, the company has an incentive to lower costs, since it keeps the resulting profits, because it allows the firm to hold on, at least for a designated period, to the profit gains from cost reductions. This method aims to give the regulated firm an automatic incentive to increase productivity, while at the same time, enabling consumers to benefit from such improvements through the tariff cuts introduced at times of revision. RPI-X price adjustments appear superior to rate-of-return price adjustments, but the real difference between them is not as high as it might seem.

The challenge for the regulator is then how to balance and reconcile all these different problems, such as, information requirement and heavy cost of regulation. The choice of adequate pricing technique

⁴¹Jones, L. (1994): *Appropriate Regulatory Technology: The Interplay of Economic and Institutional Conditions* in *Proceedings of the World Bank Annual Conference on Development Economics, 1993*. Klein, M. & Irwin, T. (1996) (op. cit.) Yarrow, G. (1994): *The Economics of Regulation* in V.V. Ramanadham (ed) *Privatization and After: Monitoring and Regulation*.

is complex and there is no best case for all circumstances. The feasible choice for pricing regulations design lies on the continuum between New Zealand and Chilean pricing systems which define the boundaries of what might be practical. New Zealand's model of extreme simplicity and Chile's model of sophisticated specificity mark the end points of the spectrum of the currently feasible pricing models. A complementary approach is then to use a benchmark as yardstick against which the enterprise measures itself, thus reducing information requirements from the regulated firm. Using yardstick competition can also reduce the undesirable effects of both RPI-X and rate-of-return pricing models.

Relationship between privatization regulation :
Some guidelines

In addition to ensuring the introduction of competition, it is equally important to harmonize the privatization sequence and coordination with regulatory reform. Some guidelines :

1. *Implementing related structural and regulatory reforms upfront and prior to privatization is important. The regulatory framework should be as little ambiguous as possible and must be completed prior to privatization. The regulatory reform and privatization processes need to be closely coordinated, and their sequencing and coordination will have to be thought through from the outset.*
2. *The emphasis and priority should thus be on the competition-based reform of the sector, rather than on the transactional aspects of the divestiture of one or more individual public enterprises. Many privatization programmes appear to focus more on revenue generation than on the longer-term gains that more radical restructuring of the enterprise or sector concerned would bring. According to Paddon,⁴² the privatization practice in Asian public utilities hitherto is generally dominated by gross figures of the overall transactions. In most cases, there is little evidence of specific assessments of a wide range of potential costs or benefits of the privatization of the utility.*

⁴²Paddon, M. (1998): *Restructuring and Privatization of Utilities in Asia Pacific Region* in Loretta de Lucca (ed) *Labour and Social Dimensions of Privatization and Restructuring (Public Utilities: Water, Gas, Electricity)*, ILO: Geneva.

3. *Defining privatization objectives is an important exercise that should be undertaken as early as possible. This is particularly necessary, given the multiplicity and sometimes mutually incompatible nature of the objectives.* An understanding of the possible conflicts between allocative efficiency and other objectives is essential. For instance, the sale proceeds to the government may be enhanced by selling a large enterprise as a single entity, whereas restructuring the enterprise into smaller units will reduce the competitiveness of the sector and the economy but reduce the proceeds of the sale. Many privatization programmes have floundered when clear objectives were lacking or where conflicting objectives were simultaneously pursued.⁴³

Problem of regulatory capacity: Privatization of regulatory tasks as a solution?

40. Regulatory capacity is an essential prerequisite for managing privatization and implementing competitive restructuring of natural monopolies. However, few countries had the essential capacity to manage a complex regulation policy. Earlier, the emergence of municipal ownership of the utilities was due, in part at least, to the lack of confidence in the early regulatory bodies; and one of the reasons for the nationalization of railways was the failure of the pre-war regulatory system to meet the needs of the industry. In the recent past, the relatively sophisticated regulatory agencies, established to control the prices set and the profits earned by the industries privatized under the Thatcherite programme in the U.K. have been beset by difficulties, and their decisions have been very controversial.⁴⁴ Instances have come to notice where the fundamental problem with lack of regulatory capacity hampered privatization and reform initiative. In fact, setting up and choosing the appropriate institutional framework of regulation presents a formidable challenge to developing countries and transitional economies.

It becomes necessary to make a conscious choice between multi-sectoral regulatory agencies

⁴³Guislain, P. (1997): Op.cit.; Bradburd, R. (1992): Op.cit.; Waddell, J. (1997): The Privatization of Monopolies in Economic Perspectives, Electronic Journals, Vol. 2, No. 1, January 1997.

⁴⁴Ogus, A. (1994): Regulation: Legal Form and Economic Theory Clarendon Press, Oxford.

and single-sector regulatory agencies, which created a regulatory agency for each industry. It is common ground that a multi-sectoral agency offers advantages over the alternatives. It pools scarce regulatory resources, such as, regulatory economists and lawyers, especially important in countries with limited regulatory capacity. Also, by pitting interest groups against one another, it obviously tends to increase resistance to regulatory capture and political interference and facilitate a more harmonized approach in different sectors.⁴⁵

Even otherwise, the question whether or not a country should adopt one or the other model of regulation should be based on a number of considerations, namely, the number of operators in the sector; the size of the market; the availability of regulatory resources; the complexity of regulatory rules to be monitored and enforced; and the political disposition regarding degree of autonomy for the regulatory agency. This would necessarily mean that the choice of regulatory institutional framework to be adopted would be guided by its good fit with the national context. In general, the larger the economy, the greater the number of operators in the sector or the more complex the regulatory rules for a sector, the greater the need for an independent sector-specific regulatory agency.⁴⁶

There are ancillary matters facing governments concerning the form of regulatory body, funding and legal authority, in particular, in connection with the important issue of ensuring effective independent regulation. The importance of ensuring *independence* of regulatory authority cannot be overemphasised. The example of Hungarian electricity sector where in 1996 the regulatory agencies reneged on the pre-privatization promises guaranteeing 8% rate of return in real dollars to foreigners on investments made in 1995 is very relevant. It has been experienced that even governments with an ambitious privatization initiatives in some emerging economies could not resist political interference. While an independent regulatory authority is certainly the most appropriate

⁴⁵Estache, A. (1997): Designing Regulatory Institutions for Infrastructure - Lessons from Argentina in Public Policy for the Private Sector, June 1997.

⁴⁶Otobo, E.E. (1998): Privatization and Regulation in Africa: Some Key Policy Issues in DPMN Bulletin, Vol. V, No. 1 December 1998.

solution for investors, as it offers a more stable environment for privatized natural monopoly firms. But it may not be applicable to all developing countries and transitional economies where there is no tradition of independent institutions, free from political interference. Such authority should be granted an independent source of funding. Moreover, independence also requires that where state-owned enterprises are operating in the sector, the regulatory function should be clearly separated from the exercise by the government of its ownership functions.

The concept of regulatory bodies independent of the industry and the government is undoubtedly attractive, but independent, autonomous regulatory agencies with decision making powers may not be suitable for all countries. If the political independence of the regulatory organ cannot be ensured, as in the case of countries with authoritarian governments, creating a new agency with decision-making powers may needlessly complicate the management of the sector by introducing an additional entity and yet another level of uncertainty. In the United Kingdom the decision making powers are given to individual and independent regulators. For developing countries and transitional economies with little or no regulatory track record, it is recommended that they should adopt a light-handed system of regulation with limited discretionary powers and the contracting out of much of the regulatory control and verification work to reputable private auditors. In fact, the idea of a small, central government team that contracts out important regulatory tasks to external auditors and institutions is clearly an interesting option deserving attention. Complex regulatory functions need to be performed professionally; where limited administrative capacity is indeed a binding constraint, at least in the short or medium term, privatization of regulatory tasks should be considered. While creation of a separate group or agency with extensive powers and a clear mandate seems to be the best solution, at least for countries with extensive privatization programmes, this option will often be better suited to some other developing countries and transitional economies administrative capacity.

The Enabling Environment

Private sector development can normally flourish in an environment in which the market forces are allowed to determine the form that development

will take. In market economies, which most developing countries and transitional economies are aspiring to create, private entrepreneurs are induced to seize economic opportunities to develop products and to provide services in response to market demands. It may be difficult to bring about such development in short-term. After a period of heavy governmental interference and intervention in economic activities, the private sector is, at times, too weak in financial resources, skills and technological information to attempt to compete with higher quality and cheaper imports when trade is liberalized. Many small enterprises may even fail in trying to make the transition to market economies. After years of languishing in centrally planned economies, where the private sector hardly existed, as in the case of countries of central and eastern Europe and the former Soviet Union, most fledgling entrepreneurs lacked financial strength and business experience, and did not possess facilities to start business operations.

The entrepreneurial surge, which may surface ultimately as a result of the process of liberalization and deregulation can be expected to take place after an efflux of time, after support services to assist in the technicalities of start-up have been established and conditions exist for upgrading technologies. However, most successful enterprises that do survive and grow will be strong and competitive to take their place in the global economy. Through competition, the incentive is strong to reduce costs and produce goods of sufficiently high quality with competitive prices. The quality of produced improves because markets will reject inferior products that offer less than true value for the price charged. As the economy opens up and there are less restrictive regulations, the role of government is inevitably reduced and the opportunity for wide range of corrupt practices is lessened.

The recent financial crises in emerging markets has shown that developing countries need economic policies which inhibit speculative transactions and flows of short-term capital, and in the meantime, encourage long-term capital inflows, especially foreign direct investment. Alternative or Complementary measures would include transforming short-term capital into long-term capital through securities market. Such policies imply effective prudential regulation and supervision of the financial system as well as improved corporate governance. International cooperation and

partnership have a vital role in creating a favourable climate in which capital flows, investment and trade can flourish. The Economic and Social Council concluded in 1997 that the broad elements of an enabling international environment include : the creation and maintenance of stable international conditions; democratization in international relations in accordance with the Charter of the United Nations and international law; establishment of an open, rule-based, equitable, secure, non-discriminatory, transparent and predictable multilateral trading system; and support for the weakest and vulnerable members of the international community through more favourable treatment in trade and finance.⁴⁷

In this context, it would be relevant to reproduce the Resolution No. 52/209 dated 27 February 1998, adopted by General Assembly on the subject: Business and development:

... *Welcoming* the fact that many countries continue to attach major importance to the privatization of enterprises, demonopolization and administrative deregulation in the context of their economic restructuring policies, as a means to increase efficiency, economic growth and sustainable development,

Recognizing the importance of the market and the private sector for the efficient functioning of economies in various stages of development,

Recognizing the sovereign right of each State to decide on the development of its private and public sectors, taking into account the comparative advantage of each sector, bearing in mind the economic, social and cultural diversity in the world.

3. *Emphasizes* the role of the private sector in each country , including international investors, to contribute positively to the implementation of national macro-economic policies and macro-economic stabilization programmes;

4. *Recognizes* that business and industry, including transnational corporations, play a crucial role in the social and economic development of a country, that a stable policy regime enables and encourages business and industry to operate responsibly and efficiently and to implement longer-

term policies and that the activities of business and industry are the primary contributors to increasing prosperity, which is a major goal of the development process;

5. *Expresses the conviction* that a stable and transparent environment for commercial transactions in all countries is essential; for the mobilization of investment, finance, technology, skills, and other important resources across national borders, in order to promote growth and development, and recognizes in this context that effective efforts at all levels to combat corruption and bribery are essential elements of an improved international business environment;

6. *Recognizes* the important role of government increasing, through transparent and participatory processes, an enabling environment supportive of entrepreneurship and facilitative of privatization, in particular in establishing the judicial, executive and legislative frameworks necessary for a market-based exchange of goods and services and for good management;

7. *Emphasizes* the importance of a supportive international economic environment, including investment and trade, for the promotion of entrepreneurship and privatization;

8. *Recognizes* the need to increase private sector involvement in the provision of infrastructure services, *inter alia*, through joint ventures between public and private entities, particularly in countries with economies in transition, while protecting essential services and safeguarding environment;

9.....

10.....

11. *Values* the promotion of entrepreneurship, including through the informal sector and micro-enterprises, in the development of small and medium-sized enterprises and industries by various actors throughout civil society and of privatization, demonopolization and the simplification of administrative procedures

Many developing countries and transitional economies still have a high level of administrative regulation of business. Several governments have examined the rationale for their administrative controls and simplified and streamlined them, often creating a one-stop agency to reduce the cost and delay, particularly to foreign investors. Administrative deregulation has the additional

⁴⁷ Official Records of the General Assembly, Fifty-second Session, Supplement No. 3(A/52/3/Rev.1), Chap. II, agreed conclusions, 1997/1.

advantage that it attracts more enterprises into the formal sector. Regulation of business activity by government would serve to correct market weaknesses and protect vulnerable groups where they are unable to look after themselves, being customers/consumers, investors/creditors, users of physical environment and employees.

Legal and regulatory framework

The existence of an appropriate and effective legal framework is a key factor in successful efforts to promote sustainable development. Yet legal frameworks, as formulated and applied so far, have not always stimulated adequate participation in economic development activities. While it is contended that an important purpose of the State is to enhance the development of civil society and to promote the private sector by enacting appropriate laws, experience has sometimes indicated that State-laws have not been utilized by local communities and indigenous people. Often transposed from outside and moulded according to the Western concepts and experience, the legal framework for development is not always adapted to the needs of the people in developing countries. Reliable information indicates various areas of law which are not adequately implemented, including : business organization, contracts, bankruptcy, banking law and system of justice. Since new approaches to development are presently being envisaged and pursued within the international community, efforts should be made to move the law closer to the people and people closer to the law.

The Government's activities can be re-defined and reduced in scope as it withdraws from the direct provision of goods and services. Experience has shown that Governments are unsuited for this latter role but that Governments can play a pivotal role in creating an effective legal and regulatory framework in which the private sector is enabled to operate. As those in countries moving towards a market economy point out, the private sector cannot develop fully unless the Government institutes a legal framework that guarantees and protects private property, governs business relationships and enforces the commitments involved in business contracts. Suitable enforceable legislation is needed as related to the personal liabilities of owners and the bankruptcy of businesses as well as obligations of those involved. An adequate legal framework is vital in developing an enabling environment in which business creation and

operation can function successfully. Some of the major complaints voiced against governments in developing countries are of excessive and burdensome regulations. Deregulation - the process of simplifying the regulatory system and abolishing altogether unnecessary and unenforceable regulations has now become a watchword for government reforms in all developed and developing countries.

In many developing countries and transitional economies, the legal framework cannot play its role for a number of reasons, in some cases, it is not adequately sensitive to critical elements of the culture, e.g. in those countries which have legal structures of foreign origin from colonial times, or because critical laws have become antiquated. Law is a result of the cultural heritage and compliance with law requires that legal rules are rooted in social values and traditions. The often-referred implementation deficit is a widely-recognized problem due to the lack of resources for implementation; the imperfection of legal drafting; the lack of an appropriate administrative organization; and the instability of laws. It can also result from lack of consistency between some structural reforms (decentralization and requirements of law that central government can no longer control). Lastly, a deficit of implementation can result from a lack of will to comply with law when in some cases, as a result of social fragmentation, informal linkages and norms overrule the legal rules established by law. There is the ironic problem that while there is under application of the law, there are systems paralysed by the excess of legal constraints which are perceived to stand in the way of innovation, effectiveness and efficiency. They are also seen to characterize Government as excessively large, complex and impersonal. At the societal level, these tendencies seem to inhibit efforts at enhanced participation and democratization.

Reforms in legal framework

Governments have to ensure economic stability, a competitive internal market that is linked to the global economy, major investments in people and infrastructure which are the key elements of a growing economy. Governments must foster competitive environments because businesses can grow through becoming competitive, invest in infrastructure, establish the necessary institutional framework and develop human resources. Successful private sector development requires a sound legal

framework and promotion of legal mechanisms to make private sector participation possible. The legal framework in a market economy has a minimum of three functions, namely:

1. To define the universe of property (including real, personal, and intellectual) rights in the system;
2. To set the rules for the entry and exit of actors into and out of productive activities;
3. To set the rules of market exchange.

Each of these functions typically involves numerous areas of laws. However, for the purpose of

creating an enabling environment, these functions must be performed in the following four areas crucial to the development of the private sector :

Several legal, regulatory and institutional reforms are key to the successful development of the private sector. It is experienced that when these reforms are implemented within the environment of stable economy and free competition, they have stimulated the healthy growth of the private sector. Some of the important elements of the crucial areas are discussed below.

Business Laws	Privatization	Financial Laws and Restructuring	Private infrastructure
Property Laws	Privatization Laws	Capital Markets and Securities Laws	Laws and Regulations for Key Infrastructure sectors
Contract Laws	Laws facilitating restructuring of public enterprises	Monopolies and restrictive practices laws	Special Laws e.g. Build-Operate-Transfer laws
Laws of business entities, (Company Laws, Partnership Laws)	Laws of transfer of liabilities	Banking laws and laws regarding prudential supervision	
Insolvency and Bankruptcy Laws	Public Finance Laws	Credit and Security Laws	
Labour Laws	State Immunity Laws		
Intellectual Property			

1. Property Law

Property rights represent the protection which an individual enjoys vis-a-vis any other people using his resources against his will. The main attributes of an efficient system of property rights are: universality, exclusivity and transferability. The property rights are universal in that all resources are owned by some one or the other. Exclusiveness implies that only the owner thereof can command its use. Transferability ensures allocative and long-term efficiency as also provides for exchange of property rights at the mutually agreeable terms. It is necessary that the buyer and seller are competent to approve the conditions under which transfer of rights takes place. No third party can ordinarily impose terms so that if the third parties, including government were to impose price controls, property rights of owners are clearly violated.

Where a society is based on the rule of law, there will be total absence of markets if the property rights do not exist. Unless property rights exist, including the right to use the asset, to permit or exclude the use by others, to collect the income generated by the asset or the ability to sell the asset, no markets can develop. Property rights are backed by social arrangements, including reasonable restraints on lawlessness, such as, protection from theft and violence; protection from arbitrary

governmental actions which may have the effect of disruption of lawful business activities; fair and predictable legal or administrative mechanisms for resolving disputes. Many developing countries lack these basic and rudimentary social arrangements. Some of the transitional economies, including Visegrad countries, namely, Poland, Hungary, the Czech Republic, and Slovakia have made significant progress in equalizing the status of public and private property and on providing protection of property rights. Since in most of these countries property was initially state-owned, legal reforms establishing private property have included the transfer of ownership of assets to private parties through privatization, restitution, and leasing arrangements. Unfortunately, the property rights are undermined by tenancy laws which restrict the rights of property owners, incomplete and imperfect property registration procedures and weak legislation governing collateral. Such tenancy laws distort the rental markets and make the re-possession of mortgaged property difficult.

2. Intellectual Property Rights (IPR)

Other property rights primarily include intellectual property rights (IPR), which are intangible assets, including copyrights on pop music to patents on pharmaceutical formulations. Presently valued at approximately US \$1 trillion, it is only now

that their importance has been recognized. Most of the modern products sell, not reflecting its cost of production, but the value which represents its substantial research costs, as in the case of prescription drugs, or the intellectual exercise enshrined in software or brand names in apparel or perfumes. These objects which have been brought into existence after heavy development costs generally do not involve significant production costs and are prone to piracy in international markets. Presently, around 50% of computer and software products, 30% of CDS and 20% of recorded music is pirated.

So far as copyrights are concerned, currently, digital technology has significantly improved the reproduction process, so that the quality of copies is as good as, if not better, than the original and the development of Internet has disregarded the impediments of distance, thus facilitating the distribution. For protection of copyrights, copyright law confers two rights, namely, to authorize the reproduction and distribution. The electronic transmission of a copyright work : whether it is reproduction or distribution? Fundamental shifts in technology and the economic landscape have raised important questions about the relevance and adequacy of the existing system of IPRs. The European Union has formulated a green (consultative) paper on copyright and related rights in a digital society , which may ultimately become a directive.

The World Intellectual Property Organization (WIPO), an intergovernmental organization with headquarters in Geneva, Switzerland is responsible for the promotion of the protection of intellectual property throughout the world through cooperation among States, and for the administration of various multilateral treaties dealing with the legal and administrative aspects of intellectual property. Intellectual property comprises two branches, namely:

1. Industrial property, chiefly in inventions, trademarks, industrial designs, and appellations of origin;
2. Copyright, chiefly in literary, musical, artistic, photographic and audio-visual works.

In certain countries, mainly those with common law legal traditions, the notion *copyright* has a wider meaning than *author s rights* and, in addition to literary and artistic works, also extends to the producers of sound recordings (phonograms, whether discs or tapes), to the broadcasters of broadcasts and the creators of distinctive

typographical arrangements of publications. Currently, around 1 million books/titles are published, and some 5,000 feature films are produced and number of copies of phonograms sold per year is more than 3,000 million.

Copyright protection generally means that certain uses of the work are lawful only if they are done with the authorization of the owner of the copyright. The most typical examples are the right *to copy or otherwise to reproduce* any kind of work; the right to *distribute* copies to the public; the right to *rent* copies of at least certain categories of works (such as, computer programs and audiovisual works); the right to make sound recordings of the performances of literary and musical works; the right *to perform in public*, especially musical, dramatic or audiovisual works; the right to communicate to the public by cable or otherwise the performances of such works and particularly *to broadcast* , by radio, television or other wireless means, any kind of work; the right *to translate* literary works; the right to rent, particularly, audiovisual works, works embodied in phonograms and computer programs; the right *to adapt* any kind of work and particularly the right *to make audiovisual works* thereof. Under some national laws, some of these rights which together are referred to as economic rights -are not exclusive rights of authorization but, in certain specific cases, merely rights to remuneration; such as the case, in certain countries and under certain circumstances, for the right to make sound recordings of musical works and the right to broadcast any kinds of works. Some strictly determined uses (for example, quotations, the use of works by way of illustrations for teaching, or the use of articles on political or economic matters in other newspapers) are completely free, that is, they require neither the authorization of , nor remuneration for, the owner of the copyright. In addition to economic rights, authors (whether or not they own the economic rights) enjoy moral rights on the basis of which authors have the right to claim their authorship and require that their names be indicated on the copies of the work and in connection with other uses thereof, and they have the right to oppose the mutilation or deformation of their works. The owner of copyright may generally transfer his right or may license certain uses of his work. Moral rights are, however, generally inalienable although their exercise may be waived by the author.

Copyright generally vests in the author of the work. Certain laws provide for exceptions and, for example, regard the employer as the original owner of copyright if the author was, when the work was created, an employee and was employed for the very purpose of creating the work. In the case of certain

types of works, particularly audiovisual works, certain national laws provide for different solutions to the question who should be the first owner of copyright in such works. The laws of almost all countries provide that protection is independent of any formalities, that is, copyright protection starts as soon as the work is created. Copyright protection is limited in time. Many countries have adopted, as a general rule, a term of protection that starts at the time of the creation of the work and ends 50 years (in some countries, 70 years) after the death of the author. However, in some countries, there are exceptions either for certain kinds of works (e.g. photographs, audiovisual works) or for certain uses (e.g. translations).

The laws of a State relating to copyright are generally concerned only with acts accomplished or committed in the State itself. Consequently, they cannot provide for the protection of the State's citizens in another State. In order to guarantee protection in foreign States for their own citizens that in 1860, 10 States established the International Union for the Protection of Literary and Artistic Works by signing the Berne Convention for the Protection of Literary and Artistic Works. Presently, its membership is ten times larger. But international protection for copyright and certain neighbouring rights is also provided for by the TRIPS Agreement. (TRIPS stands for Trade-Related aspects of Intellectual Property Rights).

Lester Thurow⁴⁸ of MIT is very critical of the current tendency of complacency of simple tinkering and adjustment of IPR. He desires for a thoroughgoing assessment so as to construct a whole new system. It is becoming increasingly difficult to protect IPR and the future portends greater scramble to capture and monopolize the IPR, which requires a socially managed system to balance social costs against economic benefits. With a view to even the playing field, the following three perspectives have to be looked into, namely

1. The system should strike a right balance between the production and distribution of new ideas: There is the inherent conflict between providing adequate financial incentives to developers to induce them to take risks as against the social need for speedy distribution of knowledge. Governments must create laws to accelerate technological and economic progress and consider modalities to encompass new

⁴⁸Thurow, Lester (1997): Needed: A New System of Intellectual Property Rights, Harvard Business Review (September-October, 1997).

2. Laws on IPR must be enforceable. The three options are : technology, law enforcement, and public education. Thurow argues that laws are meaningless and should not be enacted unless technological choke points exist to make enforcement possible. A huge technological effort is being made to develop pirate-proof ways to transmit material, e.g. IBM's system of secure packaging for sending digital information over Internet and a clearing house through which commercial content providers can track delivery of and payment for contents held in such packages .

3. The system should be capable of adjudicating on rights and resolve disputes quickly, because the present laws governing the patent system are inadequate due to inconsistent, slow and high-cost of adjudication. A solution could be to make the user pay a fee, which could be adjusted to reflect the income level of the applicant and equalize the burdens on large corporations and small, individual inventors.

Thurow contends that the new system will have to reconcile the following competing interests and allow for some critical distinctions, namely

1. Public versus private knowledge: There is need to distinguish between public and private domain. This does not mean that patents and copyrights should be forbidden in areas where social interest exists in allowing general access to knowledge at little or no cost. No incentive would exist to produce such generally useful knowledge. Those generating knowledge in public domain should get paid.

2. Developed versus developing countries: This system should reflect the needs of both developed and developing countries. There is no equivalence between low-cost pharmaceuticals with low-cost CDS.

3. Different industries, different patents: The optimal patent system will not be identical for all industries, all types of knowledge, or all types of inventors. While the electronics industry requires speed and short-term protection because most of its money is earned soon after new knowledge is developed, the pharmaceutical industry requires long-term protection since most of its money is earned after a long period of testings to prove the drug's effectiveness. ~~technology into the existing legal framework.~~

Unfortunately, copyright-related piracy is on the rise. As a result of recent TRIPS agreement, governments will have to incorporate the international copyright agreements, as the Berne Convention in their national laws. Intellectual

property, such as, know-how or trade secrets can be trade intangibles or marketing intangibles. Know-how and trade secrets are proprietary information or knowledge that assists or improves a commercial activity, but that is not registered for protection in the manner of a patent or trade-mark. The know-how is a less precise concept. Paragraph 11 of the Commentary on Article 12 of the OECD Model Tax Convention gives this definition : Know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; in as much as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique. Know-how may thus include secret processes or formulae or other secret information concerning industrial, commercial or scientific experience that is not covered by patent. Any disclosure of know-how or a trade secret could substantially reduce the value of the property.

3. Contract law

The development of law relating to contracts is a barometer reflecting the state of socio-economic development of a society. Civil codes have traditionally provided the general rules on formation and cancellation of contract or on breach and warranties. These norms apply only in cases the parties have not agreed to a separate set of rules or have specifically excluded normal practices. Prior to the demise of communism, most transitional economies had expanded the scope of non-state economic activities. The countries have since endorsed the principle of freedom of contract for most of their economic activities. With the on-set of market economy, contracts are interpreted in view of the intent of the parties rather than any ideological principles. This reflects the transition from the command to market economy. Most of the Visegrad countries have improved their commercial codes but institutional weaknesses still undermine the contract enforcement, with the limited court capacity, non-development of procedures for out-of-court settlement of contract-related disputes and lack of market-based liquidation companies and secondary markets for pledged assets. Private sector should get assurance that terms of contract will be binding and enforceable in a court of law. Another important aspect is the cost of enforcement of a contract, which, if high, in terms of time and money, will render the worth of such a contract questionable and may divert

businesses to conduct their affairs beyond the legal domain.

4. Company law

The company law along with laws relating to foreign investment and bankruptcy, are among the subset of laws which determine the entry and exit of factors of production in and out of economic activities.

A. Ease of entry and exit. Entrepreneurial initiative can be dampened if the business environment impedes the start of a business activity. The activity of starting a business venture usually involves registration of business, opening a bank account and establishing business credentials, which in a developed country can be done over a telephone call, may take anywhere up to 90 days in a developing country. Transitional economies have, in principle, liberalized and rationalized the legal requirements governing business organization and provided basic framework for different types of organizations. Entry into domestic markets is open to both domestic and foreign investors, subject to registration requirements. Where the procedures are onerous and subject to bureaucratic red tape, registration requirements tend to stifle the initiative and undermine the freedom of entry. According to an expert, the number of permits and documents required to registration of business range from a high of ten to a low of two in certain in transitional economies. In some transitional economies, the business licences for commencement of economic activity is required prior to the incorporation, while in some it is deferred to post-registration. In some countries, a company with foreign participation will get the licence after the project is approved by state planning authorities, the relevant ministries and state committee for foreign economic activities. The whole procedure takes from a few months to years depending on the size, the location and the individual bureaucrat in charge.

In most developed countries, the minimum capital requirement for commencement of new business activity were either scrapped or reduced considerably. But in developing countries and transitional economies, it is found that it can be as high as US \$77 000 for a Visegrad country Joint Stock Company to US\$ 20 000 for another transitional economy country Limited Liability Company. Such large capital requirements frustrate the efforts to create the entrepreneur-friendly environment.

B. Bankruptcy laws

In some countries, difficult procedures or high-cost of closure of unsuccessful businesses may deter even the starting of a business venture. In some countries, business closures involve major costs. Western style bankruptcy procedures were neither needed nor known in erstwhile predecessors of transitional economies because of absence of adversarial interests. Companies' creditors - whether banks or suppliers were owned by the State which also owned the debtor company and would arrange the settlement of the financial disputes amicably. This was accomplished often by infusion of additional cash for either the debtors or creditors. In one Visegrad country, debt disputes are settled out of court while in another, in contrast, bankruptcy and liquidation procedures are automatically applied to companies that default on loans. Some others prefer less formal methods for restructuring large enterprises unless liquidation is necessary. Social pressures as also problems with collateral claims, seizure (credit hierarchy) and resale inhibit the use of bankruptcy and liquidation proceedings. In developing countries and transitional economies, western-style bankruptcy procedures must be adopted as the private sector grows because the private suppliers and banks will face budgetary constraints and will have strong incentive to collect on outstanding bad debts. Efficient bankruptcy procedures and other bad debt collection instruments are an essential part of the market economy and will have to be brought into full use for proper development of the private sector.

C. Laws relating to financial institutions.

The legal framework under which a financial institution functions influences the availability of funds. Financial institutions lend moneys on long-term for purchase of capital assets or for financing day-to-day operations for working capital requirements. Most financing operations are secured by a collateral. This necessitates defining the proper scope of the term property and the assets that can be used as collateral. It is equally important to be able to re-possess and sell the collateral, if need arises, without incurring high costs in an efficient and quick manner. The time and cost of taking repossession of collateral becomes an important constituent of availability of finance. The delays involved in this behalf in developing countries and transitional economies as compared to in developed countries affect the smooth business operations in the former group of countries. In some countries, the only collateral favoured is immovable property and not raw materials, inventory, equipment or machinery

and plant. This causes considerable hardships to landless farmers (who do not own land) in obtaining credit. Many countries require director's personal guarantee for any loan not backed by real estate, which negates the benefits of limited liability inherent in an entrepreneur's ability to take risk.

D. Labour laws

In many countries, there are stiff labour laws which prohibit hiring and firing of labour as the exigencies of business demand. There are also difficulties in closing an unprofitable business in view of the retrenchment and unemployment which results. Many loss-making businesses in developing countries have to carry on unproductive business operations merely because of rigidity of labour laws. Many foreign and domestic entrepreneurs hesitate to start business operations under such onerous conditions. In addition, labour legislation in some countries requires heavy social security contributions, thus adding to the fixed costs, thus demotivating the entrepreneurs.

Apart from payment of high wages resulting from periodic wage settlements with labour unions, many entrepreneurs are required, under labour laws to make large severance payments which makes it costly to fire unproductive or recalcitrant workers. Such uneconomic labour welfare payments have led to deterrence to formal hiring of workers leading to shrinkage of new job creation although structural reforms have improved economies of many countries in Asia and Latin America.

In short, while examining the efficacy of the legal framework, it is also necessary to foster a mature financial market, which is based on stable relationship among players that rely on enlightened self-interest, and in which official involvement can be limited to establishing strong legal, regulatory and supervisory frameworks. From the players, regulators and supervisors, the only expectations are the simple, basic values of good governance, transparency and cooperation. The responsibility of debtors is the principle that contracts must be honoured since it constitutes the very foundation of the successful operation of mature markets. Proposals for involving the private sector, far from encouraging countries to take their commitments less seriously, must ensure that obligations are honoured. If there is an equivalent singular responsibility of governments, it is the obligation to pursue the macro-economic policy objectives of stability and growth within a transparent economic and financial policy framework, including the dissemination of comprehensive, accurate and timely data. Other obligations involve elements of a shared

responsibility and call for extensive cooperation and consultation :

1. A strong legislative framework-including a workable bankruptcy law-and an independent judicial system;
2. Adoption and adherence to internationally accepted standards of disclosure and governance. Even if some of these standards are still work-in-progress , there are many that can be adopted already;
3. The development of a robust regulatory and supervisory framework for the financial sector;
4. Policies and practices that promote sound debt management and the high-frequency monitoring of private external liabilities, a key aim of which should be to avoid excessive short-term debt.

In this scenario, the creditors, in other words, the private sector-and their governments- contribute to a better financial system. The first area is risk assessment and risk management. Every investment involves risk and hence the obligation to develop adequate techniques and practices for assessing, pricing and managing risk. Secondly, creditors can play an important role in adhering to internationally recognized standards, by attaining high standards of disclosure but also by encouraging borrowers to adopt good practices by factoring this into their investment and pricing decisions. Thirdly, creditors should accept that national authorities need to adapt the principles and standards that support their regulation and supervision of national financial systems. One practical suggestion is to reflect more adequately the risk of lending to emerging markets by increasing the risk weights assigned to short-term lending in the balance sheet of creditor banks under the Basle Core Principles. In this connection, the activities of off-shore funds, and highly leveraged institutions - including hedge funds and similar operations of other financial institutions- and the role of short-term credit will require in-depth scrutiny. Fourth, private creditors can help countries to preserve their foreign exchange liquidity when there is a threat of contagion by establishing contingent financing arrangements that can be activated if crisis looms. Fifthly, since cooperation is vital, debtors and creditors need to establish and activate good lines of communication during normal times reflecting timely and effective consultation among debtors and creditors, for example, countries may emulate Mexico's practice established after 1994/95 crisis of regular consultation with inter-national financial market participants, and Brazil's consultative approach to its creditors in the context of securing a

voluntary roll-over of interbank and trade related credit lines.⁴⁹

REGULATORY FRAMEWORK

While weak and economically dependent states must tailor their ambitions according to their capability, some inescapable tasks warrant priority consideration. Sustainable, shared and poverty-reducing development has five crucial ingredients, namely:

1. A foundation of law;
2. A benign policy environment, including macro-economic stability;
3. Investment in people and infrastructure;
4. Protection of the vulnerable;and
5. Protection of the natural environment.

There is much less agreement about the state's precise role in regulation and industrial policy. The rise of the state-dominated development strategy in the early post-war years resulted in considerable expansion in government regulation. Since there has been an important move towards economic liberalization, those aspects of regulatory framework that have proved counterproductive are being abandoned. Governments in developing countries and transitional economies have realized that market reforms and technological advances pose their own regulatory challenges. While states cannot abandon regulation, they have to adopt approaches to regulation that fit not only the shifting demands of the economy but, critically, the country's existing institutional capability. Interest has revived in finding ways for the government to work with the private sector in support of economic development and to provide regulatory frameworks supportive of competitive markets. In many countries, state and markets remain fundamentally at odds. Private initiative is held hostage to a legacy of antagonistic relations with the state. Rigid regulations inhibit private initiative, while state enterprises endowed with monopoly privileges dominate economic terrain that could deservedly and beneficially be given over to competitive markets.⁵⁰ At the other extreme, a

⁴⁹Camdessus, Michel (1999), Managing Director, IMF: Preventing and Resolving Financial Crises: The Role of the Private Sector at Bretton Woods Committee Annual Meeting, June 1999.

⁵⁰World Development Report, 1997: The State in a Changing World World Bank.

mass of inefficient and loss-making state enterprises blocks private dynamism entirely even as it imposes a crushing unbearable fiscal and administrative burden on the rest of the public sector. In such countries, the first step toward increasing the state's effectiveness must be to reduce its reach.

Effective and skilful regulation can help societies influence markets outcomes to achieve public purposes, protecting the environment, workers and consumers from information asymmetries. Regulation can make markets work more efficiently by fostering competition and innovation and preventing abuse of monopoly power. It can also help win public acceptance of the fairness and legitimacy of market outcomes. While with the advent of economic liberalization, some areas of regulation have been abandoned as being counterproductive, yet in some areas the traditional rationales for regulation subsist and market liberalization and privatization have themselves brought new regulatory issues to the fore. In respect of three important regulatory domains, namely, banking, utilities and the environment, it is necessary to find regulatory approaches in each country that match its needs and capabilities.

Some new rationales for regulation have evolved in the 1990s. In the case of financial sector, the depth of a country's financial sector is a powerful predictor and driver of development and that the control-oriented regulation widely adopted in the early post-war years—directing subsidized credit to favoured segments of economic activities at very negative real interest rates, limiting the sectoral and geographic diversification of financial intermediaries—may often work against financial deepening. The new approach has been to move away from controls over the structure of financial markets and their allocation of finance and embark on a process of liberalization.

Having regard to the recent financial crises in South East Asian countries, particular emphasis is given to reduce the risk of disruptive shifts in market sentiment, limit damaging contagion and spillover effects and strengthen the process and procedures of crisis resolution. The development and implementation of international standards and principles of good practice, although still at the stage of evolution and dissemination, have the following objectives,⁵¹ namely

- strengthen effective financial market supervision and regulation;
- improve the institutional infrastructure;
- enhance transparency, market discipline, and corporate governance; and
- enhance risk management by financial institutions.

Supervision and regulation of financial markets

The Basle Committee⁵² has developed the Core Principles for Effective Banking Supervision which will serve as a basic reference and minimum standards for bank supervisory and other public authorities. Consistent with these principles, IMF⁵³ has developed a framework for financial sector surveillance, which helps to analyse the financial sector vulnerabilities. Increased liberalization of financial markets in general and of the banking sector in particular has been given the priority treatment in the economic policy agenda in many developing countries in the last three decades. During this period, the frequency of systemic banking problems has increased markedly all over the world, raising the issue of whether greater fragility may be a consequence of liberalization. A recent study by IMF⁵⁴ of 53 countries during 1980-95 finds that financial liberalization increases the probability of a banking crisis, but less so where the institutional environment is strong. The panel includes countries that liberalized their financial markets several years before 1980, and others that liberalized at different dates over the sample period; also, countries that experienced one or more banking crises are represented along with countries that had a stable banking system throughout the period. The first result that emerges from the analysis is that financial fragility is affected by a multiplicity of factors, including adverse macro-economic developments,

⁵²Basle Committee on Banking Supervision (1997): Core Principles for Effective Banking Supervision: Consultative Paper (Basle, Switzerland, Basle Committee, 1997).

⁵³Folkerts - Landau, David & Lindgren, Carl-Johan (1998): Towards a Framework for Financial Stability: World Economic and Financial Surveys IMF, January 1998.

⁵⁴Demirguc-Kunt, Asli and Detragiache, Enrica (1998): Financial Liberalization and Financial Fragility: IMF Working Paper: WP/98/83.

⁵¹World Economic and Financial Surveys (October 1998): World Economic Outlook: Financial Turbulence and the World Economy Survey by the Staff of the IMF, pp 29-30.

bad macro-economic policies, and vulnerability to balance-of-payments crises. When these factors are controller for, financial liberalization exerts an independent negative effect on the stability of the banking sector, and the magnitude of the effect is not trivial. However, a strong institutional environment, characterized by effective law enforcement, an efficient bureaucracy, and little corruption, can curb the adverse effects of liberalization on the financial system. The data also show that, after liberalization, financially repressed countries tend to have improved financial development even if they experience a banking crisis. This is not true for financially restrained countries. In conclusion, the IMF study observes as under:

These findings suggest that institutional development needs to be emphasized early in the liberalization process; in countries where the institutional environment is weak, achieving macro-economic stabilization before or during liberalization would certainly bring an important independent source of financial instability under control. However, even in an otherwise well-functioning economy weaknesses in the institutions and in the regulatory framework necessary for financial markets to operate efficiently may fail to check perverse behaviour on the part of financial intermediaries, creating the foundations for systemic financial sector problems. Unfortunately, strong institutions cannot be created overnight, not even by the most reform-oriented government; thus, the path to financial liberalization should be a gradual one, in which the benefits of each further step to liberalization are carefully weighed against the risks. Another implication of our findings is that more research effort should be focussed on the design and implementation of prudential regulations and supervision especially in developing countries.

An unstable macro-economic environment is a principal source of vulnerability in financial system. Sudden spurts and downfalls in the performance of the real economy, and volatility of interest rates, exchange rates, asset prices and inflation rates create difficulties for banks to assess correctly the credit and market risks incurred by them. The developing countries and transitional economies have serious constraints and limitations to diversify these risks compared to the developed countries. Moreover, the general cause of vulnerability in the banking sector stems from weakness in the management of the banks themselves and in the structural environment in which they operate, which in conjunction with a poor incentive structure leads to excessive risk-taking and thereby undermines corporate governance and market

discipline - fundamental ingredients for sound banking. For purposes of organizing the elements of a framework, according to IMF, five sets of challenges can be identified, namely :

1. Inadequate bank management leads to undue risk-taking, which is prejudicial to the interests of depositors and other creditors;

2. A lack of adequate information on the financial condition of banks - due in part to inadequate accounting standards and reporting and disclosure requirements, but principally owing to insufficiently stringent rules and practices for loan valuation and loan loss provisioning - undermines the disciplinary force of markets and delays recognition of banking problems until well after the onset of difficulties which makes their resolution harder and costlier.

3. The presence of implicit or explicit public sector guarantees of the liabilities of banks has often contributed to weakness in banking systems by encouraging excessive risk-taking by individual banks and weakening the discipline that would be imposed by depositors with money at risk. Forbearance in dealing with insolvent banks through as weak exit policy - with generous support for depositors and excessive lender-of-last-resort assistance frequently increases the ultimate costs of banking crises.

4. An ineffective bank supervisory environment frequently fails to counter the incentive problems created by public sector safety net and by a lack of market discipline. While many countries have elaborate regulatory systems they are not effectively implemented and enforced because of a supervisory autonomy and capacity.

5. Concentrated bank ownership and connected lending patterns may increase the vulnerability of banking systems, mostly in developing countries. Banks belonging to important industrial conglomerates tend to concentrate their lending to group companies making it difficult to evaluate the credit quality of loans, collateral and to measure the origin and quality of a bank's capital. In addition, state ownership of banks is frequently associated with inadequate governance, extensive guarantees of bank liabilities and lax implementation of supervisory requirements.

Controlling risk through regulatory and supervisory oversight regulation and supervision of banks limits the adverse consequences of the official safety net on risk-taking and to force banks to internalize the externalities of failures. Such an oversight is not intended to assure the survival of

each and every bank but primarily to ensure the soundness of the banking system as a whole. The natural consequence of such oversight would be the exit of insolvent banks when the market discipline fails. Banking laws and prudential regulations seek to:

- establish policies that allow only the financially viable banks to operate;
- limit excessive risk-taking by owners and managers of banks;
- establish appropriate accounting, valuation and reporting rules;
- provide for corrective measures and restrictions on activities of weak institutions.

Most often, banking legislation leaves matters of implementation to be specified by prudential regulations to provide a degree of flexibility as circumstances change or as exigencies of situation demand. The supervisory authority is usually vested with the authority to promulgate the regulations. These regulations normally provide for appropriate entry policies, including licensing requirements, as also specify capital adequacy ratios (which ensure that banks maintain a minimum amount of own funds in relation to the risks they face, to absorb unexpected losses and give owners and managers incentive to run banks safely). Limits on excessive risk-taking seek to promote prudent banking by constraining lending concentration, lending to insiders, liquidity mismatches, and net foreign asset (or liability) position. In many countries, prudential liquidity regulations are imposed to ensure that they are able to meet their creditor and depositor obligations without resorting to forced asset sales or other costly means to raise funds. Further, constraints on managerial actions may restrict activities usually associated with high-risk lending or investment activities that may expose banks to excessive risks. These constraints have been both restrictive and prescriptive, applying to cases where doubts persist about managers and owners satisfying fit and proper criteria. Prescriptive rules include requirements about managers putting in place adequate risk-management systems, including procedures for credit approval, monitoring, classification, and recovery, as well as for accounting, reporting and internal audit functions. The supervisory authority is normally empowered by law to apply a range of corrective and punitive measures, when banks breach laws, prudential regulations, or licensing agreements. Supervisors should tailor their responses in conformity with the

offence and gradually intensify the corrective measures. As a general duty to promote financial stability, supervisors monitor the soundness of the banking system, the adequacy of banks' risk-management practices and financial data, and their compliance with prudential regulations. To be effective, the supervisory authority should have sufficient autonomy coupled with legal accountability, freedom from political influences and interference, powers, capacity and adequate financial resources to meet supervisory objectives. The question whether supervisory function should be located in the central bank, or a separate board or an independent supervisory agency has involved considerable controversy but the consensus, so far the developing countries or transitional economies are concerned, appears to be in favour of the central bank for the several advantages this arrangement provides.

The structure and concentration of ownership of the banking system may also adversely affect the performance and stability of the system. The trend towards larger banks and financial conglomerates increases the potential for systemic risk which necessitates official oversight. Concentrated ownership also means that more focussed political pressure can be applied for public sector guarantees for the liabilities of the bank. In developing countries, the absence of a qualified controlling shareholder can result in ineffective oversight over management. The question of desirability of state, private or foreign ownership of banks is controversial but state owned banks can bring competitive distortions due to access to low-cost capital and liabilities being guaranteed by public sector. Nonetheless they can operate effectively if they conform to commercial criteria and the same prudential rules as private banks, as also fully and transparently transfer all their quasi-fiscal undertakings to the government budget. Since these criteria are seldom met in emerging market countries, privatization may pave the way to sounder banking system. But efficient banking system may be achieved by allowing foreign banks to stimulate competition, if there are only a few domestic banks.

Non-bank financial intermediaries fall into three categories, firstly, insurance, securities trading, and fund management businesses, normally regulated separately, but are increasingly in common ownership with banks leading to complex consolidated supervision problems. Secondly, there are finance companies usually owned by banks, created mostly to obviate the full rigour of prudential, monetary or tax problems, which not being permitted to accept deposits from public, depend upon bank funding and create potential for systemic risk. Thirdly, there are less reputed entities indulging in

questionable pyramid schemes and other forms of accepting deposits outside the books of licensed financial institutions, which necessitate prohibition of receipt of deposits by unauthorized entities or forms together with prosecuting authority responding to requests from central bank or the supervisory authority. Sound banking is facilitated by strong financial market infrastructure, efficient payments system and money, foreign exchange and capital markets, which enable banks to manage their liquidity, raise capital, and issue debt. Efficient banking also requires credit culture - an environment where credit contracts are customarily honoured and enforced, in the context of a legal and judicial system that promotes enforcement of financial contracts, loan recovery, realization of collateral and bankruptcy.

In many countries, banks and other ingredients of financial sector are regulated and supervised by different national agencies which requires harmonization and coordination of regulatory and supervisory policies and practices to reduce the scope of contagion and regulatory arbitrage. Regulatory standards and supervisory practices are also being harmonized internationally which facilitates consolidated supervision and information sharing among supervisors internationally as also improves efficiency and can bring additional discipline to national supervisory and regulatory structures. The growing tendencies towards internationalization of banking undermines the effectiveness of nationally focused prudential supervision in many ways, including complex corporate structures and off-shore derivatives to evade domestic financial restrictions.

Banking statutes and prudential regulations should create necessary environment for banks to operate in a safe and prudent manner, and regulatory and supervisory framework needs to counteract distortions generated by public sector guarantees. This necessitates consistent set of requirements governing accounting, asset valuation, supervisory reporting and public disclosure, risk taking and risk management and entry and exit. Since weaknesses in the banking system in any country can threaten both internal and external financial stability, the need to improve the strength of financial systems has attracted growing international concern. The Basle Committee on Banking Supervision has prepared Core Principles for Effective Banking Supervision comprising of 25 basic principles which should be followed for ensuring effective bank supervision. While the cost of banking supervision is high, the cost of poor supervision is even higher.

The after-effects of crises in emerging market financial systems and their potential to disrupt the financial systems of other countries has been recognized in pursuance of financial crisis in East Asia, Russia and Latin American countries. Weak financial institutions, inadequate bank supervision and regulation, and lack of transparency are the root cause of the economic crises in these countries. These experiences have underlined the importance of a sound banking sector for macro-economic stability but also the influence of macro-economic and structural policies on the soundness of the banking system.

Securities regulation

The International Organization of Securities Commission (IOSCO) has undertaken to establish universal principles for securities market regulation and for improvement of requirements as also a disclosure standard for international cross-border offerings. The Emerging Markets Committee of IOSCO's main objective is the development and improvement of the efficiency of emerging securities markets through the establishment of sound regulatory principles and minimum standards. The dramatic growth of international financial operations has had a major impact on the work of securities regulators, who, in an age of borderless markets, must work together internationally to be effective domestically. In view of the ease of transfer of funds from one jurisdiction to another and thereby be out of reach of defrauded investors, there is need for regulators to cooperate to track and facilitate the recovery of funds across international borders.

It is necessary to lay down well-defined procedures for licensing and regulation of securities markets participants and transactions are crucial to sound regulatory systems in both developed and emerging markets. It is critical to the public confidence in financial markets that client assets are properly handled and accounted for. This aspect assumes importance when the firm is unable to compensate its client for losses due to its insolvency. The regulatory authority should establish best practice to provide a high level of protection for assets and interests of clients held by financial intermediaries. Similarly, procedures for the orderly disposition of a market default are a key component of any sound regulatory regime and are essential for client confidence. This assumes considerable importance in the case of futures and options transactions. It is necessary to manifest transparency of market default procedures for providing certainty and predictability to market participants, facilitating

orderly handling in case of a default and facilitating market participants to make informed assessments.

Emerging markets have to face the challenges posed by the rapid growth in derivatives activities. In 1994, IOSCO has published a set of principles and guidelines for the development of derivatives markets in developing countries which deal with the conditions for the development and regulation of derivatives markets, and the characteristics of an adequate financial infrastructure and market structure, which would be of interest to these countries. On the basis of experience of six emerging market agencies, namely, Brazil, Chinese Taipei, Korea, Malaysia, South Africa and Thailand, IOSCO has formulated guidelines and recommendations on the appropriate regulatory approach for jurisdictions that are developing derivatives markets. These analyses provide a useful reference for jurisdictions considering development of derivatives markets. [*Legal and Regulatory Framework for Exchange Traded Derivatives*, (1996)].

Effective supervision of market intermediaries is absolutely imperative to maintain just, sound and efficient markets. The financial responsibility of market participants will have to be ascertained in the effective supervision of market intermediaries. The fast growth of derivatives trading activity in the securities sector has prompted firms to develop methods to analyse, control and report their trading risk in a proper and consistent manner. Many firms have turned their attention to sophisticated quantitative risk management techniques using modern option and portfolio theory. This trend has led to the development of value at risk modelling techniques. The IOSCO's July 1995 report on the *Implications for Securities Regulators of the Increased Use of Value-at-Risk Models by Securities Firms* recognises the role played by value at risk models in improving internal controls and risk-based capital standards for securities firms. The Report explains how the value at risk models are constructed, informs the role that models should play as part of a firm's risk management procedures, and considers implications for securities regulators of recognizing the output of value at risk models for the purpose of calculating capital requirements for market risk. IOSCO and Basle Committee have set out guidelines [*Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* (May 1995)] for the type of information that regulators and supervisors should obtain from banks and securities firms in order to form a judgement as to the risks associated with proprietary and client-based derivative trading activities. They have also jointly prepared a set of

recommendations for improved disclosure of both quantitative and qualitative information about derivative trading activities [*Public Disclosure of the Trading Activities of Banks and Securities Firms* (November 1995)].

In many emerging markets, Collective Investment Schemes (CIS) are an important segment of securities business, which offers a flexible, simple and convenient means for investors, including small savers, to participate in domestic and international securities markets. The development of CIS can, therefore, increase both foreign and domestic investment in an emerging market. IOSCO has prepared a report *Collective Investment Schemes* focussing specifically on the needs of emerging markets regulators and also includes a comparative analysis of the CIS regulatory regimes in place in four important countries. It is considered that international regulatory cooperation can be of critical importance to maintain market integrity in emergencies involving the cross-border activity of CIS. These emergencies can include the insolvency or threatened insolvency of the CIS manager, trustee, custodian, or affiliated company, or of a misappropriation of funds. In view of the internationalization of the markets in which CIS and their principals operate, these emergencies can, doubtless, have cross-border implications. The report examining issues for cooperation between regulators during an emergency and also general principles for regulators to consider in the context of the suspension of dealing and marketing is entitled *Regulatory Cooperation in Emergencies* (June 1996). The growing popularity of CIS as an investment channel has also increased the need for disclosure of risk. Market integrity and investor protection depend, to a large extent, on the issue of accurate disclosure. It would be necessary to lay down different ways to improve the presentation of risk factors in CIS offering documents and advertising, and policies for ensuring that financial intermediaries adequately explain the risks of CIS investment to potential investors. Another category of risks associated with CIS are regarding the custody of cash deposits and non-cash assets. The failure of a financial institution with responsibility for custody will have consequences for CIS regulators, supervising CIS and fund management entities alike. In conclusion, the dramatic growth in securities transactions and the increasingly globalized marketplace has set new challenges for securities regulators world-wide. Market integrity, investor protection and financial stability can be achieved through a high level of cooperation and communication. It must be observed that IOSCO has made an important contribution to the development

of sound securities regulatory principles in both emerging and developed markets.

Foreign investment

One of the major developments since 1980s concerning the financial resources and mechanisms for sustainable development is the impressively large increases in private capital flows to developing countries. The average of annual private capital flows - excluding export credits - to developing countries from OECD Development Assistance Committee (DAC) countries from 1993 to 1995 was about US \$125 billion which represented about 62% of the total net resource flows from DAC countries to developing countries which compares with US\$60 billion annual average for the period 1991-92 (which represented about 45% of the total net outflows of DAC countries to developing countries). What is more important, FDI from DAC countries, a type of investment which is more stable and reliable than portfolio investment and international bank loans in the long-term has increased from an annual average of US\$25 billion (about 19% of total net resource flows) in the period 1991-92, to an annual average of US\$47 billion (about 23%) in the period 1993-95. In real terms, both total private flows and FDI have almost doubled between 1992 and 1995.

Most developing countries have expressed their concern that private capital flows, particularly portfolio investments are very volatile, which poses a threat to the stability of exchange rates. Hence, recognizing that large external capital movements are likely to be the response to changes in expectations about domestic economic performance, IMF Interim Committee has enhanced the IMF ability to monitor the economic policies of member countries and increase the transparency of national policies through improved and more timely provision of data. IMF has also substantially increased its capacity to provide emergency funds in case of future threats of currency collapse.

Developing countries have expressed concern that private capital flows are concentrated in a few developing countries (12 countries accounted for about 80% of total private flows and 3/4 of FDI in developing countries during the first half of 1990s), mostly middle income countries in Asia (which accounted for about 2/3 rd of the expansion of total private flows) and Latin America that have adopted outward-looking strategies and sound macro-economic policies. This is clearly borne out by the Table 4 which shows the net capital flows to developing countries and transitional economies in three components : (1) net foreign direct investment

(FDI) inflows (i.e. establishment or purchase of plant and equipment or net inflows of controlling equity); (2) net inflows of portfolio investment, including changes in net foreign liabilities of banks, the private sector and governments and flows of portfolio (i.e. non-controlling) equity; and (3) other net inflows, including trade credits, loans and other accounts. These flows finance both the current account deficits and the net reserve accumulation of these countries.

The increase in the capital inflows to developing countries and transitional economies in 1990-96 and the sharp rise in the share of FDI in the total are the net results of many factors, namely, macro-economic adjustment programmes initiated by many developing countries with the financial support of IMF arrangements or World Bank loans. By 1990s, these reform programmes resulted in lower inflation and better growth performance in a number of developing countries. In late 1980s, many central and eastern European countries initiated structural transformations which induced FDI inflows as these economies were privatized and their markets expanded. Since 1992, many of the Baltic countries, Russian Federation and former Soviet Union countries undertook structural reforms which has achieved monetary stabilization and are showing some positive signs of economic resurgence.⁵⁵ In many developing countries in Asia, Latin America and the Middle East, the structural reforms undertaken during the last decade were accompanied by substantial initiatives for privatization of public enterprises and financial institutions, a significant trend which increased the market capitalization and widened the choice of financial instruments available to both domestic and foreign asset holders.

Since the early 1990s, many developing countries and transitional economies have resorted to currency convertibility. In the 1960s and 1970s, many developing countries - members of IMF- had followed the transitional discipline of Article XIV of its Articles of Agreement, allowing them to continue to impose certain restrictions on current account transactions and not moved to currency convertibility, since the pace of liberalization was slow. On the other hand, under Article VIII, a country commits itself to refrain from imposing restrictions on payments for external current account transactions. By 1990, only 68 IMF member

⁵⁵ Knight, M. (1997): Central Bank Reforms in the Baltics, Russia and other countries of the former Soviet Union: IMF Occasional Paper No. 157 (Washington: IMF).

countries (35 developing countries) accepted the obligations of Article VIII, while during 1991-96, 52 developing countries and transitional economies accepted Article VIII, and by end 1996, fully three-fourths of 182 members of IMF had formally established current account convertibility. In many developing countries and transitional economies, the acceptance of the discipline of Article VIII has been accompanied by liberalization of capital account transactions as well. These liberalizing measures⁵⁶ have strengthened the confidence of international asset holders about their ability to move funds freely into or out of these countries' financial markets as economic conditions and circumstances change. Unfortunately, this liberalization has not been followed by strict supervision of domestic financial institutions which have been intermediating these flows. The phenomenal increase in financial flows to these countries in 1990-96 was also due to the continuing process of financial innovation in developed countries which encouraged a greater spreading of risk exposures to emerging markets, as reflected in the proliferation of emerging market mutual funds. As result, the portfolio managers viewed the emerging markets as a means to diversify portfolios, more so, because in 1994-96, the low interest rates in developed countries to seek higher yields as also to take higher risks by increasing financial holdings in developing countries and transitional economies. However, the events of 1997 have highlighted the risks of investing in emerging markets but a recent study of World Bank⁵⁷ has concluded that institutional investors could continue to increase expected yields and reduce overall risks until the share of their portfolios allocated to emerging markets reached a level three times as high as it is today. 81. The East Asian crisis of 1997-98 has led many to advocate capital controls or the perennial idea of even a tax on currency transactions, but a more popular idea is of prudent capital controls on short-term flows. Chile is credited with the originator of this idea as it has discouraged 'hot money' by demanding that 30% of all inflows should be deposited without interest with the Central Bank for one year. For short-term inflows, this measure translates into a hefty tax. Ultimately, the extent to which capital movements destabilise the

⁵⁶Knight, Malcolm (1998): Developing Countries and the Globalization of Financial Markets: IMF Working Paper: WP/98/115.

⁵⁷World Bank (1997): The Roads to Financial Integration: Private Capital Flows to Developing Countries (Oxford: Oxford University Press).

economies depends largely on the strength of the country's financial system and the soundness of its economic policies. The following conclusions are drawn in this behalf, namely:

1. There is a general consensus that countries should liberalize their domestic financial systems before opening up to foreign capital.
2. Financial liberalization requires strict bank regulation and supervision to prevent a reversal in capital flows or a sharp rise in interest rates from breaking the banks, including placing a ceiling on banks' foreign exchange exposure..
3. Exchange rate flexibility is the next pre-requisite. Free capital movement and pegged exchange rates are a dangerous recipe for disaster. Fixed exchange rates prevent a central bank from using interest rates to prevent an economy from overheating (because higher interest rates would push up the value of the currency), but it also encourages large foreign currency borrowing when foreign interest rates are lower than domestic ones.
4. Financial markets need reliable information to work efficiently. If the creditors had better information about the borrowing of South Korea's private sector or the reserves of Thailand's banks, they could have pulled back sooner and the ultimate situation would perhaps have been much better.

There is a growing realization that globalization increases the scope for the weak and destabilizing financial practices to migrate to the least regulated jurisdictions. Even if it is necessary that supervision and regulation should concern itself with domestic situation of each individual country, there should be greater awareness among countries to adopt reasonably homogenous norms, minimum standards, and best practices for financial activities. Moreover, there is gradual realization that the financial systems of most developing countries and transitional economies are vulnerable to economic and financial crises which have serious repercussions not only for these countries- in terms of increased macro-economic instability and weakened economic growth performance- but also on the world-wide allocation of savings and investment.

Framework reforms for Small and Medium Enterprises (SMEs)

Small and medium enterprises have been recognised as an important ingredient of promotion of economic development in view of their contribution to the national production, employment generation potential, innovativeness, excellent use of

scarce capital and skills, provision of a range of services to the large corporations and technological advancement in developed and developing countries. However, the SMEs face several constraints, namely, lack of access to capital, appropriate technology, and information about national and international markets. In most of the former centrally-planned economies, government policies and business attitudes do not favour SMEs and even create barriers to their operations. They are often subject to excessive regulation and the weight of regulatory costs decreases with the growing size of the firm. A study undertaken in 1995 gave an empirical evidence for the Netherlands : whereas the average cost of administrative burdens for all enterprises in 1993 was ECU 1800 per employee, for enterprises with 1 to 9 employees it was ECU 3 500, and for enterprises with 100 or more employees it was ECU 600.

The task of promoting small enterprises development involves essentially two main strategies : as a top-down indirect approach and a bottoms-up/direct approach. The top-down seeks to create an enabling or fostering environment, which provides the right incentives for small firms, together with enough positive support and protection (e.g. against unfair practices of larger corporations) to allow such firms to make the best of their potential. The top-down approach seeks to improve the business environment by operating on macro-economic variables, such as, prices, government regulations and policies, by providing legislation and enforcement, and by building up the physical infrastructure. The second strategy, bottoms-up approach, aims at supporting small enterprises directly by mobilizing the indigenous resources, creating or reinforcing local institutions and support systems, and with the active participation of beneficiaries. Central and local governments, decentralized government bodies, financial institutions, business and industry associations, chambers of commerce, universities, international organizations and donor agencies have worked, independently and together, in both the creation of an enabling environment and the provision of direct support to small enterprises. In fact, governments should concentrate on creating the enabling environment, including macro-economic policy-making, legislation and enforcement, catalytic promotion and regulation and that direct support to the sector should be provided by private individuals, firms and non-government organizations.

In an ideal situation, through partnership, governments and private entities assume co-responsibility and co-ownership for the promotion of small enterprises and through these novel modalities, the advantages of the private sector - dynamism,

access to finance, knowledge of technologies, managerial efficiency, entrepreneurial spirit are combined with the social responsibility, network of contacts, environmental awareness, local knowledge, and employment generation concerns of the public sector. For example,

1. The government farms out the functions which need to be performed for SME promotion, such as, organization of support/regulation system, to private entities, seeking whenever possible, the joint financing of such initiatives;
2. The government allocates a specified share of government procurement to SMEs;
3. Public-private partnerships are established for the creation of institutions, such as, business support centres, business incubators, industrial parks, or centres to disseminate technical or commercial information for SMEs. These institutions are optimally financed and/or operated by both public and private sector entities, such as, universities, public development corporations, development banks, industry and entrepreneur associations , venture capital firms;
4. More cooperation of local authorities and less involvement of national governments, with local NGOs, industry and entrepreneur associations and universities.
5. The establishment of institutional mechanisms for dialogue between the government and interest groups representing SMEs. The development of effective means of consultation with the private sector is important even for decisions which must remain in the public sector.

Lack of financial accommodation is reported as the principal problem of small enterprises. The limited access of SMEs to capital from the formal financial sector is the higher administrative costs and higher default risk as perceived by the financial institutions. Such cost differentials explain why the credit goes disproportionately to the large-scale sector. Lack of collateral and security and an undefined legal framework contribute to this bias. Commercial financial institutions cannot easily provide a large flow of credit in small loans to firms with no track record, no guarantee and no security. Most banks have special relationship with large clients who may be part of the same conglomerate which necessitates a corrective action to level the playing field among potential borrowers. Some special problems affecting the growth of SMEs requiring reforms are as below

1. **Contracts:** In most countries, enforcement of contracts is a time-consuming and costly proposition. There are no arbitration mechanisms or courts for small claims for quick settlement of disputes. Hence, SMEs find it difficult to enter into legal contracts.
2. **Collateral:** The World Bank has supported capital reforms which encourage securitization of equipment loans, real estate mortgages and credit card accounts receivable. While such mechanisms change the conduits through which financing takes place, improve the allocations of capital and promote competition in the financial sector, their effectiveness is limited by the difficulty of creating, perfecting and enforcing the underlying secured transaction. Governments can implement certain legal reforms to address the fundamental problems in the credit market which makes it difficult to secure loans with movable property.
3. **Land registration:** In most developing countries, a large proportion of bank loans are unsecured made to borrowers with real estate, in the expectation that in the event of default, banks can file a claim. However, the mortgages are unregistered and the creditor is unaware of prior claims with reference to the same property. Since no other types of collateral are used, about half the non-residential private capital stock is inaccessible to banks as security for loans. This can be remedied as below
 - (a) Change in law to permit a greater variety of security interest in a wider range of transactions by a broader group of people;
 - (b) Insistence on registration records being made public, reform state-operated registries, and privatize registry services or allow private registry services to compete with public ones; and
 - (c) Speed up enforcement, make enforcement cheaper, and change the law to permit private parties to contract for re-possession and sale without government intervention.
4. **Access to credit.** Most merchants willing to sell on credit to SMEs with good reputation find difficulties in obtaining credit due to legal constraints on collateral secured by inventories or accounts receivables. Such sellers wishing to advance credit to SMEs will have to do so out of their own capital.
5. **Term finance.** While SMEs may get credit to acquire plant or real estate with mortgage, they have real difficulty in obtaining medium-term loans for working capital except with real estate as collateral.

6. **Land title.** Use of real estate as collateral may be difficult in the absence of title to urban or agricultural property because of inaccurate or incomplete records of multiple pledges of the same property and unsettled claims arising from demands for restitution and transfers of property to or among state entities.

7. **Collection methods.** In some developing countries, in the absence of ownership of real estate, poor borrowers can borrow only against post-dated cheques. If they bounce, the borrower is jailed. Such unconventional and brutal collection methods makes prospective entrepreneur wary of starting an enterprise.

Informal economy

Informal economy covers activities which do not enter the national income statistics and is characterized by ease of entry, reliance on indigenous resources, family ownership, small scale operations, labour-intensive techniques of production, and unregulated competitive markets. The genesis of informal economy can be traced to tax evasion, avoidance of economic legislation, avoidance of bureaucratic controls, social security fraud, illegal immigrants, etc. The growth of informal sector has reached alarming proportions in many developing countries and has tended to encroach on legal and legitimate business activities. The informal sector has successfully avoided payment of taxes, social security payments and reduced labour costs appreciably. The legally operating businesses feel threatened due to unfair competition from informal sector. Some businesses operate both in legal and informal sector to take advantage of regulation-free environment leading to reduction of costs and higher profits.

In many countries, a large portion of economic activities is composed of informal sector. The advent of globalization with regulatory frameworks of post-economic liberalization era has, in fact, not only failed to eliminate but, on the contrary, stimulated the growth of informal sector. This phenomenon has reduced the legitimate tax dues, and social security contributions and has led to raising the taxes on the formal sector leading to distortions of market mechanisms and affected its competitiveness. This has stimulated many governments to take active steps to integrate the informal sector into the mainstream of formal economic activities through reforms in the legal and regulatory frameworks which are responsible for pushing the normal businesses into the informal sector.

The most important causes of creation and proliferation of informal economy are the unreasonable tax rates and crushing burden of social security contributions paid exclusively by employers, in addition to a frightening array of rules and regulations governing every aspect of economic life. The most obvious solution is reduction of tax rates to reasonable levels and operation of a presumptive taxation scheme applicable to small and petty businesses and professionals not requiring much intellectual inputs, such as, plumbers, fitters, electricians, tailors, barbers, etc who do not maintain books of account and whose income may have to be estimated on a rough and ready basis. Another remedy is to reduce the rigour of labour legislation, about employment of domestic or alien unskilled or semi-skilled labour or any other legal or regulatory aspects relating to business operations which are found by SMEs or small businesses to be unreasonable or irksome. These measures may not completely eliminate the informal sector but may reduce its adverse impact on the competitiveness of legitimate businesses and increase government revenues and other dues.

CONCLUSION

The last two decades have seen the globalization of trade and financial markets coupled with liberalization of international capital markets which have resulted in higher standards of living, as resources are allocated with increased efficiency and risk sharing is improved. But the increased volume and volatility of capital flows have exposed critical problems in the domestic and international financial systems, including financial sector vulnerabilities, often in the form of unsound financial and banking systems and deficiencies in financial incentive structures, institutions and policies. While the global markets have become increasingly integrated, the investment and savings behaviour has been changing world-wide as manifested by proliferating securities markets, diverse financial institutions and instruments, and large flows of foreign investment and cross border lending. While the plus-point of the globalization is that the savings and investment can be allocated most efficiently, the negative aspects have been amply illustrated in the past two years by the succession of crises situations which have shaken many emerging market economies directly and threatened many others with contagion effect.

These events have highlighted the fact that many macro-economic and micro-economic factors can cause financial problems for developing countries and transitional economies and that regulatory oversight and market discipline are

complementary means for achieving a stable and robust financial system. Supportive legal and regulatory environment, strong internal governance, external discipline provided by market forces, as also external governance provided by regulation and supervision at both domestic and international levels are the attributes of a sound financial system. With the growing recognition of the declining role of governments in the economic sphere coupled with the withdrawal from the activity of producing and delivery of goods and services, the assumption of the dual roles of enabling and regulating have marked the last two decades of the present century.

The advent of privatization - the marketization of public sector activity, i.e. the subjection of micro-economic decision-making to market forces, being a feature of profit-oriented private sector activity, has imposed new tasks on governments, such as, setting up legal and regulatory frameworks, draw up, negotiate, enforce contracts, coordinate, support, and finance producers, regulate monopolies, and provide consumers with information on their options and remedies. Projects and activities in sectors which were hitherto government monopolies including physical infrastructure and social services are being increasingly financed or managed by private enterprises under negotiated programmes and contracts. There is a wide spectrum of disengagement by governments and engagement of private sector through contracting out (also called out-sourcing, service contracting or alternative delivery), turnkey construction, management contracts, leasing, concessions, build-operate-transfer, partial disinvestment/joint ventures and full disinvestment.

However, in many developing countries and transitional economies, in actual practice, the theoretical benefits of privatization were lost due to faulty implementation. In a case study of ten developing countries in West Africa, the following conclusions were drawn,⁵⁸ namely:

1. The identification process for selecting the appropriate enterprises to be privatized was often faulty, inconsistent or totally absent. As a result, the enterprises that were being disinvested were often enterprises with low or non-existent rates of return, and or large accumulated losses. This resulted in the

⁵⁸Shishtawy, Hana (1995): African Training and Research Centre in Administration for Development (CAFRAD) Seminar and Workshop on Diverse Approaches to Privatization in Africa, Tangier, Morocco: 12-16 June 1995. United Nations, New York.

privatization process to appear unsuccessful and problematic;

2. The legal and regulatory framework in many countries was often conflicting or at best, cumbersome, sending mixed signals to potential investors- both domestic and foreign;

3. The financial and fiscal regimes were often contradictory, with very little interministerial coordination to standardize/harmonize economic objectives with investment promotion and development of private sector;

4. There is a significant gap in gauging data on the composition of the labour force and employment trends and gaps. As a result, labour laws governing the employment of nationals in different industrial sectors are contradictory;

5. The standardization of audits and contracts and negotiating capacities are areas which need to be strengthened. In many cases, valuation of enterprises to be privatized proceeded on inaccurate basis. Contracts for individual enterprises being considered for disinvestment are required to be drawn up on standardized methodology and clarity; and

6. The definition of strategic sectors has changed over time; with increased globalization, strategic sectors have become difficult to delineate. As a result, government policy objectives should be clear in communicating the degree of integration in the world economy in order to avoid giving mixed signals and pursuant conflicting legislation.

In terms of the percentage share of GDP produced by private sector, privatization has been most rapid in countries of East and Central Europe. The EBRD Transition Report (1994) examined privatization in 25 countries of the above region and Central Asia where the share of private sector had risen to about 40% by mid-1994, up from 3% in 1986. The main source of higher private sector share in the transitional economies has not been the disinvestment of public enterprises, as might be expected, but rather the faster growth of private enterprises compared with the public sector. Liberalization and progress towards a strong legal base for protecting private ownership have together paved the way for the rapid emergence of private enterprises in these countries, though this should not be equated with the realization of the benefits of higher efficiency, which in many cases are still missing. A recent World Bank study (1995) confirms that private sector growth is the major modality of privatization in the developing countries also. Actual disinvestments have been few (less than 3 per country per year), so the rise in the private share has

been due to more to the faster growth of the private sector compared with the public sector than to the transfer of enterprises from public ownership to private ownership.

For most developing countries, a clear enumeration of the goals of a privatization and private sector development programme is a necessary pre-requisite to any programme implementation. To this end, a matrix of *legislative, regulatory* and *institutional* mechanisms directly related to the implementation of the programme needs to be established at the outset. Undervaluation has been a recurrent problem in privatization by disinvestment, mostly associated with corruption which has given privatization a bad name. In some cases, in uncertain capital markets, it was the usual practice to set the issue price of shares at below market value so as to reduce the risk of failure and avoid need for underwriting. Many governments have sanitized privatization by broad-based ownership which partially corrects for any undervaluation or overvaluation and improves the equitable distribution of wealth and consequent income. On the contrary, this tends to dilute the control of those with best ideas for the future directions of the enterprise and thereby reduces the efficiency dividend.

In conclusion, there is a growing consensus amongst financial system regulators to develop a consistent international framework of financial and supervisory standards and best practices to promote strong and healthy financial systems in all countries, including the emerging markets. The regulatory systems should create economic incentives for all participants in financial markets to take action *suo moto* which will strengthen internal governance and market discipline. As in the case of financial markets themselves, supervision and regulation should become global and homogeneous. The Report⁵⁹ of the representatives of G-10 and emerging market countries urges countries to take early action in three key areas, namely:

1. The Establishment of an appropriate institutional setting and financial infrastructure as a basis for sound credit culture and efficient functioning of financial markets.

⁵⁹Group of Ten (1997): Financial Stability in Emerging Market Economies - A Strategy for the Formulation, Adoption, and Implementation of Sound Principles and Practices to Strengthen Financial Systems: Report on Financial Stability in Emerging Market Economies. Basle, BIS.

2. The Promotion of the functioning of markets so that owners and other stakeholders in financial institutions have strong incentives to exercise adequate discipline.

3. The Creation of a regulatory and supervisory arrangements that complement and support the operation of market discipline.

In short, it is common ground that the regulation and supervision of financial markets and institutions engaged in international capital flows raise difficult question of implementation to cover even cross-border activities and that the standards for regulation and supervision will have to be coordinated and harmonized more extensively across nations.

7. CONCLUSION

The goal of governance initiatives should be to develop capacities that are needed to realise development that gives priority to the poor, advances women, sustains the environment, and creates needed opportunities for employment and other livelihoods. [UNDP, 1994]

It is increasingly being realized that sound governance is essential for ensuring sound and sustainable human development. Effective public sector management and improvements therein promote the realization of objectives of sustainable human development, which places people at the centre of the development process and makes the central purpose of development as creating an enabling environment in which all people enjoy a long, healthy and creative life.

Governance encompasses all methods, systems and strategies that human societies use to distribute power and manage public resources and problems. Sound governance consists of a subset of governance, where public resources and problems are managed effectively, efficiently and in response to critical needs of society. Effective democratic forms of governance rely on public participation, accountability and transparency. However, financial accountability presents an extraordinary challenge seeking immediate and practical solution, in the context of transparency and responsive as well as responsible governance.

The challenge facing all countries is to create a system of economic governance which promotes the processes of decision making which directly or indirectly affect a country's economic activities or its relationships with other economies. In other words, economic governance is concerned with effective, efficient and efficacious manner of raising

public financial resources with a view to utilizing them to yield optimum results intended to raise the socio-economic welfare of the population. Economic governance has a major influence on social issues, such as, equity, poverty and quality of life.

Economic governance is seriously affected by the absence of effective and efficient economic and financial administration or such an administration which is not responsive to the legitimate hopes and aspirations of the population. Ineffective administration is primarily caused by the perceived absence of integrity which, in its turn, weakens the credibility of democratic institutions, results in misuse of scarce public resources, restricts investment and slackens economic growth. Inefficient economic and financial administration may be result of the utilization of services of incompetent, untrained and unmotivated public officials. In either case, the ineffective and inefficient economic and financial administration seriously affects economic governance and frustrates all possibilities of economic growth.

The United Nations General Assembly Resolution 51/59 Action Against Corruption, dated 28 January 1997 requested that the Secretary-General should help Member States design strategies to prevent and control corruption. The Resolution adopts the International Code of Conduct for Public Officials for the United Nations and recommends it to Member States. A cooperative effort is envisaged in which the United Nations works with other intergovernmental and non-governmental organizations to develop an implementation plan.

Most developing countries and transitional economies have experienced inability to collect adequate amount of tax and customs revenue commensurate with its full tax revenue potential. Corrupt practices on the part of tax and customs officials, tax evasion through smuggling, maintenance of duplicate books of account and fraudulent accounting practices all contribute to lost revenue. A vicious circle develops when revenue shortfalls lead to higher marginal tax rates which are then more likely to be evaded. This complex problem cannot be resolved by introduction of tax reforms, since, in certain situations, taxpayers may not discharge their statutory obligations for political reasons, namely, their aversion to the legitimacy of regime in power believing that public spending choices are distorted by the corrupt search for private gain.

Developing countries and transitional economies embarking on ambitious programmes for achieving significant economic growth through heavy

investment in infrastructure projects may not obtain commensurate benefits due to corrupt practices on the part of public officials, in awarding contracts to inefficient or incompetent private firms, faulty selection process through wrongful structuring of bidding specifications and in privatization of state-owned enterprises. Aid organizations concerned with the success of the projects sponsored by them will be troubled by endemic corruption in host countries and may discontinue aid efforts in disgust.

For developing and transitional economy countries, effective financial management assumes additional importance in view of large budgetary deficits, high debt-servicing charges and debt-repayments, inflation, declining export earnings, continuous currency depreciation and shrinking financial resources base. There exists substantial consensus regarding desirable components of an effective government financial management system,

encompassing budgeting, accounting, tax collection and auditing standards and procedures. However, in view of widely different internal and external factors affecting these countries which are at varying stages of economic development, it would be difficult to prescribe a unique and innovative formula applicable to all of them.

The limited objective of this publication is to highlight important issues bearing on economic governance in so far they affect primarily the developing countries and transitional economies in their search for achieving sustainable socio-economic development and to provide guidelines for establishing effective financial management consistent with the twin-principles of economic growth with social justice. It is hoped that this publication will stimulate the interest of the readers in pursuing a serious study of this subject.

**Table 1 - The Growth of General Government Expenditure, 1870-1996
(In percent of GDP)**

	Later 19th Century about 1870*	Pre World War I 1913	Post World War I 1920	Pre World War II 1937	Post World War II 1960	1980	1990	1996
General Governments for all years								
Australia	18.3	16.5	19.3	14.8	21.2	34.1	34.9	36.6
Austria	-	-	14.7**	20.6	35.7	48.1	38.6	51.7
Canada	-	-	16.7	25.0	28.6	38.8	46.0	44.7
France***	12.6	17.0	27.6	29.0	34.6	46.1	49.8	54.5
Germany	10.0	14.8	25.0	34.1	32.4	47.9	45.1	49.0
Ireland****	-	-	18.8	25.5	28.0	48.9	41.2	42.0
Japan	8.8	8.3	14.8	25.4	17.5	32.0	31.3	36.2
New Zealand**	-	-	24.6	25.3	26.9	38.1	41.3	34.7
Norway****	5.9	9.3	16.0	11.8	29.9	43.8	54.9	49.2
Sweden***	5.7**	10.4	10.9	16.5	31.0	60.1	59.1	49.2
Switzerland	16.5	14.0	17.0	24.1	17.2	32.8	33.5	49.2
United Kingdom	9.4	12.7	26.2	30.0	32.2	43.0	39.9	41.9
United States	7.3	7.5	12.1	19.7	27.0	31.4	32.8	33.3
Average	10.5	12.3	18.7	23.2	27.9	41.9	43.0	44.5

	Later 19th Century about 1870*	Pre World War I 1913	Post World War I 1920	Pre World War II 1937	Post World War II 1960	1980	1990	1996
Central government for 1890- 1937 general government thereafter								
Belgium	-	13.8	22.1	21.8	30.3	57.8	54.3	54.3
Italy	11.9	11.1	22.5	24.5	30.1	42.1	53.4	52.9
The Netherlands	9.1	9.0	13.5	19.0	33.7	55.8	54.1	49.9
Spain	-	11.0	8.3	13.2	18.8	32.2	42.0	43.3
Average	10.5	11.2	16.6	19.6	28.2	47.0	51.0	50.1
Total Average	10.5	11.9	18.2	22.4	27.9	43.1	44.8	45.8

Source: Compiled by Tanzi and Schuknecht based on several authorities.

* Or closest year available for all columns. Pre-WWII data sometimes on the basis of GNP/NNP

** Central government data for this year, New.Zealand: 1960-1970 & 1994/95-1996

*** 1996 data; calculations are based on the "Maastricht" definition, and are smaller than that published by INSEE

**** 1995 instead of 1996, because of break in data calculation.

Table 2 - Privatization of State-owned Enterprises

Region	Government Enterprises Privatized	Share of Total Privatization %
Eastern Europe	5.305	47.21
German Democratic Republic	4,500	39.71
OECD Countries	170	1.50
Latin America & Caribbean	804	7.09
Sub-Saharan Africa	373	3.29
Asia	122	1.07
Arab States	53	0.51
Total		

Annex III

**Table 3 - Network industries: Modes of privatization and sector reform
(Selected developing and transition economies)**

Mode \ Sector	Divestiture	Concession and leasing contracts (periodic introduction of competition for the market through competitive bidding)	Introduction of competition in the market (e.g. through vertical breakup of integrated companies)	Yardstick Competition
Telecom (wireline voice) Active privatization and competition-based reform	Argentina, Chile, Cuba, Guinea, Hungary, Jamaica, Mexico, Peru, Venezuela	China, Cook Islands, Guinea-Bissau, Hungary, Indonesia, Madagascar, Mexico	Chile, Mexico, Philippines	Argentina (basic telephone services),
Electric power (generation) Active private participation and unbundling	Argentina, Bolivia, Chile, Hungary, Pakistan, Peru	China, Cook Islands, Guinea-Bissau, Hungary, Indonesia, Madagascar, Mexico	Chile, Mexico, The Philippines	Argentina (basic telephone services), Tanzania (basic telephone services)
Gas (transport and distribution)	Hungary, Latvia, The Russian Federation	Argentina	Argentina, Hungary	Argentina (distribution)
Railways Mainly franchising	Bolivia	Argentina, Brazil, Cote d'Ivoire, Burkina Faso, Chile, Mexico		
Water (distribution) Relatively small private participation; concession preferred		Argentina, Brazil, Chile, China, Colombia, Cote d'Ivoire, Guinea, Hungary, Macao, Malaysia, Mexico, Senegal		

Note: The table includes only countries that have privatized by transferring existing public-sector facilities to the private sector, not those that have opened up the sector in question through greenfield concessions or Build Operate Transfer and Build Operate Own contracts only, such as Thailand (telecommunications) and China (power generation).

Source: Dnes (1995), Guislain (1997), Nells and Neil Roger (1994), Otobo (1998), Paddon (1998), Plane (1998), Thompson and Budin (1997).

Table 4 - Capital Flows to Developing Countries and Countries in Transition
(In billions of U.S. dollars)

	1970	1980	1990	1991	1992	1993	1994	1995	1996
Developing countries									
Total net capital inflow*	8.1	34.7	60.2	156.9	141.7	164.5	138.7	182.2	196.9
Net foreign direct investment	2.3	6.0	19.3	26.7	34.3	50.2	69.5	72.5	90.7
Net portfolio investment	0.2	0.4	18.5	36.1	53.0	89.3	83.6	16.9	44.6
Other**	5.5	28.3	22.4	94.0	55.8	25.6	-14.7	92.7	61.1
Of which: Net credit and loans from IMF	-0.4	2.5	-1.9	1.1	-0.4	-0.1	-0.8	12.6	-1.0
Africa									
Total net capital inflows*	1.4	9.4	7.3	11.4	14.2	10.9	18.2	17.6	15.4
Net foreign direct investment	0.6	-0.1	1.4	2.4	1.9	1.2	3.4	2.3	5.1
Net portfolio investment	0.1	-0.6	-1.6	-1.6	-0.7	0.9	0.4	1.9	0.7
Other**	0.7	10.0	7.5	10.6	13.1	8.8	14.3	13.4	9.6
Of which: Net credit and loans from IMF	0.0	0.8	-0.6	0.2	-0.2	0.2	0.9	0.8	0.6
Asia									
Total net capital inflows*	1.8	13.8	33.8	43.0	32.5	62.8	69.4	94.8	101.9
Net foreign direct investment	0.3	1.7	10.0	12.1	17.7	34.0	43.6	49.5	54.8
Net portfolio investment	0.0	0.1	0.3	0.5	1.8	11.7	10.0	10.2	9.2
Other**	1.5	12.0	23.5	30.3	14.4	17.7	15.4	35.0	37.4
Of which: Net credit and loans from IMF	-0.2	1.5	-2.4	1.9	1.3	0.6	-0.8	-1.5	-1.0
Middle East									
Total net capital inflows*	1.0	-28.3	0.4	74.3	41.5	27.9	7.9	11.3	13.6
Net foreign direct investment	0.4	-1.3	1.3	1.4	1.9	1.5	0.9	0.8	0.8
Net portfolio investment	0.0	0.0	2.2	22.6	21.2	15.6	12.2	12.2	7.6
Other**	0.6	-27.0	-3.1	50.3	18.3	10.8	-5.3	-1.7	5.1
Of which: Net credit and loans from IMF	0.0	0.4	-0.1	0.0	0.1	0.0	0.4	0.4	0.1
Latin America									
Total net capital inflows*	3.9	39.8	18.6	28.2	53.5	62.8	43.2	58.4	66.0
Net foreign direct investment	1.1	5.6	6.6	10.9	12.9	13.4	21.5	19.9	29.9
Net portfolio investment	0.1	0.9	17.5	14.5	30.6	61.1	60.8	-7.5	27.1
Other**	2.8	33.3	-5.5	2.8	10.0	-11.7	-39.1	46.0	9.1
Of which: Net credit and loans from IMF	-0.2	-0.1	1.2	-1.0	-1.6	-0.9	-1.3	12.9	-0.7
Countries in transition									
Total net capital inflows*	-	-7.5	10.8	-0.1	7.1	14.1	5.1	37.9	10.6
Net foreign direct investment	-0.5	-0.5	0.0	2.4	4.2	6.0	5.4	13.1	11.3
Net portfolio investment	0.0	0.0	0.0	0.8	-0.8	3.4	2.7	3.4	1.6
Other**	-	-7.0	10.8	-3.2	3.7	4.7	-3.0	21.5	-2.2
Of which: Net credit and loans from IMF	0.0	0.0	0.3	2.4	1.6	3.7	2.4	4.7	2.2
Total									
Total net capital inflows*	8.1	27.1	71.0	156.8	148.8	178.6	143.8	220.1	207.6
Net foreign direct investment	1.8	5.4	19.3	29.1	38.5	56.1	74.9	85.5	101.9
Net portfolio investment	0.2	0.4	18.5	36.9	52.1	92.8	86.3	20.3	46.2
Other**	5.5	21.3	33.2	90.8	59.6	30.3	-17.7	114.2	59.0
Of which: Net credit and loans from IMF	0.4	2.5	-1.6	3.5	1.1	3.6	1.6	17.3	1.2

Source: IMF, World Economic Outlook Database.

* Not including reserve assets.

** Short-and long-term trade credits, loans (including use of Fund credit); currency and deposits, and other accounts receivable and payable

