Transparency and good governance in transition economies

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Transparent - easily seen through or understood, evident, obvious.[1]

Webs of intrigue are more easily woven in the dark; greed, misdeeds and honest mistakes are more easily hidden. A public service, which holds tight to a culture of secrecy, is a public service ripe for abuse.[2]

Introduction

Reform in post-communist countries has been – to put it bluntly – more protracted and complex than originally anticipated. Initial conditions and the complexity of problems were greatly underestimated after the fall of the Berlin Wall. Also, powerful opposition by entrenched interests as well as general resistance from skeptical societies have delayed a process of moving from a centrally planned economy to a market one. This process, which is essentially about the transition from governance by a single political party and its central planners to governance in which democracy and market forces dominate, has been frustratingly slow. Despite considerable achievements in many areas, cozy relationships between the state and quasi-private firms exist, the dearth of institutions to protect property rights and contracts prevents market based transactions and the abundance of other largely unforeseen institutional shortcomings is in evidence throughout Europe and the former USSR. Even in Poland - labeled a "European tiger" and considered one of the most successful transition economies – discontent runs high with only 8 per cent of Poland's population viewing the country's transition process as having been a success.[3]

Many transitional issues remain to be addressed despite the fact that the vast majority of post-communist countries are currently considerably more democratic and considerably more open than they were under communism. More importantly, several transition economies continue to be led by authoritarian regimes and many others, although democratic, are often marked by undesirable features such as non-existent checks on the power of government, inequality under the law and disrespect for the rights of minorities. Many observers have already declared these developments to be initial symptoms of "transition" from central planning to dictatorship.

Recent election reports by the Organization for Security and Co-operation in Europe provide illustrative and alarming evidence. The reports, while praising the general progress towards democratization, highlight the arduous challenges still facing many transition economies. They note "illegal interference by executive authorities and intimidation and obstruction of opposition parties and candidates", "breach of the election law", "absence of a minimum level of pluralism", "concerns about the transparency of the counting and tabulation procedures", "obstacles to full and equal participation by all political forces" and "no clear dividing line between the state affairs and the incumbent's campaign".[4]

Considering this demanding "institutional work in progress", it stands to reason that there is an ongoing need to strengthen governance and institution building in post-communist countries. With this purpose in mind, this paper provides a background on the importance of transparency in economic matters. In doing so, it contributes to a better understanding of democratic principles and economic freedom in the formerly centrally planned economies.

* The views and opinions expressed here are the author's and not necessarily those of the United Nations Economic Commission for Europe.

[1] *The New Shorter Oxford English Dictionary*, Clarendon Press, Oxford, 1993.

[2] Information Commissioner of Canada in his *Annual Report*, 1997/98, Minister of Public Works and Government Services, Ottawa, Canada, 1999.

[3] "Kraj sfrustrowany" [A frustrated country], *Gazeta Wyborcza* (Warsaw), 10 August 2000.

[4] OSCE Election Observation Missions, various press releases and reports (www.osce.org).

Governance and transparency

Empirical evidence strongly suggests that good governance is an essential component of sustained economic growth.[5] In contrast, poor governance and slow economic development appear to be mutually reinforcing. Without a doubt, in practice or in theory, governments are necessary in countries at all levels of development. They are needed everywhere to provide public goods to correct market failures and to design and enforce rules to make markets work more efficiently. This, in turn, requires the existence of service providers and recipients who collect revenues as well as demand the required public goods such as "property rights" and "law and order". In doing so, all participants interact within an institutional framework. The interaction, the framework and the relations within its boundaries constitute governance. Governance, of course, is not solely a responsibility of the state as many of its functions are delegated or assumed by the private sector or civil society. Nevertheless, they all operate within an overall framework defined by the state.[6]

The above-noted rationale for government intervention is as common as it is widespread to observe - even in the countries at a similar level of development - considerable differences in governance. This diversity, however, is natural and explicable in view of country-specific, unique sets of tradition, culture and historical circumstance. Clearly, there is not – and neither will there be – a single model of governance in market economies.[7] Neither is governance a static concept: it is continually evolving in response to the increasingly complex nature of human activities and changes in what is regarded as acceptable behaviour. As a result of this multi-dimensionality, formulating a universal definition of governance may be an extremely difficult, if not futile, undertaking.

Because of the apparent difficulty in defining governance, many competing definitions have emerged. The broadest appears to be "the exercise of political, economic and administrative authority to manage a nation's affairs".[8] Similarly, governance can be defined as "the traditions and institutions that determine how authority is exercised in a particular country".[9] An example of a narrower definition is "economic governance": a rules-based system that ensures a secure economic environment through the existence of effective laws and institutions, including the government. The principal role of this system is to guarantee freedom of entry into the market, access to information and the security of contracts.[10]

As much as it is difficult to define governance, poor governance is readily recognizable.[11] The World Bank identifies the symptoms of poor governance to be the failure to make a clear separation between what is public and what is private; arbitrariness in the application of rules and laws; excessive rules and regulations which impede the functioning of markets and encourage rent-seeking; and narrowly-based or non-transparent decision-making. Moreover, it is also possible to measure poor governance. Evidence comes usually from stock market valuations of oil and natural gas companies. In 1996, stock markets valued Russian oil companies at less than 5 cents per barrel of proven reserves compared with typically $4-5 per barrel for western oil firms. This 99 per cent discount – it is argued - reflects the risk of discretionary government expropriation, regulation and taxation as well as the ability of firm managers to divert profits and assets to themselves.[12] In 2000, Gazprom, Russia's largest firm, was valued at 3.5 cents per barrel of hydrocarbon reserves compared to $13 for Exxon. This valuation – it is suggested - reflects opaque accounting and poor governance as well as many risks associated with the company that its price cannot be much higher than zero.[13]

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[5] See D. Kaufmann, A. Kraay and P. Zoido-Lobaton, Governance matters, *World Bank Research Working Paper 2196*, October 1999 and G. Abed and H. Davoodi, Corruption, Structural Reforms and Economic Performance in the Transition Economies, *IMF Working Paper*, July 2000.

[6] Not surprisingly, there has been a lively debate among economists and public policy makers as to the most efficient division of responsibilities between the private and public sectors. See for example, M. Friedman, *Capitalism and Freedom*, The University of Chicago Press, 1962 and J. Stiglitz, *Whither Socialism?*, The MIT Press, 1994.

[7] There are also differences in private sector governance (but corporate governance is not a focus of this paper). For example, in English speaking nations, corporations have traditionally been responsible only to those who have invested in them. In contrast, in Japan and most of Europe, public companies have been regarded as responsible to a broad group beyond stockholders – employees, customers, suppliers and the community at large. As a result, companies attempting to meet a standard of governance clarity – in order to be accountable - often fail because clarity of goals is impossible when one stakeholder has an interest totally opposite from another. R. Fleming, *How and Why Corporate Governance is Changing Worldwide*, remarks to the International Corporate Governance Conference in San Francisco, 9 July 1998 (www.tse.com).

[8] UNDP, *Reconceptualising Governance*, Discussion paper 2, New York, January 1997, p.9.

[9] "This includes (1) the process by which governments are selected, held accountable, monitored and replaced; (2) the capacity of governments to manage resources efficiently and formulate, implement, and enforce sound policies and regulations; and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them." D. Kaufmann, A. Kraay and P. Zoiso-Lobaton, Governance matters from measurement to action, *Finance and Development*, June 2000.

[10] P. Dhonte and I. Kapur, Towards a Market Economy: Structures of Governance, *IMF Working Paper, WP/97/11*, December 1996.

[11] World Bank, *Governance and Development*, Washington DC, 1994, p.9.

[12] A. Shleifer and R.W. Vishny, A Survey of Corporate Governance, *NBER Working Paper Series, No. 5554*, April 1996, p. 18.

[13] W. Bowder, "Crime and Punishment", *Wall Street Journal Europe*, 10 May 2000.

More importantly, good governance, regardless of how it is defined, rests on three overlapping pillars: public participation, accountability and transparency. First, effective public participation is the clearest expression of legitimacy in democracies. Secondly, politicians and public servants – to ensure good governance - must be accountable to the public. Thirdly, good governance requires transparent rules and effective flow of information to ensure fairness, integrity, credibility and accountability. Transparency represents an indispensable tool for citizens to learn about and influence their country's public institutions as well as to scrutinize them.[14]

In summary, transparency – or openness towards the public about government structures and functions, policy intentions, public sector accounts and projections - constitutes an inseparable feature of good governance. Its key operational feature is access to reliable, comprehensive, timely, understandable and internationally comparable information.[15]

Transparency and economic efficiency

From an economic perspective, the most important function of transparency is to allow the electorate to assess the government's financial position and the true costs and benefits of government actions. Similarly, private sector firms should provide information that is material to investors' decisions.[16] Greater transparency can be expected to lead to better-informed decisions in both private and public sectors contributing to better governance. This, in turn, leads to improvements in resource allocation, macroeconomic stability, greater productivity of public expenditure and higher credibility of public institutions.[17] All of these elements are likely to result in higher economic growth and greater prosperity. By contrast, opaque rules and unpredictability often generate many undesirable economic consequences. Opacity is usually associated with slower economic growth, increased uncertainty and unfairness, low credibility and rampant corruption. Non-transparent or fraudulent practices may even lead to social unrest.[18]

Competitiveness requires and relies on broadly based access to information - this is why distorted information lessens markets' allocative efficiency and slows economic growth. Macro-economic imbalances associated with incomplete or false information render economies vulnerable to crises. Thus, greater transparency is beneficial for the maintenance of macroeconomic stability. Moreover, macro-stability crucially depends on expectations and these, to be formed appropriately, must be based on informed assessments of current economic conditions and policies.

In the context of financial crises, enhanced transparency can also help to encourage macro-economic policy adjustments to begin earlier and occur more smoothly. These adjustments can help resolve crises by reducing uncertainty. Greater transparency may also reduce the risk of contagion by helping market participants to differentiate among borrowers. It also allows private institutions to take into account the implications of their actions on themselves and their counterparts.[19] Unquestionably, greater transparency will make financial markets work more efficiently, though some observers caution that, in this area, too much is expected of the initiatives to improve information disclosure. Critics point out that financial crises are a result of information asymmetries and these are intrinsic to financial markets and will remain despite greater transparency.[20] In summary, from the macro-economic perspective, distortions arising from opacity tend to be destabilizing and can also inflict painful and long-lasting social costs, especially, if the most vulnerable part of an economy – the banking and financial sectors - are affected.

Furthermore, the less available or credible is the information, the greater the uncertainty and risk and, as a

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[14] "Ethical conduct cannot be enforced; conduct can only be scrutinized. Any society aspiring to be free, just and civil must depend upon and nurture a wide array of methods for exposing, and imposing sanctions on, ethical failures." [And] "all the checks and balances designed to limit abuses of government power are dependent upon there being access by outsiders to governments' insider information". *Annual Report, 1997/98*, Information Commissioner, Minister of Public Works and Government Services, Ottawa, Canada, 1998.

[15] Adapted from G. Kopits and J. Craig, Transparency in Government Operations, IMF Occasional Paper 158, Washington DC, January 1998. An alternative, broader definition of transparency (that includes private sector) could be: "a process by which information about existing conditions, decisions and actions is made accessible, visible and understandable". G-22 Report on the International Financial Architecture, *Report of the Working Group on Transparency and Accountability*, October 1998 (www.bis.org).

[16] Such information should reflect timeliness, completeness, consistency, risk management and audit processes. Poor disclosure in the private sector can be partly attributed to the lack of principles and standards to guide the compilation and reporting. See G-22 Report on the International Financial Architecture, *Report of the Working Group on Transparency and Accountability*, October 1998 (www.bis.org).

[17] Some go further and claim that "there is reason to believe that government disclosure of information benefits the economy, as commercial firms take raw government information, add value to it, and sell the new value-added product, thus creating new private sector jobs." T. McMahon, Access to Government Information: A New Instrument for Public Accountability, *Government Information in Canada/Information gouvernementale au Canada 3*, no.1, 1996.

[18] In the early 1970's, Poland's "propaganda of [economic] success" deviated so much from the grim reality of low standards of living that the communist party's attempt to raise food prices in 1976 to redress macro-economic imbalances met with demonstrations, riots and violent clashes with the police.

[19] For more analysis about transparency and financial crises, see G-22 Report on the International Financial Architecture, *Report of the Working Group on Transparency and Accountability*, October 1998 (www.bis.org).

[20] B. Eichengreen, *Toward A New International Financial Architecture: A Practical Post-Asia Agenda*, Institute for International Economics, Washington DC, 1999. See chapter 6: What won't work, pp. 79-84 about the limits of transparency in the context of financial crises.

result, the cost. Governments that do not disclose sufficient information to financial markets are likely to incur an increased risk premium. In addition, non-transparency does not improve the credibility of the government either. Given that government actions are always a major factor in shaping business decisions, an insecure economic setting negatively affects investment levels and consequently economic growth. Finally, the importance of transparency in government operations is underscored by the fact that governments often establish standards for other information providers to emulate.

While it appears that the benefits inherent in transparency are self-evident and provide the strongest incentive for observance, non-transparent regimes are common because greater transparency is hard to achieve. First, transparency, is not costless. Transparency imposes non-negligible, up front fixed costs necessary to create the technical capacity and institutions, and it also requires incurring the ongoing variable costs to maintain these practices. The overall costs of transforming a culture of secrecy into one of transparency may be very large.[21]

Second, transparency is foremost a means to greater accountability and public participation and not an end in itself. That is why it can sometimes be legitimately limited. The constraint on access to information is typically invoked when there are fears that premature disclosure may compromise the quality of internal policy deliberations. However, when this privilege is abused, it often leads to non-transparent and poor quality decision making.[22]

Third, there are currently few mechanisms to monitor transparency or countries' compliance with internationally recognized standards. Recently, however, the international financial community has begun to recognize the importance of "transparency about transparency" and it has called for experimentation with "transparency reports". It was suggested that "assessments of the extent to which standards are observed can help identify weaknesses that may contribute to economic and financial vulnerability".[23] The assessments are based on an IMF-developed framework for fiscal transparency.[24]

To date, the IMF has issued transparency reports for five transition economies: Albania, Bulgaria, the Czech Republic, Estonia and Ukraine. Predictably, despite the marked differences in assessments, some of the reported deficiencies appear to be typical for transition economies. For example, in the area of fiscal transparency, the budget process in a transition economy does not generally give a complete picture of the consolidated government. Unreported or misreported information on quasi-fiscal activities, state guarantees and interactions with state-owned enterprises are prevalent and decrease transparency. The IMF concludes that in Bulgaria, the Czech Republic and Ukraine, better quality information in these areas, provision of which is in part function of institutional reform, would reduce an important source of fiscal risk (i.e. the potential requirement for future financial support).

Among other transparency issues, the IMF identifies a need for official national accounts to be compiled in Albania while the assessment of Ukrainian transparency emphasizes lack of clarity over the relative role of government vis-à-vis the rest of the economy. Ukraine and Bulgaria have also been singled out for discretionary interpretation and enforcement of tax laws compromising fiscal transparency. In the field of monetary policy transparency, the assessments are generally more favourable: Bulgaria, the Czech Republic and Estonia provide comprehensive, timely and good quality monetary policy information.[25]

Transparency and corruption

Corruption or "the abuse of public power for personal gain" has existed for a long time. It occurs in all countries and takes many forms such as bribery, nepotism or conflict of interest. It is a sign of institutional malfunction and it usually flourishes in an environment of excessive regulation, high discretion in economic activity or when governments rather than markets allocate scarce resources. Its occurrence is related to low

[21] For arguments for and against transparency, see G. Kopits and J. Craig, Transparency in Government Operations, *IMF Occasional Paper 158*, Washington DC, January 1998, pp. 2-4.

[22] For example, while the IMF claims to support the development and maintenance of a transparent and stable economic and regulatory environment, its critics point out that it does not practice what it preaches. Commenting on IMF economic strategies in South-East Asia, one prominent economist accused the organization of adopting a veil of secrecy: "Smart people are more likely to do stupid things when they close themselves off from outside criticism and advice. If there is one thing I have learned in government, it is that openness is most essential in those realms where expertise seems to matter most." J. Stiglitz, "Arrogance beyond compare", *The Banker*, June 2000.

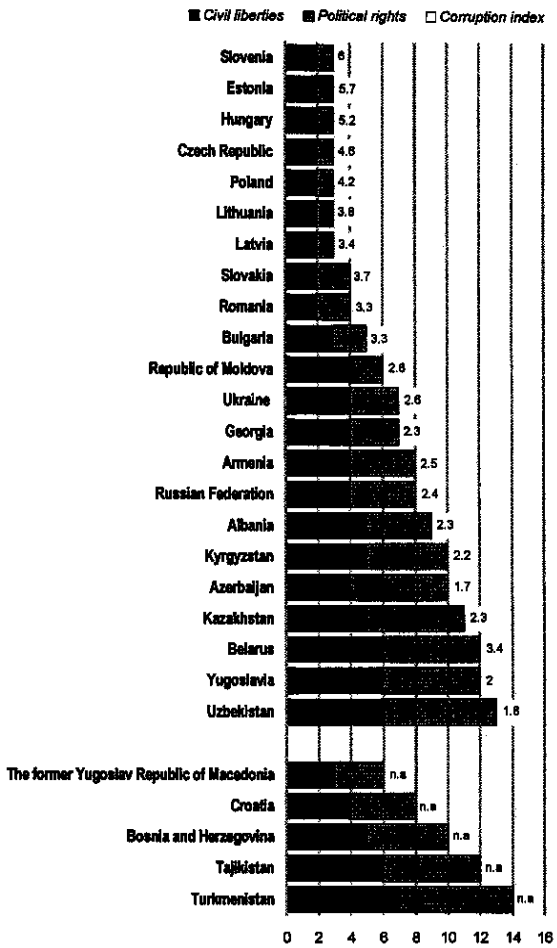
[23] Reports on the Observance of Standards and Codes: An Update, 20 March 2000 (www.imf.org).

[24] The framework relies on four principles: clarity of government's roles and responsibilities, public availability of information, open budget preparation, execution and reporting and independent assurances of integrity. A Code of Good Practices on Fiscal Transparency – Declaration of Principles, updated 26 April 1999. A similar framework exists for monetary policy transparency. A Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles, 26 September 1999 (www.imf.org).

[25] Many transition economies are also fully compliant with the IMF's Special Data Dissemination Standard established in 1996 to promote the disclosure of accurate and timely economic and financial statistics. As of July 2000, over one third of the 47 countries subscribing to SDDS did not fully meet its requirements, including the world's wealthiest economies such as Australia, Austria, Belgium, France, Ireland, Portugal, Sweden and Switzerland. The list of those fully compliant includes the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia (www.imf.org).

CHART 1

Corruption, civil liberties and political rights, 1999



Source: Transparency International, perceived corruption Index, 1999, scale 0 - *'highly corrupt'* to 10 - *'highly clean'*. Freedom House Comparative Measures of Freedom, 1998-1999, scale 1 - *'the most free'* to 7 - *'the least free'*.

likelihood of disclosure and/or punishment. In many cases, it is also a symptom of institutional collapse, missing institutions or institutional hiatus.

While it is not possible to measure corruption, Transparency International, an anti-corruption organization, conducts annual surveys to estimate "perceived corruption" (Chart 1). In 1999, Slovenia was perceived to be the least corrupt transition economy – scoring 6 out of 10 points which placed it 25th on the list of 99 countries. Notably, most countries of the former USSR are perceived to be the most corrupt and appear at the bottom of the ranking – among transition economies as well as among all surveyed countries. For example, Republic of Moldova placed 75th and Azerbaijan 96th overall.

It is not surprising that corruption is as prevalent as it is damaging in transition economies. These countries have inherited (or do not have any) state institutions that are inexperienced with regulating markets and, more importantly had been shaped by decades of discretionary power and arbitrary justice. As a result, unaccountable public institutions and a badly functioning legal system – one that does not provide security of persons and property, does not enforce private contracts and does not allow the people to hold their government accountable - are still characteristics of many transition economies.[26]

Corruption destroys public confidence in democratic institutions and erodes the legitimacy of the state. Corruption also exacts heavy economic cost – just the opposite of the previously espoused "grease-the wheels" argument, which asserted that bribery was necessary to allow the supply and demand to operate. Growing empirical evidence indicates that corruption has a strong negative effect on the economic growth by distorting incentives, reducing investment and diminishing the fundamental role of the government.[27]

In the transition context, corruption is particularly damaging because it reduces public revenue and destroys the ability of public institutions to deliver essential services. In other words, it makes the state weak in the areas where it should be strong. Moreover, the disproportionate and discretionary state control (combined with corruption) increases the costs of doing business. This makes the state too strong in the area where it should be limiting its functions to building legal and regulatory foundations for competitive markets as well as prudential supervision of financial markets.[28] As a result, this intrusiveness induces a large part of private sector's activities to move "underground". This rational response to higher costs and the unpredictability of government measures can be debilitating for a transition economy as a whole. As the size of the unofficial economy increases, more taxes go unpaid, further impairing the government's ability to provide public goods such as law and order. The state's inability to perform its basic functions, in turn, encourages more corruption.

The functioning of this vicious circle is not uncommon. In fact, in transition economies, the relationship between corruption, taxes and the regulatory environment and the size of the unofficial economy is strong. Transition economies - located in Eastern Europe - with relatively light regulatory framework, high tax revenues and relatively good provision of public goods have grown faster and have had a lower share of unofficial activity. In contrast, most of the economies of the former Soviet Union with unfair taxes, relatively

[26] For an overview of corruption issues in transition economies see K. Murphy and M. Hessel, Stealing the State, And Everything Else, *Project Syndicate Survey*, winter 1999 (www. project-syndicate.cz).

[27] M. Paolo, Corruption and Growth, *Quarterly Journal of Economics*, 1995, 110(3), pp.681-712.

[28] Including many other areas such as efficient management of public expenditures and collection of revenues which calls for meritocratic public service, unbiased policy advice and good financial management.

onerous regulations and poor public goods have had low growth and a high share of unofficial activity.[29] Similarly, countries with more corruption have higher shares of the unofficial economy.[30]

In transition economies, many factors contribute to the persistence of corruption, but the main weapon against corruption is simply to reduce the opportunities for it. Above all, in the transition context, fight against corruption must be linked to the reform of the state. In some countries, especially those where the state and politicians maintain their grip on the economy, honest leadership by example and basic economic reforms, including privatization, would sharply curtail opportunities for dishonesty.[31] In these cases, economic distortions and administrative controls which should be given priority include those that involve high discretion such as issuance of licences, permits, quotas, customs and border crossing documentation and tax exemptions.

Such simple anti-corruption measures can produce immediate results. For example, in Albania, firing corrupt customs officials contributed to an almost one-third increase in customs receipts in the first quarter of 2000.[32] In Bulgaria, basic but promising work to fight corruption concentrates on collecting information on corruption cases and encouraging reporting of corrupt activities. In Bosnia and Herzegovina, a "transparency office" reviews all proposed new legislation.[33] Overall, in South Eastern Europe basic anti-corruption activity emphasizes the need to collect and disseminate information and to alter legislation so that corruption can be identified and punished. These countries focus on elementary issues such as conflict of interest, procurement rules and party financing, as this approach is believed to be more effective than "anti-corruption campaigns" such as the ones undertaken in Bulgaria, Georgia, Poland, Russia and Slovakia in the 1990's.[34]

At the same time, what should not be done is to allow regulations to proliferate, even those that are specifically aimed at fighting corruption. In this sense, it is difficult to condone a scheme that would compensate foreign companies suffering from lost revenues as a result of corruption, legal changes or political instability. This controversial "corruption insurance", being considered in Kazakhstan, is meant to assuage the fears of foreign investors who have long been concerned about the absence of laws, discriminatory and arbitrary government actions in the country.[35]

In other more advanced transition economies, where the economic reforms have already deprived state bureaucracy or insiders of its discretionary powers (where the old political and economic institutions were largely destroyed), the emphasis should on replacing them with those of a market economy. The list is long and challenging: creating a modern, enforceable tax regime without special exemptions, establishing transparent revenue and expenditure mechanisms, reforming the civil service, customs and legal systems.

In conclusion, corruption and transparency are closely related. Non-transparent rules and non-transparent implementation breed corruption and the innate secrecy surrounding corruption sustains it. Greater transparency, therefore, through clear rules, less discretion and more disclosure, is a necessary condition to control corruption. In fact, transparency is capable of generating a significant deterrent effect and that is why it appears to be a tailor-made solution for corruption. The other necessary elements are competition in political area as "political competition opens up the government, reduces secrecy, and so it can reduce corruption."[36] Democracy therefore introduces a contest of ideas rather than goods allowing the public to evaluate alternative policy options.

Transparency and policy choice debates

Openness therefore is also a factor in policy-making where it is as important for authorities as it is for individual citizens. By virtue of being transparent, the authorities' decisions gain legitimacy and credibility while concurrently citizens' participation in the

[29] S. Johnson, D. Kaufmann and A. Shleifer, The Unofficial Economy in Transition, *Brookings Papers on Economic Activity*, Washington, 1997.

[30] S. Johnson, D. Kaufmann and P. Zaido-Lobaton, Regulatory Discretion and the Unofficial Economy, *American Economic Review*, 1998, 88(2), pp.387-392.

[31] In transition economies, privatization has also provided opportunities for corruption. Some have argued however that the incidence of corruption is, or would be, larger without privatization, and that corruption is more prevalent in non-privatized sectors. Overall, "even in its relatively corrupt incarnations, privatization is likely to contribute positively to the long run movement from a bankrupt and essentially corrupt economic system to a freer and more democratic one." D. Kaufmann and P. Siegelbaum, Privatization and Corruption in Transition Economies, *Journal of International Affairs*, vol.50, no.2, 1996, p.458.

[32] Balkans: Corruption Challenge, *Oxford Analytica Brief*, 21 June 200.

[33] But at the same time, the Bosnian leadership seeks to consolidate its control over the economy, which it uses to provide it with funds. For example, the books of state-owned companies in Bosnia-Herzegovina are closed to independent auditors, preventing them from being evaluated prior to potential privatization. W. Petritsch, "Bosnian Boondoggle", *Wall Street Journal Europe*, 22 May 2000.

[34] Georgia's president openly admits that the country's anti-corruption campaign has not been successful despite arresting 3,000 individuals and convicting 600 to jail terms in the last three years. E. Shevardnadze, "Kwestia priorytetow" [A question of priorities], *Rzeczpospolita* (Warsaw), 28 August 2000.

[35] The program is controversial, but proponents see it as a means for the local authorities to understand the limit of corruption and administrative failures by their own agencies. J. Andrew, "Kazakhs in plan for corruption loss insurance", *Financial Times*, 23 February 2000.

[36] A. Shleifer and R.W. Vishny, Corruption, *NBER Working Paper Series, No. 4372*, May 1993, p. 21.

democratic process is enhanced. Moreover, closed decision-making increases the risk of government error and, at the same time, enhanced transparency increases the political risk of unsustainable policies.

Recognizing the importance of openness in furthering accountability and thus good governance, many countries have specific freedom of information legislation.[37] In general, these countries have explicitly recognized that governments exist to serve its citizens, and taxpayers deserve to be well informed about the government, the services it provides and the basis for policies and decisions that affect individuals. In the words of the Polish Premier: "access to information legislation is a moral debt, which all politicians have to repay to their electorates."[38]

Regrettably, politicians' words and commitments are often not matched by their deeds. For example, in a recent assessment of the capacity of media in Bulgaria, Hungary, Romania and Ukraine to investigate corruption issues that endanger nascent democratic institutions, Freedom House concluded that "journalists as well as the public lack access to basic government information. [And] where freedom of information legislation exists, it lacks implementing legislation or is contradictory and confusing. Understandably, then, it is neither understood nor enforced."[39]

Among transition economies, only Bosnia and Herzegovina, the Czech Republic and Hungary have access to information legislation.[40] Other transition economies have typically guaranteed access to information and freedom of expression in their constitutions, but they have not followed through with the necessary implementing legislation. In Poland, for example, Article 61 of the Constitution of 1997 secures citizens' right to obtain information on activities of the public service. However, the Constitution is not precise on this right's limitations and it is silent on access procedures because the implementing legal acts do not exist. This is crucial as the decision to withhold or release the information is at the discretion of the executive branch. In other words, due to the absence of necessary legislation, it is impossible to distinguish between the legitimate reason for withholding access and frivolous protection from criticism, embarrassment or inconvenience.

Access laws vary, but typically, they establish a statutory, enforceable right of access to information under the control of government institutions.[41] The basic principles are that government information should be available to the public and any necessary exceptions to the right of access should be limited and specific. In other words, the right of access is not absolute or unlimited. Exceptions are either explicitly spelled out and/or subject to a "balance of interest test" (weighing the interest of disclosing the information against the interest of non-disclosure) or a "harm test" (potential harm or injury to specific interest protected by the legislation). In addition, decisions on the disclosure of government information are usually reviewed independently of government (i.e., by the Information Commissioner or Ombudsman). Governments explicitly recognize the duty to inform and pledge to disclose to those requesting so, the most information possible, which is not injurious to the public and private interests identified in the exemptions.

Access to information legislation is one of many tools for ensuring a more transparent government and greater integrity in public life. Also, there exist other laws that ensure the efficient allocation and use of public resources. These include financial accountability systems such as detailed accounting reports how each public institution plans to spend money and how they actually spent it as well as a variety of financial rules and accounting requirements that specify how the public money can be spent. Finally, there is typically an independent auditor charged with reviewing government programs. The purpose is to reinforce expenditure control by increasing the risk of exposure and subsequent sanctions. The auditor reports regularly to parliament thus the public, commenting publicly on the efficiency of government spending.

The legal framework and internal system of checks and balances are indispensable for a country's good governance, but they do not automatically bring about greater accountability. An important aspect of transparent governance is the presence of civil society – individuals and organizations that analyze, discuss and contribute to policy formulation. Mature democracies offer a variety of formal and informal mechanisms such as free press and mass media through which citizens articulate their interests. Unfortunately, governments in transition economies have often introduced limitations on these through administrative pressures, censorship, judicial orders or even by purchasing them outright. As a result, political and economic reporting is pro-

[37] Among them all EU members (except Germany and Luxembourg), Australia, Canada, Hong Kong, Israel, Japan, New Zealand, South Korea, and Thailand and the United States.

[38] J. Buzek, Wolnosc informacji fundamentem [Freedom of information – a foundation], *Rzeczpospolita* (Warsaw), 14 July 2000.

[39] "Media Responses to Corruption in the Emerging Democracies: Bulgaria, Hungary, Romania and Ukraine", p.6 (www.freedomhouse.org).

[40] In Bosnia and Herzegovina the *Freedom of Access to Information Act* was passed on 23 October 2000 and was drafted by the Organization for Security and Cooperation in Europe. "Freedom of Access to Information law breaks new ground in South-Eastern Europe", *OSCE Mission to Bosnia and Herzegovina Press Release*, 24 October 2000 (www.osce.org).

[41] For a review of laws in EU member countries see, "Comparative Analysis of the Member States' Legislation Concerning the Access to Documents" available at www.europa.eu.int.

TABLE 1

Press Freedom Survey, 2000
(Points) [a]

Free				Partly free				Not free			
10-15		16-30		31-45		46-60		61-75		76-100	
Poland	19	The former Yugoslav Republic of Macedonia	42	Georgia	47	Kyrgyzstan	61	Belarus	80
Czech Republic	20	Romania	44	Albania	56	Croatia	63	Yugoslavia	81
Estonia	20			Bosnia and Herzegovia	56	Kazakhstan	68	Uzbekistan	83
Lithuania	20			Armenia	57	Azerbaijan	70	Turkmenistan	86
Latvia	24			Republic of Moldova	58			Tajikistan	94
Slovenia	27			Russian Federation	60				
Bulgaria	30			Ukraine	60				
Hungary	30								
Slovakia	30								

Source: Freedom House Survey 2000, Freedomhouse.org

[a] Points reflecting laws, political pressures and economic influences on print/broadcast media content as well as repressive actions. The lower the freer.

government, while independent outlets avoid covering sensitive topics (Table 1).

The internet, the newest communication device, offers a powerful tool that contributes towards greater, cheaper and faster exchange of information. In the context of transparency, the information revolution has drastically reduced the costs of being transparent – effectively contributing to global integration, decentralizing information and empowering civil society. As the price of information falls, more of it is demanded. At the same time, other factors such as globalization, the spread of democratic ideals, presence of a vocal civil society and an emerging culture of transparency appear to have helped to shift "the demand curve to the right" indicating a farther increased demand for information.[42]

Regrettably, through excessive control, the information highway's potential is often blocked. According to *Reporters Sans Frontières*, forty-five countries restrict their citizens' access to the internet. The organization has described twenty of these countries as "enemies of the internet" because they either prevent their citizens' access, control a single provider, install filters blocking access to some sites or force users to officially register with the authorities. Azerbaijan, Belarus and all five central Asia CIS countries were among the twenty because they control access totally or partially, have censored web sites or taken action against internet users.[43]

Governance in transition economies

As noted above, greater transparency serves the public interest and is necessary for both the smooth functioning of markets and good governance. It is a foundation of participatory democracies, but non-transparent regimes exist around the world, including in many developed market economies.[44] Although transparency issues in many of the wealthiest economies often require more attention and improvement, it may be confidently said that a culture of secrecy - the hallmark of totalitarian regimes – flourishes in transition economies. The magnitude of the task required to change this culture must not be underestimated. For example, the proposed Romanian *State Secrets Act* declares in just one sentence that "access to information of public interest is guaranteed" without subsequently defining it or specifying how access will be guaranteed. By contrast, *the Act* takes 35 pages to describe the importance of protecting state secrets of a scientific, technological, economic nature in the public as well as private sectors.[45]

The reasons for this state of affairs are many, but the most fundamental fact is that free and fair, democratic elections do not always produce democratic governments. This is a surprising proposition because in western countries, democracy has always stood for liberal democracy – a political system characterized by free and

[42] A. M. Florini, Does the Invisible Hand Need a Transparent Glove? The Politics of Transparency, paper prepared for *the Annual World Bank Conference on Development Economics*, 28-30 April 1999.

[43] "Enemies of the Internet", Reporters Sans Frontières (www. rsf.fr).

[44] This includes the EU as one influential writer describes the European structure to be "no basis for an active democracy, but an attempt by a political elite to escape its constraints" which consists of "an unelected Commission with a monopoly of legislative initiative...a supreme court that takes promotion of further integration as its raison d'etre....and a Council of Ministers acting sometimes as the legislature and sometimes as the executive, but always in secret." M. Wolf, "Europe's constitutional dilemma", *Financial Times*, 4 July 2000.

[45] J. Ottaway, "Is Romania serious about joining the EU?", *Wall Street Journal*, 17 March 2000

fair elections and inextricably linked to what political scientists call "constitutional liberalism", that is the rule of law, private property rights, freedom of speech and assembly. In other words, true democracy cannot exist without other necessary elements to underpin it such as impartial courts, an independent and critical media and an aware and educated population.

Developments in post-communist countries, however, have provided clear evidence that constitutional liberalism - interwoven in the social, economic and political fabric in many western countries - is neither theoretically nor practically inseparable. In many transition economies, democracy is thriving today but complementary and indispensable "good governance" is largely absent. This fact has given rise to a hypothesis that some newly democratizing countries are locked in by governments that mix a substantial degree of democracy with a substantial degree of illiberalism.[46]

The tentative answer to this hypothesis – which also sheds light on the political and economic developments in post-communist states - appears to reject it. Initially, a "young and inexperienced democracy" may produce adverse, divisive as well as grave side effects such as nationalism, ethnic conflict or war, but over time democracy helps instill habits of transparency, integrity, tolerance, and accountability. In the words of one economist, "we can think of democracy as a meta-institution for building good institutions."[47] The need for this transitional period is linked to the fact that "good governance" cannot be imposed upon a society.

In other words, the practice of constitutional liberalism is a result of an evolutionary process which involves bringing about incremental changes in political culture. While it requires formal institutions and rules, it also crucially depends on political attitudes and habits.[48] To conclude, sensible rules (and their enforcement) are necessary, but they alone are not enough. A wide acceptance of standards of accountability and transparency – which in turn depend on a culture of abiding by the rule of law and social norms - must exist to provide enforcement and improve the efficacy of rules.

At this point, it is worth asking why so little attention has been paid to governance if it is so necessary and takes a long time to evolve? Why were the issues of institutional reform not always on the priority list in reforming transition economies? [49] After all, the experience of Central Europe forcefully suggests that when liberal democratic regimes protect individual rights and create a framework of law and administration, capitalism and economic growth follow. In contrast, if that basic institutional framework is violated, disasters strike almost immediately and the gains are quickly reverted.[50]

The current weak governance and slow progress in institutional change in many transition economies must be evaluated in the context of massive structural changes. The changes – often involving simultaneous building of states and markets - were unprecedented. A new political order had to be created – often against powerful opposition to change. The wave of transformation often took place in countries that have a long history of paternalism and weak or non-existent democratic habits (see Chart 1 for the 1999 estimates of political and civil liberties). As a result, leaders in many countries still appear more powerful than legitimate. They frequently and destructively promote the need to break down entrenched forces, override vested interests and bring order to "chaotic" societies instead of proposing constructive and long-term coalition building. Moreover, market-oriented, economic reforms have inflicted short-term adjustment costs and the new, market-based incentive structure has brought about previously hidden or unknown income inequalities. All these political and economic forces have also introduced a large dose of uncertainty creating further opposition to change. Finally, war and violent challenges to territorial integrity often interrupted transition to new governmental and civic institutions.

In such an environment - where the old political and economic institutions were often destroyed more rapidly than a market economy could replace them - governments could not cope.[51] As a result, the new "institutional hiatus" brought about inevitable social conflict. Conflicts erupted - with criminals often taking over the state role - because transition economies had little institutional framework to support market activities. The conflicts were generally more severe in countries with less developed institutions, as effective institutions tend to reduce the rewards to socially uncooperative strategies and thus encourage social groups to cooperate.

One flagrant outcome of this type of coordination failure is related to the increased likelihood that

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[46] F. Zakaria, The rise of illiberal democracy, *Foreign Affairs*, November/December, 1997.

[47] D. Rodrik, Institutions for High-Quality Growth: What They Are and How to Acquire Them, Draft paper prepared for *the IMF Conference on Second-Generation Reforms*, Washington DC, November 8-9, 1999 (www.imf.org).

[48] C. A. Kupchan, Democracy first, *Foreign Affairs*, May/June 1998.

[49] For an interesting argument calling for early creation and emphasis on market institutions because they take long time to take effect see R. Dornbusch, Strategies and Priorities for Reform, *in The Transition to a Market Economy, vol.1*, ed., by P. Mare and S. Zecchini, OECD, 1991, pp. 169-183.

[50] In the Czech Republic, flawed voucher privatization promoted cronyism and asset stripping; stock market self-regulation and supervision of state-owned banks was unsuccessful; and poor disclosure rules and insider trading scandals hurt foreign investor confidence. Ultimately, all of these led to the fall of government and economic crisis.

[51] R. Kozul-Wright and P. Rayment, The institutional hiatus in economies in transition and its policy consequences, *Cambridge Journal of Economics, 21(5)*, September 1997, pp.641-661.

TABLE 2

Reported direct impact of state capture on the firm, 1999
(Per cent of firms)

	Parliamentary legislation	Presidential decrees	Central bank	Criminal courts	Party finance	Overall capture index
Uzbekistan	5	4	8	5	4	6
Armenia	10	7	14	5	1	7
Hungary	12	7	8	5	4	7
Slovenia	8	5	4	6	11	7
Belarus	9	5	25	–	4	8
Estonia	14	7	8	8	17	10
Czech Republic	18	11	12	9	6	11
Lithuania	15	7	9	11	13	11
Kazakhstan	13	10	19	14	6	12
Poland	13	10	6	12	10	12
Albania	12	7	8	22	25	16
Romania	22	20	26	14	27	21
Georgia	29	24	32	18	21	24
Slovakia	20	12	37	29	20	24
Croatia	18	24	30	29	30	27
Bulgaria	28	26	28	28	42	28
Kyrgyzstan	18	16	59	26	27	29
Latvia	40	49	8	21	35	30
Russian Federation	35	32	47	24	24	32
Ukraine	44	37	37	21	29	32
Republic of Moldova	43	30	40	33	42	37
Azerbaijan	41	48	39	44	35	41

Source: J.S. Hellman, G. Jones and D. Kaufmann, Seize the State, Seize the Day, An Empirical Analysis of State Capture and Corruption in Transition, Paper prepared for ABCDE 2000 Conference, 13 April 2000, p.11.

governments will be captured by narrow vested interests. It is an important factor explaining differences across transition economies in the quality of governance and it has been a primary threat to economic reform. High capture states tend to focus on providing specific advantages to influential firms and lobbies, while under-providing the institutions essential to improving governance. Such groups gain from the market distortions and corrupt practices associated with partial reforms.[52]

The joint EBRD and World Bank investigation of state capture provides interesting insights into high-level corruption in transition economies. As the ability of firms to buy "decision making" to suit their own interests is a very strong indication of state capture, the researchers asked firm managers to assess the extent to which the sale of state, judicial, and regulatory decisions has had a direct impact on their business. EBRD/World Bank evidence suggests that in most transition economies a small group of firms exercises disproportionate influence over state policies that affect activities of many firms (Table 2).[53]

Firms in the most advanced and least advanced transition economies have more favourable assessments of governance than those in countries that have adopted partial reforms. For the most advanced economies, this reflects strengthened accountability and economic liberalization while for the least advanced, the concept of state capture has little meaning in command economies. For the partial reformers, the survey results reflect the dismantling of the old command system in those economies without the development of functional, market-oriented institutions.

Conclusions

Greatest possible information disclosure is a necessary condition for meaningful public participation in a democratic process. It similarly deepens public interest in accountability by developing greater awareness and understanding of government decisions. By doing so, it enhances confidence in public institutions. There are good reasons to believe that transparency also improves economic efficiency and public administration, and thus it raises standards of living. Secrecy and discretion breed and sustain corruption - adding importance to the clarity of rules and regulations.

While the benefits of greater transparency appear to be overwhelming, opacity and a culture of secrecy persist. Transparency meets obstacles ranging from the legitimate privacy concerns to the desire of rent-seekers to hide their illicit gains and the process by which they get them. It is an obvious threat to all those who gain by controlling access to information. Greater transparency strikes those who build their careers or wealth by having privileged access to information and use it to create new unjust hierarchies. Greater transparency also represents a risk to all those who live and take advantage of unclear rules and regulations. Finally, in many parts of the world, transparency runs counter to entrenched beliefs that governments need not to be accountable to their constituents.

Increasing transparency is therefore not an easy task. To begin with transition economies could attempt to follow these few simple yet demanding "policy rules". First, citizens must limit discretionary powers of their bureaucrats to the areas where discretion is unavoidable. Second, bureaucrats must design and enforce simple and uniform rules as opposed to differentiated ones. Third, citizens must demand protection against unpredictable or frequent change to the rules. Finally, to allow for constructive participation and to avoid state capture by vested interests, individuals, firms and civil society must be engaged at arm's length in policy formulation and implementation.

[52] See EBRD Transition Report 1999, Chapter 6 and J.S. Hellman, G. Jones and D. Kaufmann, Seize the State, Seize the Day, An Empirical Analysis of State Capture and Corruption In Transition, paper prepared for the *ABCDE 2000 Conference*, 13 April 2000.

[53] One may ask if this not also increasingly the case in many advanced market economies.