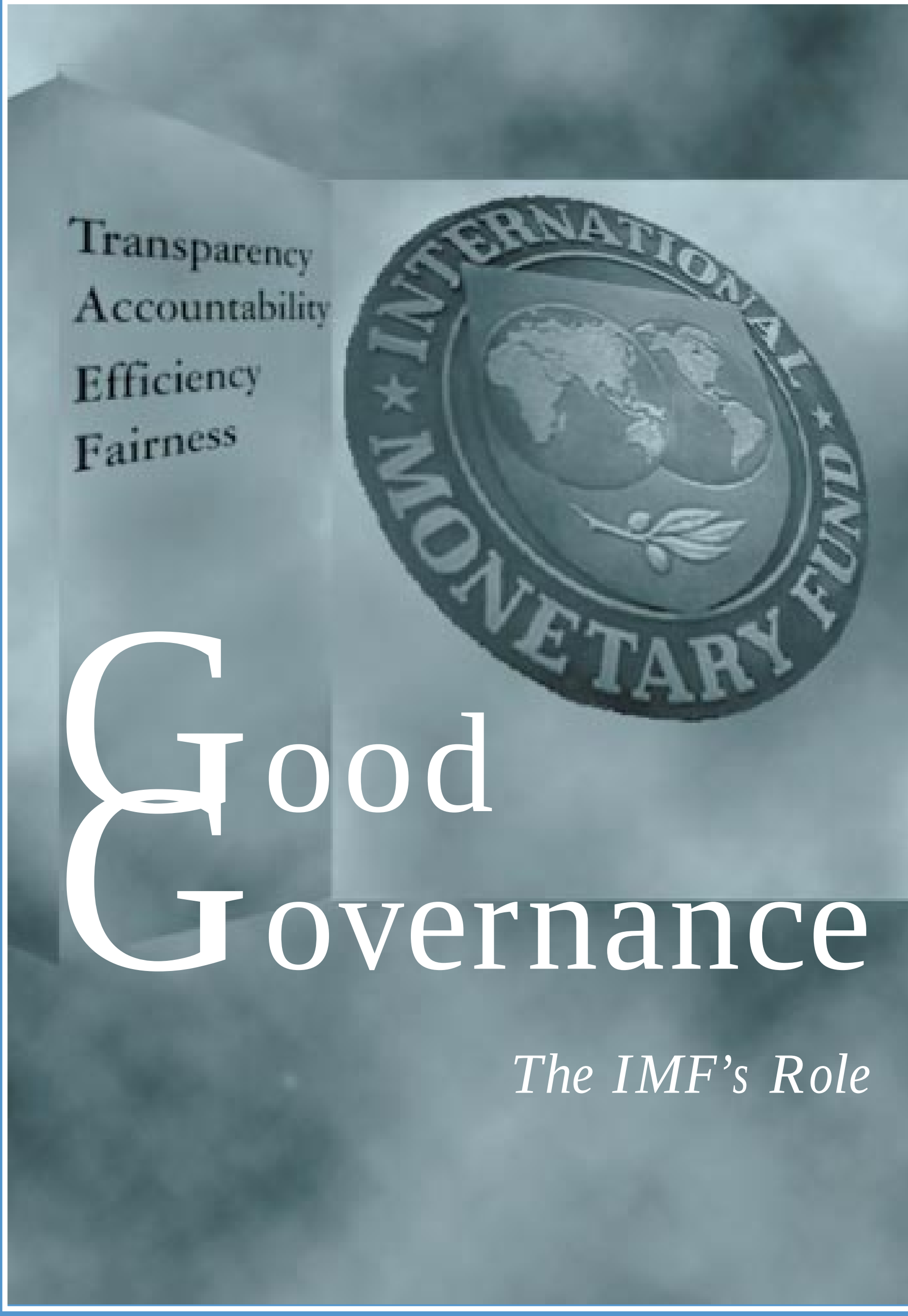

Good Governance

The IMF's Role

INTERNATIONAL MONETARY FUND

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Good governance is important for countries at all stages of development. . . . Our approach is to concentrate on those aspects of good governance that are most closely related to our surveillance over macroeconomic policies—namely, the transparency of government accounts, the effectiveness of public resource management, and the stability and transparency of the economic and regulatory environment for private sector activity.

Michel Camdessus

IMF Managing Director

Address to the United Nations Economic and Social Council
July 2, 1997

The International Monetary Fund has long provided advice and technical assistance that has helped to foster good governance, such as promoting public sector transparency and accountability. Traditionally the IMF's main focus has been on encouraging countries to correct macroeconomic imbalances, reduce inflation, and undertake key trade, exchange, and other market reforms needed to improve efficiency and support sustained economic growth. While these remain its first order of business in all its member countries, increasingly the IMF has found that a much broader range of institutional reforms is needed if countries are to establish and maintain private sector confidence and thereby lay the basis for sustained growth.

Mirroring the greater importance the membership of the IMF places on this matter, the declaration *Partnership for Sustainable Global Growth* that was adopted by the IMF's Interim Committee at its meeting in Washington on September 29, 1996, identified "promoting good governance in all its aspects, including ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption" as an essential element of a framework within which economies can prosper. The IMF's Executive Board then met a number of times to develop guidance for the IMF regarding governance issues.

The Guidance Note reprinted in this pamphlet, adopted by the Board in July 1997, reflects the strong consensus among Executive Directors on the significance of good governance for economic efficiency and growth. The IMF's role in these issues has been evolving pragmatically as more was learned about the contribution that greater attention to governance issues could make to macroeconomic stability and sustainable growth. Executive Directors were strongly supportive of the role the IMF has been playing in this area in recent years. They also emphasized that the IMF's involvement in governance should be limited to its economic aspects.

Taking into account lessons from experience and the Executive Board's discussions, the guidelines seek to promote greater attention by the IMF to governance issues, in particular through:

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

Jack Boorman
DIRECTOR
POLICY DEVELOPMENT AND
REVIEW DEPARTMENT

The Role of the IMF in Governance Issues: Guidance Note

(Approved by the IMF Executive Board, July 25, 1997)

I. Introduction

1. Reflecting the increased significance that member countries attach to the promotion of good governance, on January 15, 1997, the Executive Board held a preliminary discussion on the role of the IMF in governance issues, followed by a discussion on May 14, 1997, on guidance to the staff.[1] The discussions revealed a strong consensus among Executive Directors on the importance of good governance for economic efficiency and growth. It was observed that the IMF's role in these issues had been evolving pragmatically as more was learned about the contribution that greater attention to governance issues could make to macroeconomic stability and sustainable growth in member countries. Directors were strongly supportive of the role the IMF has been playing in this area in recent years through its policy advice and technical assistance.

2. The IMF contributes to promoting good governance in member countries through different channels. First, in its policy advice, the IMF has assisted its member countries in creating systems that limit the scope for ad hoc decision making, for rent seeking, and for undesirable preferential treatment of individuals or organizations. To this end, the IMF has encouraged, among other things, liberalization of the exchange, trade, and price

[1]The Interim Committee Declaration of September 26, 1996, on *Partnership for Sustainable Global Growth* also attached particular importance "to promoting good governance in all its aspects."

systems, and the elimination of direct credit allocation. Second, IMF technical assistance has helped member countries in enhancing their capacity to design and implement economic policies, in building effective policymaking institutions, and in improving public sector accountability. Third, the IMF has promoted transparency in financial transactions in the government budget, central bank, and the public sector more generally, and has provided assistance to improve accounting, auditing, and statistical systems. In all these ways, the IMF has helped countries to improve governance, to limit the opportunity for corruption, and to increase the likelihood of exposing instances of poor governance. In addition, the IMF has addressed specific issues of poor governance, including corruption,[2] when they have been judged to have a significant macroeconomic impact.

3. Building on the IMF's past experience in dealing with governance issues and taking into account the two Executive Board discussions, the following guidelines seek to provide greater attention to IMF involvement in governance issues, in particular through:

- a more comprehensive treatment in the context of both Article IV consultations and IMF-supported programs of those governance issues that are within the IMF's mandate and expertise;
- a more proactive approach in advocating policies and the development of institutions and administrative systems that aim to eliminate the opportunity for rent seeking, corruption, and fraudulent activity;
- an evenhanded treatment of governance issues in all member countries; and
- enhanced collaboration with other multilateral institutions, in particular the World Bank, to make better use of complementary areas of expertise.

[2]Corruption could be defined as the abuse of public office for private gain, a definition also used by the World Bank.

II. Guidance for IMF Involvement

Responsibility for Good Governance

4. The responsibility for governance issues lies first and foremost with the national authorities. The staff should, wherever possible, build on the national authorities' own willingness and commitment to address governance issues, recognizing that staff involvement is more likely to be successful when it strengthens the hands of those in the government seeking to improve governance. However, there may be instances in which the authorities are not actively addressing governance issues of relevance to the IMF. In such circumstances, the staff should raise their specific concerns in this regard with the authorities and point out the economic consequences of not addressing these issues.

Aspects of Governance of Relevance to the IMF

5. Many governance issues are integral to the IMF's normal activities. The IMF is primarily concerned with macroeconomic stability, external viability, and orderly economic growth in member countries. Therefore, the IMF's involvement in governance should be limited to economic aspects of governance. The contribution that the IMF can make to good governance (including the avoidance of corrupt practices) through its policy advice and, where relevant, technical assistance, arises principally in two spheres:

- *improving the management of public resources* through reforms covering public sector institutions (e.g., the treasury, central bank, public enterprises, civil service, and the official statistics function), including administrative procedures (e.g., expenditure control, budget management, and revenue collection); and
- *supporting the development and maintenance of a transparent and stable economic and regulatory environment conducive to efficient private sector activities* (e.g., price systems, exchange and trade regimes, and banking systems and their related regulations).

"Staff should . . . address governance issues . . . on the basis of economic considerations."

6. Within these areas of concentration, the IMF should focus its policy advice and technical assistance on areas of the IMF's traditional purview and expertise. Thus, the IMF should be concerned with issues such as institutional reforms of the treasury, budget preparation and approval procedures, tax administration, accounting, and audit mechanisms, central bank operations, and the official statistics function. Similarly, reforms of market mechanisms would focus primarily on the exchange, trade, and price systems, and aspects of the financial system. In the regulatory and legal areas, IMF advice would focus on taxation, banking sector laws and regulations, and the establishment of free and fair market entry (e.g., tax codes and commercial and central bank laws). In other areas, however, where the IMF does not have a comparative advantage (e.g., public enterprise reform, civil service reform, property rights, contract enforcement, and procurement practices), the IMF would continue to rely on the expertise of other institutions, especially the World Bank. But, consistent with past practice, policies and reforms in these areas could, as appropriate, be part of the IMF staff's policy discussions and conditionality for the IMF's financial support where those measures were necessary for the achievement of program objectives.

7. Although it is difficult to separate economic aspects of governance from political aspects, confining the IMF's involvement in governance issues to the areas outlined above should help establish the boundaries of this involvement. In addition, general principles that are more broadly applicable to the IMF's activities should also guide the IMF's involvement in governance issues. Specifically, the IMF's judgments should not be influenced by the nature of a political regime of a country, nor should it interfere in domestic or foreign politics of any member. The IMF should not act on behalf of a member country in influencing another country's political orientation or behavior. Nevertheless, the IMF needs to take a view on whether the member is able to formulate and implement appropriate policies. This is especially clear in the case

of countries implementing economic programs supported by the IMF from the guidelines on conditionality that call on IMF management to judge that "*the program is consistent with the IMF's provisions and policies and that it will be carried out*."[3] As such, it is legitimate for management to seek information about the political situation in member countries as an essential element in judging the prospects for policy implementation.

Criteria for IMF Involvement

8. The IMF's mandate and resources do not allow the institution to adopt the role of an investigative agency or guardian of financial integrity in member countries, and there is no intention to move in this direction. The staff should, however, address governance issues, including instances of corruption, on the basis of economic considerations within its mandate.

9. In considering whether IMF involvement in a governance issue is appropriate, the staff should be guided by an assessment of whether poor governance would have significant current or potential impact on macroeconomic performance in the short and medium term and on the ability of the government credibly to pursue policies aimed at external viability and sustainable growth. The staff could draw upon comparisons with broadly agreed best international practices of economic management to assess the need for reforms.

10. As regards possible individual instances of corruption, IMF staff should continue raising these with the authorities in cases where there is a reason to believe they could have significant macroeconomic implications, even if these effects are not precisely measurable. Such implications could arise either because the amounts involved are potentially large, or because the corruption may be symptomatic of a wider governance problem that would require changes in the policy or regulatory

[3]Guidelines on Conditionality, Decision No. 6056-79/38, March 2, 1979, *Selected Decisions and Selected Documents of the International Monetary Fund,* Twenty-First Issue (Washington: International Monetary Fund, 1996), p. 99.

framework to correct. Instances could include, for example, the diversion of public funds through misappropriation, tax (including customs) fraud with the connivance of public officials, the misuse of official foreign exchange reserves, or abuse of powers by bank supervisors that could entail substantial future costs for the budget and public financial institutions. Corrupt practices could also occur in other government activities, including the regulation of private sector activities that do not have a direct impact on the budget or public finances, such as ad hoc decisions made in relation to the regulation of foreign direct investment. Such practices would be counter to the IMF's general policy advice aimed at providing a level playing field to foster private sector activity.

11. Instances of corruption that do not meet the threshold of having significant macroeconomic implications are best addressed through the IMF's efforts to promote transparency and remove unnecessary regulations and opportunities for rent seeking consistent with the broad principles that apply to other issues of economic governance. Staff recommendations could include improvements in government management processes and systems that would have the beneficial side effect of preventing a recurrence of corrupt practices or advice to the authorities to seek the assistance of competent institutions for advice in these areas.

Modalities of IMF Involvement in Governance Issues

12. Governance issues are relevant to all member countries, although the problems differ depending on economic systems, institutions, and the economic situation. The mode of IMF involvement will have implications for the manner in which governance concerns are addressed by staff in different member countries. Nonetheless, whatever the mode of involvement, the IMF's main contribution to improving governance in all countries—both countries receiving financial support from the IMF and other countries—will continue to be through support for policy reforms that remove opportunities for rent-seeking activities

and through sustained efforts to help strengthen institutions and the administration capacity in member countries.

Article IV Consultation Discussions

13. In Article IV consultation discussions, the staff should be alert to the potential benefits of reforms that can contribute to the promotion of good governance (e.g., reduced scope for generalized rent seeking, enhanced transparency in decision-making and budgetary processes, reductions in tax exemptions and subsidies, improved accounting and control systems, improvements in statistical dissemination practices, improvements in the composition of public expenditure, and accelerated civil service reform). The potential risk that poor governance could adversely affect private market confidence and, in turn, reduce private capital inflows and investment—even in countries enjoying relatively strong growth and private capital inflows—should also be brought to the attention of the authorities. IMF policy advice should also make use of the broad experience of countries with different economic systems and institutional practices and be based on the broadly agreed best international practices of economic management and on the principles of transparency, simplicity, accountability, and fairness. In the case of international transactions that involve corruption, the staff should pay equal attention to both sides of corrupt transactions and recommend that such practices be stopped if they have the potential to significantly distort economic outcomes (e.g., the tax deductibility of bribes in member countries or certain operations of official agencies). Where poor governance with a significant economic impact is evident and brought to the staff's attention in its surveillance activities, the staff should discuss the issue with the authorities.

Use of IMF Resources

14. While the policy advice indicated above in relation to Article IV consultations is also relevant in the case of IMF-supported programs, the need to safeguard the IMF's resources must also be taken into account.

"Weak governance should be addressed early in the reform effort."

15. The use of conditionality related to governance issues emanates from the IMF's concern with macroeconomic policy design and implementation as the main means to safeguard the use of IMF resources. Thus, conditionality, in the form of prior actions, performance criteria, benchmarks, and conditions for completion of a review, should be attached to policy measures, including those relating to economic aspects of governance that are required to meet the objectives of the program. This would include policy measures that may have important implications for improving governance but are covered by the IMF's conditionality primarily because of their direct macroeconomic impact (e.g., the elimination of tax exemptions or recovery of nonperforming loans). While the IMF staff should rely on other institutions' expertise in areas of their purview (e.g., public enterprise reform by the World Bank), it could nevertheless recommend conditionality in these areas if it considers that measures are critical to the successful implementation of the program.

16. Weak governance should be addressed early in the reform effort. Financial assistance from the IMF in the context of completion of a review under a program or approval of a new IMF arrangement could be suspended or delayed on account of poor governance, if there is reason to believe it could have significant macroeconomic implications that threaten the successful implementation of the program, or if it puts in doubt the purpose of the use of IMF resources. Corrective measures that at least begin to address the governance issue should be prior actions for resumption of IMF support, and, if necessary, certain key measures could be structural benchmarks or performance criteria. Examples of such measures include recuperation of forgone revenue and changes in tax or customs administration. The staff would need to exercise judgment in assessing whether the actions adopted by the authorities were adequate to address the governance concerns; as in the case of other policies in which the track record is weak and the commitment of the authorities is in doubt, it may be appropriate

in some circumstances to call for a period of monitoring prior to a resumption of financial support. The authorities' policy response could also entail changes in management in public institutions and, as appropriate, the removal of individuals from involvement in particular operations where corruption had occurred, and efforts to recover government funds that have been misappropriated. The staff must, of course, be mindful of the need to avoid action prejudicial to any related domestic legal processes in a particular case.

Technical Assistance

17. The IMF's technical assistance programs should continue to contribute to improving economic aspects of governance. This would apply to areas of IMF expertise, including budget management and control, tax and customs administration, central bank laws and organization, foreign exchange laws and regulations, and macroeconomic statistical systems and dissemination practices. In these areas, technical assistance missions should bring to the attention of the authorities areas in which procedures and practices fall short of best international practices.

Identification of Governance Problems

18. In the context of Article IV consultations, program negotiations, and technical assistance missions, the staff should be alert to aspects of poor governance that would influence the implementation and effectiveness of economic policies and private sector activities. For example, this could be related to a weak and poorly remunerated civil service, which could be addressed through civil service reforms encompassing a restructuring or selective increase in pay scales or the process and transparency of the privatization process. The staff should also pay attention to inconsistencies or improbabilities in the various data and accounts in member countries. For instance, tax collection might fall short of the expected potential yields as a result of weak administration of tax laws, procedural complexities, or the widespread abuse of exemptions. The staff should bring data

inconsistencies that are not judged to be the result of problems in statistical collection and compilation to the attention of the authorities. The staff should also advise that greater transparency in macroeconomic policy implementation could help build private sector confidence in government policies; for example, the consolidation of all extrabudgetary accounts within the budget, the early publication of the budget, and early reporting on the outcome at the end of the fiscal year.

19. It is recognized that there are clear practical limitations to the ability of the staff to identify deficiencies in governance. The availability, quality, and reliability of information are likely to be important factors affecting IMF involvement in corruption cases. The staff should continue to rely on information provided by the authorities. If inconsistencies in public accounts and reports suggest that a problem exists, the staff should, in the first instance, raise the issue with the authorities. In its endeavor to seek information, the staff may need to be prepared to face some tension in the working relationship with country authorities in specific cases potentially involving corrupt practices. The staff may also point out that, in an atmosphere of widespread rumors of corrupt practices, and where the rumors have some genuine credence, an independent audit may be desirable to address such concerns. If the staff considers that further information is required to resolve an issue that has a significant macroeconomic impact, it may be appropriate to make use of information from third parties, including other international organizations and donors. In view of the confidential nature of the information obtained by the staff from member countries, staff inquiries will need to be handled with due discretion and regard for the sensitive nature of the issue.

Coordination with Bilateral Donors and Other Multilateral Institutions

20. The IMF should collaborate with other multilateral institutions and donors in addressing economic governance

"IMF staff should also keep abreast of . . . activities of partner organizations."

issues. Recognizing that the interests of these bodies are more diverse than the IMF's—ranging from political aspects of governance to specific project-related issues—the IMF staff should exercise independent judgment in formulating policy advice. In addition, the staff should focus its analysis and technical assistance only on those issues that are within its expertise. However, as noted in paragraph 6, conditionality may apply to measures to address governance concerns in areas outside the IMF staff's expertise. IMF staff should also keep abreast of changes in the policies of partner organizations and specific efforts in member countries on governance issues. This should include the activities of partner organizations, particularly the World Bank, in addressing governance issues in areas that are outside the IMF staff's competence but nonetheless important for the achievement of the economic policies advocated by the IMF (e.g., the reliable enforcement of contracts).

21. Given the commonality of interest with other multilateral institutions, the IMF should seek to strengthen its collaboration on issues of governance with them and, in particular, with the World Bank. This should include, especially when requested by the authorities concerned, coordination of action to improve governance.

22. As regards bilateral donors, it is useful to distinguish two different cases in which donor responses to economic and noneconomic governance issues affect the IMF's relations with its members, although in practice there is seldom a clear separation between such economic and noneconomic aspects:

- In cases where bilateral donors or creditors withhold or interrupt external support because of concern over political and/or economic aspects of governance, the IMF should have an independent view on the economic implications. The IMF staff should examine whether these issues have a direct and significant impact on macroeconomic developments in the short or medium term. If this is the case, the staff should seek to assist the member country concerned through policy advice and technical assistance in areas of its expertise and coordinate as appropriate with donors, with a view to helping to address the governance issues before recommending provision of IMF financial support. If this is not the case, but donors continue to withhold support, the staff should seek to assist the authorities in reformulating a program with greater internal adjustment to compensate for reduced external financing, paying due regard to the medium-term sustainability in the absence of a resumption of external assistance. If this is not feasible because of a lack of financing assurances—that is, adequate external financing for the reformulated program is not in place—as a last resort, the staff should recommend that the IMF withhold its own financial support but continue to provide technical assistance support.

- In cases where governance issues significantly affect short- or medium-term economic developments but donors and creditors continue their financial assistance to the country concerned and do not assist the government in improving governance, the IMF staff nevertheless has an independent responsibility for raising the governance issue with the authorities and for reporting to the Executive Board on this issue. There may be occasions when the IMF staff may raise its concerns with donors and creditors, including at consultative group meetings and in roundtables. But these instances would need to be addressed with care, with the guidance of the Board and due regard to the confidential nature of such information. There are clear limitations to what the IMF's contribution to improvements in governance in member countries can achieve without the active support from the rest of the international community.

Reporting to the Executive Board

23. The Executive Board will be kept informed about developments in significant cases involving governance issues and will have the opportunity to comment on the operation of these guidelines as country cases are brought forward. In addition, there will be a periodic review by the Executive Board of the IMF's experience with governance issues.

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