



# IMF POLICY PAPER

## REVIEW OF 1997 GUIDANCE NOTE ON GOVERNANCE—A PROPOSED FRAMEWORK FOR ENHANCED FUND ENGAGEMENT

April 2018

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its April 6, 2018 consideration of the staff report.
- The **Staff Report**, prepared by IMF staff and completed on March 9, 2018 for the Executive Board's consideration on April 6, 2018.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

Electronic copies of IMF Policy Papers  
are available to the public from  
<http://www.imf.org/external/pp/ppindex.aspx>

**International Monetary Fund**  
**Washington, D.C.**



INTERNATIONAL MONETARY FUND



Press Release No. 18/142  
FOR IMMEDIATE RELEASE  
April 22, 2018

International Monetary Fund  
Washington, D.C. 20431 USA

### **IMF Executive Board Approves New Framework for Enhanced Engagement on Governance**

On April 6, 2018, the Executive Board of the International Monetary Fund (IMF) adopted the policy framework outlined in a staff paper on “Review of 1997 Guidance Note on Governance—A Proposed Framework for Enhanced Fund Engagement.” The new framework supplements the policy on governance detailed in “The Role of the IMF in Governance Issues: Guidance Note,” adopted by the Executive Board in 1997 (1997 Governance Policy). The approach taken in this paper builds on the July 21, 2017 Board discussion of the staff paper—“The Role of the Fund in Governance Issues—Review of the Guidance Note-Preliminary Considerations.”

The 1997 Governance Policy was adopted to guide the IMF’s efforts in helping its member countries to address governance and corruption issues. The July 2017 Board review of the 1997 Governance Policy found that, while considerable progress had been made in implementing the Policy, there remained several areas in which the IMF’s engagement on governance and corruption issues could be strengthened. The current paper responds to the Executive Board’s call for further work to strengthen the identified areas of engagement.

The paper articulates the principles that will continue to underpin the Fund’s engagement on governance issues in surveillance and use of Fund resources, and provides a framework for enhanced implementation (Framework for Enhanced Fund Engagement). The Framework is designed to promote more systematic, effective, candid, and evenhanded engagement with member countries regarding governance vulnerabilities, including corruption, that are judged to be macroeconomically critical.

The Framework consists of four elements:

The first element is designed to enable the Fund to assess the nature and severity of governance vulnerabilities—including corruption. This includes an assessment of those state functions that are most relevant to economic activity, namely (i) fiscal governance; (ii) financial sector oversight; (iii) central bank governance and operations; (iv) market regulation; (v) rule of law; and (vi) Anti-Money Laundering and Combatting the Financing of Terrorism. Given its particularly pernicious impact on a member’s ability to achieve sustainable inclusive growth, the assessment will also examine the severity of corruption.

The second element will guide the Fund's assessment of the macroeconomic implications of governance vulnerabilities taking into account the applicable standards for surveillance and the use of Fund resources. The paper lays out empirical evidence of the negative impact of governance vulnerabilities on economic performance, which provides a strong basis to determine that these vulnerabilities should be addressed in surveillance when they are assessed as severe.

The third element provides a framework for policy advice and capacity development support to members where Fund engagement is warranted.

And, the fourth element focuses on measures designed to prevent the private actors from offering bribes or providing services that facilitate concealment of corruption proceeds.

### **Executive Board Assessment<sup>1</sup>**

Executive Directors welcomed the review of the 1997 Guidance Note on the Role of the Fund in Governance Issues (the "1997 Governance Policy"). They concurred that, while the 1997 Governance Policy remains an appropriate basis for the Fund's work in this area, further guidance from the Executive Board is needed to enhance the effectiveness of Fund engagement. To that end, they noted that today's adoption of the Framework for Enhanced Fund Engagement will promote a more systematic, candid, and evenhanded engagement on governance issues, including on corruption. Directors underscored that, in circumstances where corruption is systemic, the failure of the Fund to address these issues in surveillance and in Fund-supported programs gives rise to reputational risks and could also undermine the safeguarding of Fund resources.

Directors agreed that the Fund's engagement should continue to be guided by the 1997 Governance Policy. They emphasized that the overall objective of the policy is to assist members in strengthening governance, including the tackling of corruption. Directors welcomed the systematic approach relied on in the Framework for Enhanced Fund Engagement to assess the severity of governance. They concurred that the state functions identified are appropriate given the Fund's mandate regarding economic activity. In that context, they emphasized that the analysis of the rule of law should focus on those aspects that are critical to economic performance and, in particular, the protection of property and contractual rights. Directors also emphasized that governance vulnerabilities may manifest themselves in regulatory capture, including in the area of financial sector oversight.

Directors agreed that the Fund's assessments of governance vulnerabilities should be holistic, relying on both quantitative and qualitative information. They also agreed that, to the extent possible and where relevant, staff would rely on information already obtained by the Fund, including from member authorities, in the context of existing Fund activities. In that regard,

---

<sup>1</sup> An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Directors emphasized that, whenever data gaps exist, they should be specifically acknowledged. They also stressed that the use of third-party indicators should be consistent with the Fund's policy in this area, and should only complement—and not displace—the analysis of Fund staff and that of other international organizations, including the World Bank and regional development banks. They noted that collaboration with these organizations, and the use of information provided by them, will be consistent with Fund policy. Directors agreed that the Fund should not publish country rankings of its assessment of corruption or other general governance vulnerabilities.

Directors also agreed that the Fund should continue to address governance issues and corruption in surveillance when the applicable standard of the Integrated Surveillance Decision has been met. Given the evidence of the negative association between weak governance and corruption, on the one hand, and inclusive growth and fiscal performance, on the other hand, Directors agreed that a determination as to whether governance and corruption vulnerabilities are relevant to surveillance will be based on an assessment of whether they are sufficiently severe to significantly affect prospective or present balance of payments and domestic stability. They supported the flexibility in the timing of the inclusion of these issues—where warranted—in Article IV consultations, in line with the approach taken for other long-term issues. With respect to use of Fund resources (UFR), Directors emphasized that reforms to address governance and corruption vulnerabilities should be conditions for UFR when these vulnerabilities are assessed as severe and addressing them is of critical importance for achieving the goals of a member's program. Directors also stressed the need to recognize any ongoing governance reforms in the member country since the responsibility for governance issues lies primarily with the national authorities.

Directors emphasized that Fund policy advice should be informed by the diagnosis of the vulnerabilities, and be specific and tailored to member countries' circumstances and implementation capacity, taking into account the inherent complexity of these issues. They stressed the importance of early and close engagement with the authorities on these issues. Directors also emphasized that, in the context of surveillance, the authorities' own views should be adequately reflected in the relevant staff report. The authorities will be informed sufficiently in advance of the intention to discuss these issues and the discussions will be open and transparent. Directors underscored the need for candid discussions in staff reports, using clear and direct language.

Directors acknowledged that there are likely to be areas where the Fund does not have a comparative advantage relative to other international institutions. They, therefore, urged the staff to continue to rely on the expertise of other institutions, especially the World Bank, in these areas. More generally, they noted that the Fund should collaborate with other institutions to minimize duplication of work. For example, with respect to AML/CFT, Directors emphasized that the Fund should continue to rely on existing division of responsibilities with other assessor bodies, particularly the FATF.

With respect to capacity development in governance and corruption, Directors agreed that the Fund's support to member countries should be appropriately prioritized with—and well-integrated into—surveillance and UFR. Given that entrenched weaknesses require sustained efforts, particularly in the context of fragile states, Directors emphasized that the Fund's capacity development strategy in this area needs to be anchored within a longer-term framework.

Directors supported the increased emphasis in the Framework on measures to prevent private actors, including those involved in organized crime, from offering bribes or providing services that facilitate concealment of corruption proceeds, thereby helping to reduce illicit financial flows. Given the importance of the transnational dimension, Directors welcomed the decision made by several jurisdictions to volunteer to have their legal and institutional frameworks assessed in the context of future Article IV consultations, and encouraged other jurisdictions to volunteer as well. The assessments will determine whether: (a) they criminalize and prosecute the bribery of foreign public officials; and (b) they have an effective AML/CFT system that is designed to prevent foreign officials from concealing the proceeds of corruption. Directors emphasized that these assessments should also take into account the effectiveness of implementation.

Directors took note of Management's plan to adopt a centralized institutional process for the assessment of the severity and impact of governance and corruption vulnerabilities to ensure that similarly-situated countries are treated similarly in both surveillance and UFR. The centralized process will be implemented by a standing Working Group with a key role in ensuring an evenhanded implementation of the Framework.

Directors welcomed Management's intention to assess the resource implications of the application of the Framework in the Administrative Budget for FY 2020. They looked forward to regular updates from the staff on the implementation of the Framework and a review by the Executive Board within three years of its adoption.



March 9, 2018

## REVIEW OF 1997 GUIDANCE NOTE ON GOVERNANCE—A PROPOSED FRAMEWORK FOR ENHANCED FUND ENGAGEMENT

### EXECUTIVE SUMMARY

1. This paper proposes the adoption of a framework that would supplement the 1997 Fund's Guidance Note on the Role of the Fund in Governance Issues, adopted by the Executive Board (the "1997 Governance Policy"). While the 1997 Governance Policy remains an appropriate basis for the Fund's work in this area, further guidance from the Executive Board is needed to ensure that the objectives of that policy are achieved. Experience over the past 20 years has underscored the critical impact that governance issues can have on the Fund's work. In particular, there is evidence that corruption can have a pernicious effect on a country's ability to achieve sustainable, inclusive economic growth. As requested by the Executive Board, the proposed Framework for Enhanced Engagement by the Fund ("Framework for Enhanced Fund Engagement") is designed to promote more systematic, effective, and candid engagement with member countries regarding those governance vulnerabilities, including corruption, that are judged to be macroeconomically critical. Perhaps most importantly, the application of the Framework for Enhanced Fund Engagement to all members on a systematic basis will enhance evenhandedness. Finally, the Framework is designed to strengthen the global fight against corruption by promoting governmental measures that prevent private actors from offering bribes or providing services that enable the proceeds of corrupt acts to be concealed, particularly in the transnational context.

2. The proposed Framework for Enhanced Fund Engagement consists of four elements:

(A) The first element is designed to enable the Fund to assess the nature and severity of governance vulnerabilities—including corruption—on a systematic basis. This is achieved through an assessment of those state functions that are most relevant to economic activity; namely: (i) fiscal governance; (ii) financial sector oversight; (iii) central bank governance and operations; (iv) market regulation; (v) rule of law; and (vi) Anti-Money Laundering and Combatting the Financing of Terrorism (AML/CFT). While the sources of information to be relied upon to make this assessment will evolve, the Framework sets forth principles that will guide both the selection and use of information. Corruption would also be assessed based on the same principles, with a recognition that, given its particularly harmful impact on the economy, it is imperative

that it be addressed specifically and forthrightly by the Fund when it is judged sufficiently severe to be macro-critical.

(B) The second element will guide the Fund's assessment of the economic impact of the governance vulnerabilities that have been identified, taking into account, in particular, the applicable standards for surveillance (under the Integrated Surveillance Decision) and the use of Fund resources (under the Guidelines on Conditionality). With respect to surveillance, in light of the evidence of the long-term impact of governance vulnerabilities, it is proposed that a determination as to whether these vulnerabilities are relevant to surveillance will be based on an assessment of their severity, irrespective of whether there is evidence of their short-term impact on the economy. For purposes of determining whether reforms to address governance vulnerabilities should be a condition for the use of the Fund's resources, the Fund will assess whether addressing these vulnerabilities is of critical importance for achieving the goals of the member's program.

(C) The third element will guide the policy recommendations provided by the Fund, which will be informed by the diagnosis of the vulnerabilities, be candid and discussed with authorities, whose views should be accurately reflected in staff reports. In those areas that are outside the Fund's area of competence, the Fund will rely on the expertise of other international institutions, particularly the World Bank. Where corruption is assessed as severe, the approach would rely on a multi-pronged strategy that promotes not only specific anti-corruption measures but also broader regulatory and institutional reforms, taking into consideration the circumstances of the member. The diagnosis of the vulnerabilities that are made for purposes of surveillance and conditionality will also help to prioritize the agenda for the Fund's support to capacity development in the country under consideration.

(D) The fourth element will involve an assessment of governmental measures to prevent private actors from offering bribes or providing services that enable the proceeds of corrupt acts to be concealed, particularly in the transnational context. More specifically, irrespective of whether a member country is experiencing severe corruption, the Fund would urge the member to volunteer to have its own legal and institutional frameworks assessed in the context of bilateral surveillance for purposes of determining whether: (a) it criminalizes and prosecutes the bribery of foreign public officials; and (b) whether it has an effective AML/CFT system designed to prevent foreign officials from concealing the proceeds of corruption—both of which address the transnational facilitation of corruption.

3. It is proposed that experience with the application of the Framework for Enhanced Fund Engagement be reviewed within three years.

Approved By  
**Messrs. Gaspar,  
Hagan, Mühleisen,  
and Obstfeld**

This paper was prepared by an inter-departmental team consisting of Olivier Basdevant, Anja Baum, Jan Gottschalk, Clay Hackney, Paulo Medas, Florian Misch, Baoping Shang (all FAD), Paul Ashin, Chady El Khoury, Alice French, Gomiluk Otokwala, Hoang Pham, Sebastiaan Pompe (all LEG), Alessandro Cantelmo, Davide Furceri, Giovanni Melina, Chris Papageorgiou (all RES), Ashvin Ahuja, Kevin Greenidge, Murna Morgan, Zsuzsa Munkacsi, Haimanot Teferra (all SPR), under the supervision of Paolo Mauro (FAD), Ceda Ogada (LEG), Jonathan D. Ostry (RES), and Sean Nolan and Zeine Zeidane (SPR). Technical and administrative support was provided by Suryanarayana Gopavajhala and Sandra Otero de Solares (all LEG).

## CONTENTS

Glossary	5
<b>I. INTRODUCTION</b>	<b>6</b>
<b>II. UNDERLYING PRINCIPLES</b>	<b>8</b>
<b>III. ADDRESSING GOVERNANCE VULNERABILITIES: A PROPOSED FRAMEWORK FOR ENHANCED FUND ENGAGEMENT</b>	<b>12</b>
A. Assessing the Nature and Severity of Governance Vulnerabilities	12
B. Assessing the Economic Impact of Governance Vulnerabilities	19
C. The Provision of Policy Advice	22
D. Combating the Facilitation of Corruption	25
<b>IV. NEXT STEPS</b>	<b>31</b>
References	33
<b>BOXES</b>	
1. Definition of Corruption	10
2. Fiscal Governance and Reduced Vulnerabilities to Corruption	14
3. Corruption Indicators	18
4. The Fund's Recent Engagement on Governance in Use of Fund Resources and Surveillance: Ukraine and Mexico	24
5. Nexus Between Organized Crime and Corruption	26
6. The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions	27
7. UNCAC Provisions on Bribery of Foreign Public Officials	28
8. AML/CFT Requirements Relevant to the Facilitation of Corruption	30



**ANNEXES**

1. Addressing Governance Vulnerabilities—A Framework for Enhanced Fund Engagement _____	37
2. A Meta-Analysis of the Impact of Corruption and Quality of Governance on Growth _____	41
3. Corruption/Governance and Inclusive Growth: Empirical Analysis _____	44
4. Improving Governance: General Equilibrium Analysis Using a Macroeconomic Model _____	52

## Glossary

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BMA	Bayesian Model Averaging
CDD	Customer Due Diligence
DIG	Debt-Investment-Growth
DNFBPs	Designated Non-Financial Businesses and Professions
ECF	Extended Credit Facility
EDEI	Equality Distributed Equivalent Income
EFF	Extended Fund Facility
EITI	Extractive Industry Transparency Initiative
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FE	Fixed Effects
FSAP	Financial Sector Assessment Program
GCB	Global Corruption Barometer
GMM	Generalized Method of Moments
ISD	Integrated Surveillance Decision
LICs	Low-Income Countries
OCG	Organized Criminal Groups
OECD	Organization for Economic Cooperation and Development
PEPs	Politically-Exposed Persons
SOE	State-Owned Enterprise
UFR	Use of Fund Resources
UNCAC	United Nations Convention Against Corruption
VAT	Value-Added Tax
WALS	Weighted-Average Least Squares
WGI-CCI	Worldwide Governance Indicator Control of Corruption Index

## I. INTRODUCTION

1. **This paper proposes the adoption of a Framework for Enhanced Fund Engagement that would supplement the 1997 Guidance Note on the Role of the Fund in Governance Issues (the 1997 Governance Policy).**<sup>1</sup> While the 1997 Governance Policy remains an appropriate basis for Fund engagement in governance, the Framework for Enhanced Fund Engagement is needed to provide more detailed guidance about when and how the Fund should engage—particularly in surveillance and use of Fund resources. The additional guidance is intended to enhance the effectiveness of the Fund’s role as well as to ensure greater evenhandedness in the treatment of members. This review takes place in a broader context where changes in the global economic landscape over the past 20 years warrant a renewed focus by the Fund on governance and corruption issues. In particular, growing inequality – exacerbated by corruption - undermines public trust in governments across many countries. In this environment, governance weaknesses and corruption fuel public discontent and take a toll on sustainable, inclusive growth, potentially leading to civil conflict and serious economic consequences.

2. **The approach taken in the paper reflects guidance provided by Executive Directors during the July 21, 2017 Board discussion of the staff paper—“The Role of the Fund in Governance Issues—Review of the Guidance Note-Preliminary Considerations.”** Directors broadly agreed that, despite progress made in addressing governance issues, there remains significant scope for strengthening the Fund’s engagement with members, particularly in the area of corruption.<sup>2</sup>

3. **Directors generally concurred that, while the 1997 Governance Policy properly called on the Fund to address corruption in member countries when it is assessed to have a significant macroeconomic impact, there had been an increasing recognition since then of the particularly pernicious effects that systemic corruption has on economic performance.**<sup>3</sup> This recognition calls for a more robust engagement by the Fund. Several areas where the Fund’s existing practice could be strengthened were identified, including the extent to which corruption is covered in Fund engagement. Coverage of corruption was found to have varied significantly even among countries facing similar corruption challenges. To ensure adherence to the principle of uniformity of treatment, Directors called for the development of approaches that would promote

---

<sup>1</sup> IMF, 1997a and Concluding Remarks by the Chairman; IMF, 1997b

<sup>2</sup> IMF, 2017a.

<sup>3</sup> IMF, 2016 defines “systemic corruption” as circumstances where “corruption is no longer a deviation from the norm, but is manifested in a pattern of behavior so pervasive and ingrained that it becomes the norm.” “Systemic corruption” has also been defined as corruption that “is both pervasive and organized, affecting different levels of government, and practiced by bureaucrats and politicians alike in nearly all government departments”. See Alam, M. Shahid, 1989, at pp. 441–456.

more systematic and evenhanded Fund engagement in terms of coverage of governance and corruption issues. Directors also highlighted the need for robust methodologies for evaluating the link between corruption and macroeconomic outcomes (including inclusive growth), and increased collaboration with the World Bank, other institutions, the private sector and civil society organizations, in order to leverage their respective expertise on governance issues. Many Directors saw a need for greater clarity and directness in staff reports about corruption and other Directors considered that the Fund’s work should address both the demand and supply sides of corruption.<sup>4</sup> Accordingly, most Directors agreed that more specific Board-endorsed guidance is needed to ensure consistency in assessing the nature, sources, extent, transmission channels, time horizon, and impact of corruption. Such guidance is also needed in tailoring the Fund’s policy advice and program conditionality, taking into account member countries’ implementation capacity and anti-corruption measures already in place.

4. **While calling for the Fund to strengthen its coverage of corruption issues in cases where its engagement is warranted, Directors also agreed “that the Fund should maintain its focus on broader governance issues and institution-building.”** They appreciated the importance and value of this broader governance work, in its own right, in helping members to improve performance in areas such as public financial management, financial sector assessments, central bank governance, and AML/CFT. At the same time, they noted that, while broader governance reforms were not always specifically targeted at corruption, these often played an important role in helping to limit opportunities for corruption.

5. **In addition to the views expressed at the July 2017 Board meeting, this paper also takes account of subsequent informal discussions with Directors.** These include the informal session to engage on February 23, 2018 and a series of bilateral and group discussions prior to the informal session. The paper also draws upon the policy on the Use of Third-Party Indicators in Fund Reports that was approved by the Board on November 10, 2017 and which remains appropriate. Also, taking into account the concerns raised by a number of Directors at the July 2017 meeting, the paper does not propose that the Fund publish country rankings of its assessments of corruption or other general governance vulnerabilities.

6. **This paper articulates the principles that will continue to underpin the Fund’s engagement on governance issues in bilateral surveillance and use of Fund resources, and provides a framework for enhanced and evenhanded implementation.** The next section (Section II) outlines the principles. Section III draws on the principles to identify four key elements for more systematic, evenhanded engagement with members: the first element would assess the nature and severity of governance weaknesses, including those arising from corruption; the second element would assess the macroeconomic implications of those weaknesses; the third element

---

<sup>4</sup> These terms were popularized by the Organization of Economic Cooperation and Development (OECD) in the context of its 1999 Convention on Combating Bribery of Foreign Public Official in International Business Transactions. They are generally used in the context of bribery where every transaction involves a supply side (the briber who offers, promises, or authorizes a bribe) and a demand side (the public official who solicits or receives a bribe). See OECD, 2000.

would provide a framework for policy advice to members where Fund engagement is warranted; and the fourth element would focus on measures designed to prevent the facilitation of corruption by the private sector. Section IV introduces the text of the Framework for Enhanced Fund Engagement proposed for adoption by the Executive Board and identifies next steps required if the Board were to adopt the Framework.

## II. UNDERLYING PRINCIPLES

7. **Several principles underpinning the 1997 Governance Policy—and the Fund’s mandate more generally—are relevant when considering the proposed Framework for Enhanced Fund Engagement.** As will be seen, these principles also take account of policies that have been adopted since 1997, including the Integrated Surveillance Decision (ISD)<sup>5</sup> and the Guidelines on Conditionality.<sup>6</sup>

8. **First, the Fund should continue to engage with its members on governance and corruption issues in bilateral surveillance and in the use of Fund resources when they are deemed sufficiently severe that they become relevant under those activities.** The 1997 Governance Policy established a general standard: Fund involvement should be guided by whether poor governance or corruption 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. This standard was not substantially changed by later decisions adopted for surveillance in 2007 and 2012 and program work in 2002. As discussed in further detail in Section III, in bilateral surveillance, this means that governance weaknesses should be addressed when they are sufficiently severe to “significantly influence present or prospective balance of payments and domestic stability” as called for by the ISD.<sup>7</sup> With respect to use of Fund resources, measures to address governance and corruption weaknesses will be established as conditions under a Fund-supported program if they are “of critical importance for achieving the goals of the member’s program” as provided by the Guidelines on Conditionality.<sup>8</sup> In the course of informal discussions, a number of Executive Directors also noted that, while the macro-criticality standard embodied in the above policies should be the primary criterion for determining when the Fund engages in governance issues, consideration should also be given to the reputational risk that arises when the Fund does not address corruption issues in surveillance or use of Fund resources. It should be noted that, where concerns regarding corruption in a member country are so severe that the failure by the Fund to address the issue would give rise to significant reputational issues, it is likely that such corruption will satisfy the macro-criticality standard under the relevant policies.

<sup>5</sup> IMF, ISD, 2012.

<sup>6</sup> Guidelines on Conditionality, as amended, adopted September 25, 2002.

<sup>7</sup> IMF, ISD, 2012, at paragraph 6.

<sup>8</sup> Guidelines on Conditionality, at paragraph 7(a).

9. **Second, when they become relevant for surveillance and use of Fund resources, the Fund’s assessment of governance vulnerabilities should not be limited only to those arising from corruption.** While corruption—identified in the 1997 Governance Policy “as the abuse of public office for private gain”<sup>9</sup>—can have a particularly pernicious effect on economic performance, the 1997 policy did not treat it in isolation, but considered it within the overall rubric of governance issues. (Box 1 identifies the elements of corruption that have become widely-accepted by the international community.) Addressing governance problems—and not just corruption—is justified for several reasons. From the outset, the 1997 policy recognized that other governance weaknesses, including those arising from lack of capacity or from inefficiency, can also be macro-critical, even when there is no evidence of corruption.<sup>10</sup> Further, an effective anti-corruption strategy will usually require broader governance reforms to curb incentives and opportunities for corruption.<sup>11</sup> Finally, as discussed in Section III, an assessment of broader governance weaknesses can bolster an assessment of the severity of corruption, the latter being more difficult to demonstrate, owing to its mostly hidden nature. However, as noted in the July 2017 Board paper, the concept of governance encompasses the “institutions, mechanisms and practices through which governmental power is exercised in a country.”<sup>12</sup> If such a broad definition were to be applied, all of the Fund’s policy dialogue with the member could be characterized as a dialogue regarding governance, which is not the intention. To retain focus, it is proposed that when identifying the governance issues to be covered by the Framework, the selection of issues will take into account governance weaknesses that are typically associated with corruption. It is recognized that, even when such weaknesses do not, in fact, evidence corruption in a particular case, addressing them may be macro-critical and, accordingly, would need to be a priority.<sup>13</sup>

10. **Third, while many of the relevant areas of governance are within the Fund’s expertise (for example, in the fiscal area), the Fund will need to rely on the work of other institutions when this is not the case.** The 1997 Governance Policy explicitly recognizes that governance weaknesses outside of the Fund’s area of expertise may have an important economic impact. In such instances, reforms in those areas may need to “be part of the Fund staff’s policy discussions and conditionality for the Fund’s financial support where those measures were necessary for the achievement of program objectives.”<sup>14</sup> In these cases, however, both the 1997 Policy and the July 2017 Board discussion call for the Fund to rely on the comparative advantage of other institutions, especially the World Bank. As will be seen in

<sup>9</sup> IMF, 1997a, at paragraph 2, Footnote 3.

<sup>10</sup> During the Eurozone crisis, addressing weaknesses in the capacity of the judiciary to enforce commercial claims in a timely and predictable manner was an important element of some Fund-supported programs, even in cases where these weaknesses were not the result of corruption.

<sup>11</sup> For instance, while a credible threat of prosecution may be an important means of deterring corrupt practices, changing the incentive structure will often require reforms that are not exclusively focused on criminal prosecution, such as institutional and regulatory reform and improvements in transparency and accountability.

<sup>12</sup> IMF, 2017a, at p.6.

<sup>13</sup> Governance is an inherently neutral term describing the framework for exercising authority, not characterizing its results. Good governance is a more normative concept, which recognizes that the quality of governance can impact its effectiveness and efficiency in achieving desired results. See *ibid.*

<sup>14</sup> IMF, 1997a, at paragraph 6.

subsequent sections, the design and implementation of a comprehensive and systematic approach to both assessing and advising on governance issues will necessitate even closer co-operation with institutions that the Fund typically partners with in the discharge of its functions.

### Box 1. Definition of Corruption

**The definition of corruption used in the 1997 Guidance Policy is “abuse of public office for private gain,”** a definition that, as noted in the 1997 Guidance Policy, is one that is also relied upon by the World Bank. There is no intention to change this definition.

**However, a key issue that arises in the application of this definition is the determination of the type of acts that constitute an “abuse” of public office.** The core set of acts that are almost universally recognized as being “corrupt” are those that involve criminality. In particular, the United Nations Convention Against Corruption (UNCAC),<sup>1</sup> which 183 state parties have ratified, identifies a core set of corrupt acts that state parties are required to criminalize. Accordingly, given the number of UNCAC signatories, these acts may be understood as those acts that are generally recognized as constituting corruption. The following acts fall within this mandatory category: (i) the offer of a bribe to a public official (Article 15(a)); (ii) the acceptance of a bribe by a public official (Article 15(b)); (iii) the offering of a bribe to a foreign public official or an official of a public international organization (Article 16(1)); (iv) the embezzlement, misappropriation or other diversion of funds by a public official (Article 17); (v) the laundering of the proceeds of crime, including the proceeds of corruption (Article 23); and (vi) obstruction of justice in relation to the prosecution of crimes covered by UNCAC (Article 25).<sup>2</sup>

**Even if actions that arise from governance vulnerabilities are not criminal in nature, they may nevertheless have a significant detrimental economic impact.** In these cases, while they would not be described as giving rise to corruption, they would still potentially fall within the scope of the policy, which as noted above deals with governance vulnerabilities that may not be associated with corruption. However, acts that exclusively involve the private sector (e.g., fraud) would not be covered—rather they would only be covered to the extent to which they involve a transaction with a public official abusing his office. This can arise through the offering of a bribe or the provision of services by a private actor that enables a public official to conceal the proceeds of his or her corrupt acts.

<sup>1</sup> UNCAC, 2003

<sup>2</sup> In addition, the UNCAC identifies acts that signatories should “consider” criminalizing. These “non-mandatory” acts include bribery in the private sector and illicit enrichment. Beyond the UNCAC, “corruption” is often – but not always – used to describe acts that violate noncriminal laws (e.g. violation of conflicts of interest laws).

11. **Fourth, an effective strategy requires action to curb the facilitation of corrupt practices by private actors, particularly in the transnational context.** The facilitation may originate in countries other than the country that is experiencing severe corruption. To address this problem, it will be important to engage with these countries to ensure that they have in place effective systems designed to both prosecute bribery of foreign officials and prevent foreign officials from concealing the proceeds of corruption.

12. **Fifth, in making assessments on governance issues, the Fund should continue to avoid interfering in domestic or foreign politics of a member or expressing views on the design of**

**particular political systems.** The 1997 Governance Policy recognizes that “it is difficult to separate economic aspects of governance from political aspects.”<sup>15</sup> Indeed, experience suggests that governance reform—particularly an anti-corruption strategy—can have important political implications where corrupt practices are attributable to high-level public officials. Conversely, a failure to address widespread corruption can create political instability, with important economic consequences. Nevertheless, as established in the 1997 Governance Policy, “the IMF’s judgments should not be influenced by the nature of the political regime of a country, nor should it interfere in domestic or foreign politics of any member,” even though it would need “to take a view on whether the member is able to formulate and implement appropriate policies.”<sup>16</sup> This principle of non-interference in domestic or foreign politics was also reaffirmed by the Board at the July 2017 meeting.

13. **The application of the principle regarding non-interference in political issues will require the exercise of judgment, taking into account the circumstances of each case.** For example, there may be situations where the senior public officials of a country abuse their offices to such an extent that significant portions of the economy are regulated and controlled for the benefit of private interests (often referred to as “state capture”). Alternatively, senior public officials may engage in embezzlement, extortion or intimidation of the private sector for the purpose of enriching themselves, their families and their associates (often referred to as a “kleptocracy”). Under the 1997 Policy, the above behaviors would be subject to Fund scrutiny, because the problem arises from criminal abuse of office by specific individuals or groups rather than from the design of the political system. Moreover, there may be cases of regulatory capture—e.g., undue influence by the financial sector on the financial supervisory agencies—where, although there is no evidence of criminality, governance vulnerabilities can become macro-critical and should be the subject of Fund scrutiny.

14. **Finally, the Fund should continue to avoid interference in individual enforcement cases.** As noted in the 1997 Governance Policy, “the IMF’s mandate and resources do not allow the institution to adopt the role of an investigative agency.”<sup>17</sup> This principle was re-emphasized by the Board at the July 2017 meeting. There have been circumstances where a corruption scheme has been judged to have significant macro-economic implications—either because of the magnitude of the amounts involved or because it is perceived as signaling broader systemic problems. Even in such cases, however, the Fund has avoided interfering in the investigation or prosecution of such a scheme. Rather, it has focused on system-wide reforms needed to address problems that have been revealed, which should be based on candid discussions with the authorities. Where allegations of corruption have arisen in relation to a specific set of transactions in the context of a program and these allegations have created uncertainty with respect to the program’s viability, the furthest the Fund has been prepared to go is to condition further access to its resources upon the conduct of an

---

<sup>15</sup> IMF, 1997a, at paragraph 7.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid, at paragraph 8.



independent audit and to make the results of such an audit available to relevant national authorities in accordance with domestic law.

### III. ADDRESSING GOVERNANCE VULNERABILITIES: A PROPOSED FRAMEWORK FOR ENHANCED FUND ENGAGEMENT

15. **This section proposes a framework for more effective and evenhanded engagement on governance issues in the context of both bilateral surveillance and the use of Fund resources.**

This Framework, based on the principles described above, consists of four elements.

- The first element will enable the Fund to assess the nature and severity of governance weaknesses—including corruption—on a systematic basis with respect to all members.
- The second element will guide the Fund’s assessment of the economic impact of the governance weaknesses that have been identified.
- The third element will guide the Fund’s policy advice in circumstances where—on the basis of the first two elements above—Fund engagement is justified.
- The fourth element will involve an assessment of governmental measures to prevent private actors from offering bribes to foreign officials or providing services that enable such officials to conceal the proceeds of their corrupt acts.

The Framework will continue to be developed in the light of its implementation. As more countries are covered, the depth of understanding and analysis will improve over time.

#### A. Assessing the Nature and Severity of Governance Vulnerabilities

16. **To ensure a systematic and consistent assessment of governance vulnerabilities across the Fund’s membership, the framework would identify those governmental functions that are most relevant to economic performance.** Taking into account inputs from the Executive Board during the July 2017 discussion, the relevant categories of state functions to be included in the proposed framework would be: (a) fiscal governance; (b) financial sector oversight; (c) central bank governance and operations; (d) quality of market regulation; (e) rule of law; and (f) AML-CFT. These categories were also identified as being of particular relevance in the 2016 Staff Discussion Note, “Corruption: Costs and Mitigating Strategies.”<sup>18</sup>

---

<sup>18</sup> IMF, 2016.

## Identifying the Relevant Issues to be Assessed

17. **Having identified the relevant categories of state functions, this element of the framework would also identify the key issues that need to be addressed in each category for the purpose of assessing the nature and severity of any governance vulnerabilities.** Although this examination is designed to address vulnerabilities in governance generally, the selection of the issues to be addressed takes into account those governance vulnerabilities that are typically associated with corruption. Set forth below are descriptions of the key issues that would be addressed in each of the relevant categories. The assessment would not only look at the legal, policy and institutional frameworks in place under each of these categories, but also at the effectiveness of the implementation of the frameworks.

18. **Fiscal Governance**—Weaknesses in fiscal governance—the institutional frameworks and practices of the public sector (central government, subnational governments, and public corporations)—can have harmful effects in three areas. First, weak practices in tax administration, including those arising from corruption, can weaken a state’s ability to collect revenues, with adverse consequences for deficits, debt accumulation, and the ability to provide public services. Second, on the expenditure side, weaknesses in public financial management (including procurement) can generate inefficiencies and inflate costs. Moreover, corruption can distort expenditure choices away from those beneficial for inclusive growth and toward wasteful subsidies or hard-to-price projects that generate greater kickbacks. Third, insufficient fiscal transparency can undermine accountability and provide opportunities for misappropriation of public funds. A systematic assessment of weaknesses in these three governance areas can inform a dialogue on potential policy measures that would reduce vulnerabilities to corruption (see Box 2).

19. **Financial Sector Oversight**—Experience demonstrates that weaknesses in the quality of regulation and supervision of the financial sector can lead to financial instability with significant macro-economic implications. An assessment of the quality of the overall supervisory framework would evaluate, among other things, the autonomy of the supervisory agency. For example, in both advanced and developing economies, regulatory capture can undermine the latter’s ability to identify and manage risk. In addition to an assessment of institutional structure, certain aspects of the design of the regulatory and supervisory framework would be examined to determine the extent to which they adequately safeguard the integrity of the financial system and minimize opportunities for corruption. Thus, for example, the capacity of the regulatory framework to preclude connected lending involving public officials would be an area of scrutiny.

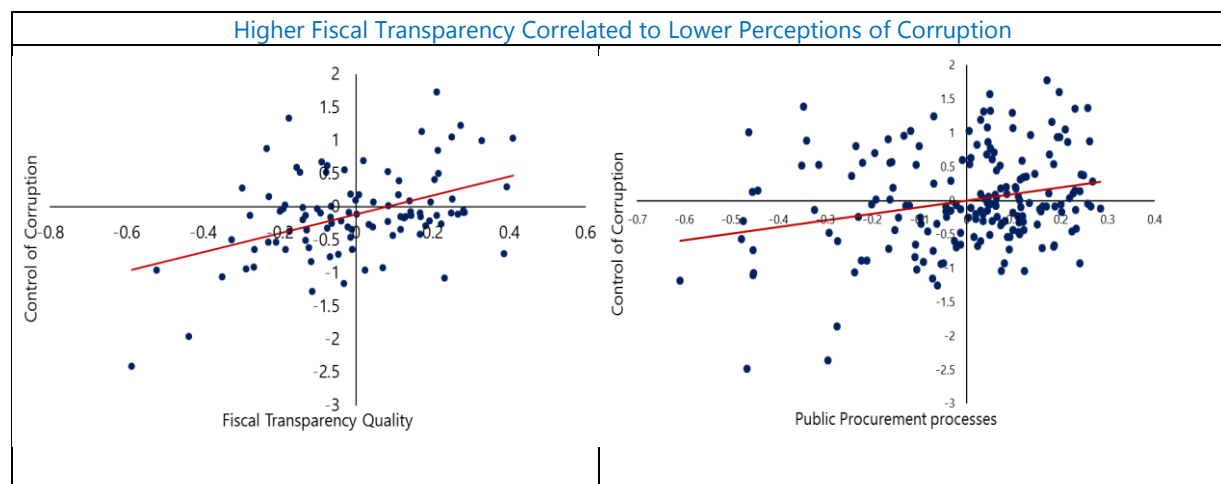
20. **Central Bank Governance and Operations**—While Central Banks are often viewed as one of the most effective institutions within a country, there have, however, been cases where central banks have exhibited severe governance weaknesses. Moreover, in the context of Fund-supported programs, such weaknesses can result in the inappropriate use of the Fund’s resources. When assessing vulnerabilities in the governance and operations of central banks, the issues that would be covered include the adequacy of: (a) the mandate, decision-making structure and autonomy of the central bank; (b) the accountability and transparency framework; and (c) the internal control environment.

### Box 2. Fiscal Governance and Reduced Vulnerabilities to Corruption

**The Fund has long engaged in work on various aspects of governance that help to reduce vulnerabilities to corruption.** In the fiscal area, for example, institutional arrangements and practices to foster transparency, enhance public spending efficiency, and improve revenue administration all reduce the risks of leakage of funds. Although inefficiencies in revenue collection or public spending may stem from various factors, including lack of capacity, better performance in specific areas of fiscal governance helps to curb opportunities that might otherwise be exploited for illicit purposes.

**Measures of fiscal governance can help to inform policy action to reduce vulnerabilities to corruption.** Indicators based on systematically structured information about specific policies or institutional arrangements can facilitate a dialogue about policy measures that can be undertaken by country authorities to reduce vulnerabilities to potential abuse of public power for private gain.

**Cross-country empirical analysis reveals that several indicators of good fiscal governance are significantly associated with improved control of corruption.** For example, an indicator of fiscal transparency (constructed by staff from systematic questionnaires assessing public access to comprehensive fiscal information; independence and quality of audit processes; etc.) is significantly correlated with a perceptions-based indicator of control of corruption. Similarly, a significant correlation with the control of corruption measure holds for an indicator of the quality of public financial management (from questions about the quality of expenditure controls and procurement, etc.), as well as for an indicator of the quality of tax administration processes (based on questions about limits to personal interactions between taxpayers and officials, limits to discretionary powers of tax officials, etc.) These empirical associations remain significant controlling for the level of GDP per capita (see chart), suggesting that they are not driven by economic development as a third factor determining both good institutions and perceptions of low corruption with economic development.



Sources and notes: The scatter plot reports the residuals of a regression of the control of corruption index (from the Worldwide Governance Indicators database, see Annex 4) on GDP per capita (vertical axis) and (i) the residuals of a regression of an indicator of fiscal transparency (compiled by staff) on GDP per capita and (ii) the residuals of a regression of an indicator of the quality of public procurement (based on the World Bank data) on GDP per capita. The coefficient of correlation is 0.44 (significant at the 1 percent level) for Fiscal Transparency and 0.25 for Public Procurement. A brief discussion of the characteristics of WGI-CCI is provided in Annex 4.

**The empirical patterns outlined above corroborate results from previous studies** (usually based on information at the level of an individual country, reform, or project), which linked detailed practices in public financial management, procurement, audit agencies, and tax administration to reduced scope for corruption (Johnson and others, 2012; World Bank, 2012; DFID, 2015; OECD, 2016).

21. **Market Regulation**—A key function of the state is to regulate the overall market in ways that promote private investment opportunities and minimize opportunities for fraud, abuse and rent extraction. The strength and resilience of the country’s regulatory and institutional frameworks are crucial to achieving a virtuous balance between encouraging private sector involvement and promoting the public good through targeted interventions that address market failures and misaligned incentives, and foster competition. However, regulatory frameworks that are complex, inaccessible, or opaque can create opportunities where public officials are able to exploit discretionary authority in return for inducement, for example, in the granting of licenses and business permits to private companies, or in the exemption from existing regulations, resulting in uncertainty and discriminatory treatment. Similarly, undue discretion in the regulation of international trade can be a source for rent-seeking behavior.

22. **Identifying and addressing vulnerabilities in market regulation is crucial to helping countries meet the dual objectives of business facilitation and avoidance of broad-based corruption as the way to achieve strong and sustainable economic growth.** The proposed market regulation category would entail an examination of the extent to which the complexity and opacity of the regulatory environment, including in the area of trade, creates significant incentives for corruption of public officials, and more generally, hinders private business.

23. **Rule of Law**—The focus would be on those aspects of the rule of law that relate to the protection of property and contractual rights, including the predictability and timeliness of the enforcement of those rights. Weaknesses in this area can, for example, undermine the availability of credit more generally (thereby undermining financial inclusion and investment). Moreover, in the context of a financial crisis, such weaknesses can undermine the ability of the authorities to restructure debt and regain market access. The most important determinant with respect to the enforcement of economic rights is the quality of the judiciary—both in terms of its technical capacity and its independence from private influence and public interference.

24. **There are other aspects of legal enforcement that will be covered under other categories.** For example, it is recognized that high levels of crime can engender corruption and have a devastating impact more generally on governance and the economy (see Box 5). The assessment of the quality of the enforcement of the anti-money laundering framework discussed below, would be of particular relevance in this context. Criminal enforcement is also central to any effective anti-corruption strategy and the assessment of this issue is also discussed below.

25. **AML/CFT**—An evaluation would be made of the adequacy of the AML/CFT framework. Weaknesses in this area can have an adverse impact for two reasons. First, money laundering and related predicate crimes can undermine the stability of a country’s financial system or its broader economy. Second, and as will be discussed in Section III(D), they can facilitate corruption, including at the transnational level, by allowing perpetrators to conceal the proceeds of corrupt acts (see also Box 5). As in other areas, the assessment would focus not only on the adequacy of the legal framework but also on the overall institutional capacity and effective implementation.

## Identifying the Relevant Sources of Information

26. **Having determined the key issues that would need to be addressed when assessing governance vulnerabilities, the next step is to identify the sources of information that would be relied upon for making these assessments.** It is inevitable that the body of sources will evolve over time, as staff engage with member countries on a more consistent basis. Nevertheless, at this stage, it is possible to identify several principles that will guide the staff in both the selection and use of information.

27. **First, to the extent possible and where relevant, staff would rely on information already obtained by the Fund, including from member authorities, in the context of existing activities.** Indeed, many of the above-referenced issues are already covered by the Fund in its activities. In the fiscal area, this includes systematic assessments of the quality of revenue administration, public financial management, and fiscal transparency. For financial sector oversight and AML-CFT, this includes the Financial Sector Assessment Program (FSAP) and Report on Standards and Codes (ROSC). For central bank governance and operations, this includes the Safeguards Assessments. With respect to market regulation, staff's experience in addressing these issues, including through the ongoing focus on macro-structural issues in surveillance, would provide useful information. These Fund instruments should be evaluated to see how they can be made more relevant to governance and corruption concerns. They would be periodically reviewed to take into account experience, methodological developments and country-specific circumstances.

28. **Second, in areas that are not typically covered by the Fund, staff would rely on information provided by other institutions, especially the World Bank.** For instance, in the fiscal area, the Bank has undertaken assessment of the quality of procurements systems, which is relevant for the assessment of the institutional quality of expenditure. To the extent that regulatory issues have not been covered by the Fund in the context of the Article IV, the Bank regularly undertakes assessments of the quality of members' overall regulatory framework in the context of its Country Partnership Frameworks and Systematic Country Diagnostics and other internal country assessments that are used to inform its published evaluations. In the area of rule of law, the Fund would also rely on the work of the World Bank and other institutions.

29. **Third, the assessments would be holistic, relying on both quantitative and qualitative assessments, including indicators.** Some of these indicators are being developed by Fund staff (e.g., tax and expenditure efficiency). With respect to the third-party indicators, although many of them utilize a scoring system, some (or at least their components) are constructed on the basis of qualitative assessment by experts. Third-party indicators will be used to complement—not displace—the quantitative and qualitative analysis of Fund staff and other international organizations, including the World Bank. Any use of third party indicators will be consistent with the recently-approved Board policy in this area.

30. **It is recognized, from the outset, that important information gaps are inevitable due to lack of universal coverage in a number of existing exercises.** Over time, however, such information gaps will be reduced as the Fund engages with its members in both surveillance and use of Fund resources. In the meantime, regular engagement with members in surveillance and use of Fund resources will enable the Fund to bridge some of these gaps by exercising its informed judgment.

### Assessing the Severity of Corruption

31. **As acknowledged by Executive Directors during the July 2017 Board meeting, systemic corruption has a particularly harmful impact on inclusive and sustainable growth.** Many Directors considered that having greater clarity in staff’s reporting and recommendations regarding corruption related issues would be helpful. As noted in the July 2017 stocktaking staff paper, the use of coded and indirect language risks clouding staff analysis and policy recommendations.

32. **Accordingly, while it is appropriate for the Fund to continue to engage on the broader range of governance issues, it is important that corruption is addressed specifically and forthrightly when it is judged to be sufficiently severe.** However, this presents a challenge because it requires assessing the severity of an activity that is mostly hidden. The definition of corruption that is most widely accepted by the membership is one that focuses on criminal activity (i.e., bribery, embezzlement, abuse of function or money laundering, see Box 1). However, it should be recognized that, in cases where corruption is systemic, conclusive evidence of criminality may not exist because the institutions charged with investigating and determining criminality (police, prosecution and courts) may themselves be corrupt or under-resourced. Indeed, as was noted by some Executive Directors during informal consultations, the existence of high-level prosecutions and convictions may signal that there has been progress in tackling corruption, notwithstanding the immediate economic fall-out that could result from the publicity of such cases.

33. **It is envisaged that the approach to be used to assess the severity of corruption would follow the general principles discussed above regarding the sources of information to be relied upon.** In the absence of there being a single “perfect” indicator for corruption, a more holistic approach is required. First, the Fund would not rely on a single third-party indicator but use a range of indicators. A variety of third-party indicators seek to measure corruption, some based on surveys that rely on direct experience (e.g., on how many occasions were you asked to provide a bribe in the past year?), some relying on the analysis of experts, while others are based on surveys of perception both of experts and of the general public (see Box 3). Second, staff would use qualitative assessments made by other international organizations, especially the World Bank. Third, an assessment would be made of the quality of the legal and institutional framework that is charged with combatting corruption. Fourth, staff will use information provided by the authorities, including from national surveys and other stakeholders, as well as staff’s own judgement to form a view on the extent of corruption. Finally, and importantly, the assessments that the Fund has made with respect to the various governance weaknesses described earlier in this section would be used to test the reliability of any preliminary findings on corruption. As noted in the introduction, the Fund will not publish country rankings of its assessments of corruption or other governance vulnerabilities.

### Box 3. Corruption Indicators

**Assessing the nature and extent of corruption in a country is inherently difficult since it is usually a concealed phenomenon that is manifested in a wide variety of behaviors.** In countries where corruption is systemic, direct evidence of corruption such as investigations, indictments, prosecutions and convictions may not exist because law enforcement agencies are themselves corrupt, under-resourced or do not properly perform their functions.

**In response to the measurement problem, various indicators have been developed by practitioners and academics to act as proxies for assessing the severity of corruption.**<sup>1</sup> These indirect measures can be broadly divided into three categories, each with their strengths and weaknesses.

**First, indicators that measure the perception of corruption have a long history and are available for a very large number of countries.** They fall into two subcategories, those based on the perceptions of private sector executives or economic experts, and those based on the perceptions of ordinary citizens. While such indicators have been challenged on the grounds that subjective perceptions may differ from reality, their defenders maintain that they correlate well with more “objective” measures (see below) and that—when it comes to investment decisions, tax compliance, capital flight, and brain drain—perceptions actually matter. Furthermore, the more sophisticated and robust measures of perception are composite indices that tend to minimize the impact of the biases present in any single underlying indicator.

**Second, there is a class of indicators that attempts to measure experience with corruption, or corruption incidence through surveys that ask respondents if they have been solicited for or have actually paid a bribe to an official, typically in the last 12 months.** These indicators also sub-divide into those surveying business executives and those where the respondents are individuals/households. While these indicators can be characterized as more “objective” than perceptions-based indicators, they have the downside of being limited to one specific form of corruption (bribery) and the difficulty of knowing whether respondents are answering candidly on a sensitive topic.

**Third, there are indicators that reflect the strength of anti-corruption institutions.** The sub-categories here are expert analyses of the legal, regulatory, and institutional frameworks (which can be distinguished from expert opinion about the level of corruption noted above) and peer country assessments of compliance with anti-corruption treaty obligations. The strength of these indicators is that they measure observable phenomena, but they can also be faulted for their judgmental component (especially in relation to the expert analyses) and for the danger that compliance assessments may only measure the formal features of the system and not how it is implemented in practice.

**The absence of a single “perfect” indicator of corruption does not mean that any attempt at measurement is fatally flawed.** Rather, the complementary strengths of the various classes of indicators argues for: (i) a holistic approach using multiple indicators to assess different aspects and to “smooth” biases; (ii) transparency and clarity on what is being measured by each indicator; (iii) understanding the source and methodology of the indicators; and (iv) exercising judgement in coming to an overall view.

<sup>1</sup> See generally UNDP, 2015. See also IMF 2017b, at Note III.

34. **A balance will need to be struck in relation to the assessment of corruption.** On the one hand, caution is needed when assessing a phenomenon in which definitive evidence of its existence is elusive. Moreover, in the initial stages of an anti-corruption drive, efforts by a country to tackle corruption may be picked up in perception indices as evidence of increased corruption – when in

fact it represents important progress in this area. On the other hand, a pervasive perception of corruption can, in and of itself, have an important impact on economic performance, including, for example, on levels of investment. Moreover, as noted by Executive Directors, failing to take into account a perception of systemic corruption solely on the grounds that there is no definitive criminal evidence poses reputational risk for the Fund—especially where perceptions of corruption extend to the institutions charged with criminal prosecution and conviction.

## B. Assessing the Economic Impact of Governance Vulnerabilities

### Bilateral Surveillance

35. **Under the ISD, the Fund "will focus on those policies of members that can significantly influence present or prospective balance of payments and domestic stability."**<sup>19</sup> The time horizon for assessing macro-criticality has traditionally focused on the short- to medium-term (up to five years). In recent years, however—and consistent with the reference to "prospective" stability in the ISD—the Fund has included topics in surveillance that are of a structural nature and which may pose longer-term risks to domestic stability. Moreover, as is specified in the ISD, a member is considered by the Fund to be promoting balance of payments stability when it is promoting domestic stability—namely, when, inter alia, it is "endeavor[ing] to direct [its] domestic economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability."<sup>20</sup> Accordingly, policies that pose a significant longer-term threat have also been considered to be relevant for surveillance. Topics include problems raised by ageing (pensions and health spending), inequality, climate change, gender issues and human capital development. In a similar vein, oil exporters need to prepare well in advance for the time when oil reserves are depleted. In many of these cases, the Fund has determined that failure to address these issues would undermine sustainable, inclusive growth which, in turn, poses a risk to prospective stability.

36. **Applying the above standard, there is empirical evidence that improvements in the quality of economic governance and lower levels of corruption are associated with stronger growth and economic stability.** For example:

- A meta-analysis of 149 estimates of the relation between growth and corruption (see Annex 3) suggests that higher levels of corruption are typically correlated with lower growth. In particular, a worsening in the corruption indicator from the 50th percentile to the 25th percentile of the distribution is associated with a decline in GDP per capita growth between 0.4 and 0.5 percentage point. These findings are consistent across different measures of corruption, estimation techniques and control variables for institutional quality. A similar analysis on 125 estimates shows a negative relation between the quality of governance and growth, with the relation being stronger for areas such as regulatory quality or rule of law.

<sup>19</sup> IMF ISD, 2012 at paragraph 6.

<sup>20</sup> IMF ISD, 2012 at paragraph 7.



- Staff estimates from panel regressions (Annex 4) indicate that a deterioration in the control of corruption index from the 50th percentile to the 25th percentile of the distribution is associated with a contemporaneous fall in GDP per capita growth in the range of 0.8–1.4 percentage points. There is also evidence of a significant relationship between corruption and medium-term growth (and long-run GDP levels). Estimates also suggest that worsening corruption (moving from the 50th to the 25th percentile) is associated with declines in investment, FDI, and tax to GDP ratios of 1.6, 1.7 and 0.3 percentage points, respectively. All these results are robust to different measures of corruption.
- Staff estimates using cross-section analysis suggests that corruption and governance are robustly and significantly associated with average long-run per capita growth, investment, and revenue (Annex 4). For example, a deterioration in the corruption (governance) indicator from the 50th percentile of distribution to the 25th percentile of distribution is associated with a drop in long-run per capita growth between 0.1 (0.2) and 0.5 (0.7) percentage point. Deterioration in corruption and governance are also associated with higher inequality (measured by the Gini index) and lower inclusive growth (proxied by the percent change in the Equally Distributed Equivalent Income).<sup>21</sup>
- Finally, staff has extended the IMF Debt-Investment-Growth model (DIG) to capture various channels through which weak governance and corruption affects macroeconomic outcomes. Simulations using this general equilibrium model illustrate how improving governance and reducing corruption could raise the private investment ratio, increase efficiency in taxation and/or public investment, boost real per capita output, create fiscal space and improve debt sustainability (Annex 5).

37. **In light of the above, it is proposed that, a determination as to whether a member’s governance and corruption vulnerabilities significantly affect its prospective or present stability within the meaning of the ISD will be based on an assessment of the severity of these vulnerabilities**, taking into account the application of the assessment framework described in Section III(A) and the overall circumstances of the member. Consistent with the treatment of other long-term issues, if a determination is made that governance and corruption vulnerabilities are sufficiently severe to significantly affect prospective or present balance of payments or domestic stability, there will be flexibility on the timing of its inclusion in the Article IV process. More specifically, the timing of its inclusion will take into account the perceived urgency of governance and corruption vulnerabilities relative to other concerns. Where these vulnerabilities raise immediate concerns—because of their immediate impact on, for example, fiscal sustainability or donor financing—they would need to be discussed at the next Article IV consultation. At a minimum, however, governance and corruption vulnerabilities that are sufficiently severe would be substantively discussed within the context of a medium-term surveillance cycle (normally within

---

<sup>21</sup> See Gaspar et al., 2017.

three years). At its July 2017 meeting, the Executive Board also made clear that in future these discussions need to be clearer and more candid than has previously been the case.

### Use of Fund Resources

**38. With regard to the use of Fund resources, measures to address governance and corruption weaknesses will be established as conditions under a Fund-supported program if they are “of critical importance for achieving the goals of the member’s program” as provided by the Guidelines on Conditionality.<sup>22</sup>**

- Where governance and corruption weaknesses are assessed to be severe in a particular country using the framework described in Section III(A), they will be judged to be “of critical importance for achieving the goals of the member’s program” in those circumstances where a judgement is made that addressing those weaknesses would be required in order to reverse the member’s underlying balance-of-payments problem within the time frame needed to repay the Fund for the use of its resources.
- This is consistent with the traditional approach of applying the standards for using program conditionality narrowly given the requirement that conditionality be parsimonious.
- As with surveillance, the Fund traditionally focused on the short- to medium-term horizon in the use of its resources. In this regard, the Guidelines on Conditionality indicate that programs should be directed to “achieving medium term external viability while fostering sustainable economic growth.”<sup>23</sup> This is generally understood to encompass the repayment period, which is 3¼–5 years for the credit tranches.
- However, in facilities that were established well after the credit tranches, the repayment period has been increasingly lengthened, given the recognition that longer-term periods are required to address entrenched and protracted structural problems under the Extended Fund Facility (EFF) and the Extended Credit Facility (ECF) (up to 4½ -10 years for the EFF, and 5½-10 years for the ECF).
- In any event, even where the repurchase period is shorter, in circumstances where the member is experiencing a balance of payments crisis and has significant governance problems, the types of measures that are recommended as means of addressing these problems—e.g., domestic revenue mobilization, PFM and central bank governance—are already present in many of the Fund’s existing programs as conditionality. Indeed, recent program experience has shown the importance of including anti-corruption measures in program conditionality in some cases, as

<sup>22</sup> Conditionality Guidelines at Paragraph 7(a). Conditionality may also be applied if it is critical for the monitoring of program implementation or for the implementation of specific provisions of the Articles. Other key issues around conditionality are to strengthen capacity to repay the Fund and to thereby mitigate repayment risk.

<sup>23</sup> Conditionality Guidelines at Paragraph 6(b).

well as the importance of national ownership of these measures, which could be developed through joint assessments at an early stage of the program design. This is also consistent with the 1997 Governance Policy that states that “weak governance should be addressed early in the reform effort.”<sup>24</sup>

- Finally, it should be noted that the 1997 Governance Policy specifically provides that financial assistance from the Fund in the context of completion of a review under a program or approval of a new Fund 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 Fund resources. In the case of delayed approval or review, measures that at least begin to address these issues should be in place before resumption, including through specific conditionality—such as the conduct of an independent audit or passage of specific laws.<sup>25</sup> As is noted in the July, 2017 paper, this approach has already been implemented in a number of cases.

39. **In light of the above analysis, the application of the Enhanced Framework for Fund Engagement can be expected to have an impact on conditionality in two respects.** First, although reforms to address governance vulnerabilities are already being addressed in many programs, the systematic application of the Framework will help ensure that it is integrated into Fund-supported programs on a more evenhanded basis. Second, it is expected that the identification of the nature and severity of the problems and the proposed reforms will be more specific and candid than has previously been the case.

### C. The Provision of Policy Advice

40. **In circumstances where governance problems are judged to be sufficiently severe to be relevant under the established surveillance or UFR standards, the Fund’s policy advice would be guided by its diagnosis of the nature of the weaknesses.** In this context, one of the advantages of a systematic application of the assessment elements (Section III(A)) to the circumstances of each country is that it provides the basis for the design of reform recommendations. Applying the proposed framework is also expected to increase the coverage of governance and corruption issues in both surveillance and UFR. In addition, language in staff reports should be more direct, clear, and transparent than has previously been the case.

41. **As outlined in Section III(A), and is recognized in the 1997 Governance Policy, many—but not all—of the relevant areas are already within the Fund’s expertise.** These include most areas of fiscal governance, financial sector oversight, central bank governance and operations, and AML-CFT. With respect to market regulation, a number of aspects of this topic (e.g., the complexity and opacity of the regulatory framework) are typically already addressed in the context of surveillance. Regarding those areas that fall outside the Fund’s expertise, the Fund will rely on the

<sup>24</sup> IMF, 1997a, at paragraph 16.

<sup>25</sup> Ibid.

work of other institutions. This would include, for example, the World Bank’s work in the area of procurement. In some areas, the relevant activity is shared between the Fund and the Bank. For example, in the context of the FSAP exercise, one of the modules relates to creditors rights, which as noted above, is central to the topic of rule of law. The Bank has typically taken the lead in this area, based on the assessment methodology that it developed with the UN Commission on International Trade Law (UNCITRAL). At the same time, the Fund has been involved in providing extensive advice in these areas in the context of both surveillance and use of Fund resources (UFR) where weaknesses were judged to be macro-critical, most recently in Europe.

42. **Where corruption itself is judged to be sufficiently severe to warrant Fund engagement, the approach would recognize the need for a multi-pronged strategy.** While strengthening the rule of law—including an effective threat of prosecution—will be critical in these circumstances, experience demonstrates that a broader reform agenda is needed for an anti-corruption strategy to be successful. In particular, institutional and regulatory reform that takes into account the diagnosis of the relevant governance weaknesses will need to play a central role. These measures include the elimination of excessive regulation, the promotion of transparency and accountability and general capacity-building of institutions. The proposed strategy should take account of political economy considerations, and be supported by effective communication and close engagement with the authorities and other stakeholders. The Fund already has considerable experience in this area in both surveillance and the use of Fund resources (see Box 4). The objective is to ensure that this approach is applied more systematically and in an evenhanded manner.

43. **There may be circumstances where the views of the national authorities differ from those of the staff.** These differences may arise from either the diagnosis or the policy recommendations—or both. In surveillance, it is important that the views of the authorities are solicited during the discussion and are adequately reflected in the relevant documentation, including in the “authorities’ views” section of staff reports. In a Fund-supported program, these differences of view may, however, delay or even preclude Fund support in circumstances where the relevant reforms are macro-critical.

44. **The governance assessments would also help to identify which areas of governance in a particular country would most benefit from the Fund’s capacity development interventions.** Technical assistance would be prioritized for the identified areas, including as a part of a medium-term strategy. This is consistent with the general approach of ensuring that technical assistance is designed to adequately support UFR and surveillance priorities. Thus, for example, in circumstances where corruption is judged to be severe, and a determination is made that inadequate fiscal transparency exacerbates this problem, a priority would be placed on capacity development that addresses this inadequacy. Training and outreach activities in areas of governance would also be better tailored, including to facilitate exchanges of experience between member countries.

#### **Box 4. The Fund’s Recent Engagement on Governance in Use of Fund Resources and Surveillance: Ukraine and Mexico**

*Ukraine. Recent Fund engagement in Ukraine spans a number of Fund-supported programs since 2010 and the Article IV consultations.* To address corruption problems and to support the authorities in their anti-corruption efforts, the Fund has used a multipronged strategy.

**The Fund focused specifically on corruption by engaging Ukraine on:**

- legislative reforms to strengthen the anti-corruption legal framework, asset disclosure by public officials, and anti-money laundering; and
- establishment—with active engagement of civil society— of a new, independent anticorruption investigative agency (National Anti-Corruption Bureau of Ukraine) and the appointment of an anti-corruption prosecutor; and ongoing efforts to establish an independent anti-corruption court.

**At the same time, the Fund engaged Ukraine on several broader governance reforms.** While their primary purpose was to build capacity and improve efficiency, they also helped to prevent or minimize opportunities for corruption. Examples include:

- streamlining and simplification of the regulatory framework, including permits and administrative procedures, and inspections of businesses;
- strengthening the public procurement law to reduce exemptions, introduce e-procurement, and increase transparency to reduce misuse of public resources;
- reforming tax administration to step up revenue collection by breaking tax evasion schemes, strengthening the Large Tax-Payer Office and the value-added tax (VAT) refund process, integrating tax and customs compliance, enhancing the dispute resolution system and accountability framework for leadership, and introducing automated electronic features;
- reforming the state-owned enterprise (SOE) sector, especially in the gas industry to remove low and differential tariffs that create opportunities for arbitrage and corruption—enhancing transparency and fairness in the privatization/restructuring of SOEs;
- reforming central bank legislation to strengthen governance arrangements and decision-making structures, and strengthening financial sector oversight through asset quality reviews, tightening of related party regulations, and recapitalization or resolution of insolvent banks.

In the meantime, the Ukrainian authorities have been pursuing broader judicial reform to enhance independence, integrity, and effectiveness. A new law on the judiciary was adopted in 2016, setting judicial reform in motion, starting with the Supreme Court. Reforms include actions to strengthen management of the judiciary (including on disciplinary oversight) and to speed up debt-claim enforcement (including order of payment procedure and garnishment).

*Mexico. Recent Fund engagement in Mexico spans a number of Flexible Credit Line (FCL) Arrangements since 2009 and the annual Article IV consultations.*

**The Fund engaged Mexico on its anti-corruption efforts, which focused on:**

- creating and empowering the new National Anticorruption System with the support and involvement of civil society, the main goal of which is improved coordination among the relevant authorities in the prevention, detection, investigation, prosecution, and penalization of acts of corruption;
- introducing financial disclosure requirements, identifying conflicts of interest, creating a specialized federal court for corruption cases, and stricter penalties for corruption offenses; and
- strengthening anti-money laundering framework to provide further tools for anti-corruption efforts (e.g., enhancing transparency of beneficial ownership and updating due diligence on politically-exposed persons).

**At the same time, the Fund also engaged Mexico on a number of broader governance reforms, including the following examples:**

- strengthening the tax compliance gap, further strengthening the fiscal framework, and improving the efficiency of public spending; and
- structural reforms in the energy and telecommunications sectors, including improved SOE governance and efficiency.

## D. Combating the Facilitation of Corruption

45. **The Fund can only address corruption effectively if it also addresses the factors that facilitate corrupt practices.** Two factors are particularly relevant. The first, referred to as the “supply” side, concerns the extent to which systemic corruption involves extensive bribery of public officials by private actors taking advantage of lax regulatory environments, and where mitigation requires identification of ways to reduce the incentives for private actors to engage in these acts. Second, the ability of public officials to engage in corrupt practices (whether in the form of bribery or misappropriation of public funds) is facilitated by certain weaknesses in the AML/CFT framework (e.g., the availability of non-transparent corporate vehicles and entities provided by lawyers, accountants, and company service providers) that enable the official to hide the proceeds of corrupt practices.

### Bribery

46. **Countering bribery requires action to be taken at both the domestic and international level.** For example, at the domestic level, organized crime can be a major source of bribery (see Box 5). There is empirical evidence to link entrenched organized crime with systemic corruption, particularly at the level of local government. Organized crime can also have a more general adverse impact on inclusive economic growth. While the fight against organized crime requires a broad strategy, many elements of which are outside the Fund’s expertise, a key anti-crime element where the Fund is playing an active role concerns the strengthening of AML/CFT frameworks. An important objective of these frameworks is to deter the commission of profit-motivated crimes by denying criminals the ability to enjoy the proceeds of these crimes.

47. **At the international level, a framework is required to deter private actors in one jurisdiction from bribing public officials in another jurisdiction.** For its signatories, the OECD Convention on Combating Bribery of Foreign Public Officials already provides an effective basis to address transnational bribery. The Convention establishes legally binding standards that criminalize bribery of foreign public officials in international business transactions and identifies a number of related measures to make it effective. Forty-three Fund members (all OECD members plus eight others) are parties to the Convention, and undergo periodic assessments of the implementation of their obligations under the Convention (Box 6). The UNCAC also has a framework for assessments in this area (Box 7).

48. **In deterring private actors from bribing foreign officials, attention to the extractive industries sector, including commodities such as oil and other minerals, is required.** A 2014 OECD study found that the extractive industry sector contributes the most to the bribery of foreign government officials—19 percent of all cases. It also found that bribes paid in the sector constitute 21 percent of the total value of a transaction—the highest of any sector.<sup>26</sup> In this area, the Fund will continue to respond by promoting transparency and building capacity for country authorities to

---

<sup>26</sup> See OECD, 2014.

better manage wealth from the sector. The Fund is also a partner organization of the Extractive Industry Transparency Initiative (EITI). The EITI is a global standard that promotes open and accountable management of natural resources, thereby reducing bribery and other forms of corruption. The EITI seeks to strengthen institutional systems, inform public debate, and enhance trust. Countries fully implementing the EITI should disclose information on tax payments, licenses, contracts, and production. In terms of capacity-building, the Fund provides extensive technical assistance on managing wealth from extractive industries, with the aim of improving tax policy, revenue administration, public financial management, statistics, transparency, and accountability. It is also noteworthy that several countries enacted legislation to enhance the transparency of extractive industries' companies by requiring the disclosure of payments they make to foreign countries.

### Box 5. Nexus Between Organized Crime and Corruption

**Organized crime and corruption typically feed on each other.**<sup>1</sup> To further their criminal goals, organized criminal groups (OCGs)<sup>2</sup> use bribery and intimidation to co-opt public officials in order to ensure continuity of their illegal operations, maintain their monopoly control over local areas (including local governments), launder the proceeds of these operations, and ensure their immunity from law enforcement.<sup>3</sup> Bribery by OCGs often takes a continuous form since some of them enroll public officials on their payroll. Also, the combination of criminal networks and political patronage can create “a vertical system of corruption that functions from top to bottom in all public institutions.”<sup>4</sup> This self-interested complicity between political actors and organized criminal networks can undermine the most basic compacts of governance between citizens and the state by institutionalizing criminal enterprises and activities.<sup>5</sup>

**Organized crime is a major threat at the international level.** OCGs are capitalizing on globalization and the expansion of international trade to broaden their range of criminal activities, including in corrupting foreign officials and money laundering.<sup>6</sup> Their global revenues are estimated at above a trillion dollars a year, of which illicit drugs are a major component.<sup>7</sup> Illegal proceeds including “proceeds of grand corruption end up in international financial centers.”<sup>8</sup> As recognized by the United Nations, “the growing threat of organized crime, with its highly destabilizing and corrupting influence on fundamental social, economic and political institutions, represents a challenge demanding increased and more effective international cooperation.”<sup>9</sup>

<sup>1</sup> “One finding that everybody agrees on, with respect to the illegal drugs economy, is that organized crime cannot survive without corruption.” OAS, 2013, at p.55.

<sup>2</sup> Under the UN Convention Against Transnational Organized Crime, an organized criminal group means “a structured group of three or more persons, existing for a period of time and acting in concert with the aim of committing one or more serious crimes or offences, in order to obtain, directly or indirectly, a financial or other material benefit.” See <https://www.unodc.org/unodc/en/organized-crime/intro/UNTOC.html>.

<sup>3</sup> Gounev and Bezlov, 2010, Center for the Study of Democracy report reviewed and analyzed the links between organized crimes and corruption in EU member states.

<sup>4</sup> Ibid, at p.3.

<sup>5</sup> See Rose-Ackerman and Palifka, 2016, at pp. 294–315.

<sup>6</sup> Financial Action Task Force: <http://www.fatf-gafi.org/faq/moneylaundering/>.

<sup>7</sup> UNODC, 2011

<sup>8</sup> See Chaikin and Sharman, 2009, at p.151.

<sup>9</sup> See the UN’s Naples Political Declaration and Global Action Plan Against Organized Transnational Crime, 1994.

### Box 6. The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions<sup>1</sup>

**The Convention was agreed in order to address the harmful effects of bribery in international business transactions, including trade and investment.** It focuses on the “supply” side of corruption. The preamble to the Convention considers that such bribery, among other things, undermines good governance and economic development and distorts international competitive conditions. Regarding the latter, a primary goal of the Convention is to level the playing field for companies active in the international market. Currently, all 35 members of the OECD<sup>2</sup> and 8 non-member countries<sup>3</sup> are signatories to the Convention.

**The Convention requires each party to subject to legal sanctions (including criminal liability) the bribery of foreign public officials by individuals and entities, the related offences of money laundering predicated on foreign bribery, and false accounting.** Sanctions for these offenses should be “effective, proportionate, and dissuasive,” and should include confiscation of the bribe and proceeds of bribery. The Convention also requires each party to: (i) provide prompt legal assistance to other signatories in their investigations or proceedings against foreign bribery allegations; (ii) effectively exercise its jurisdiction based on the territorial nature of the offense or the nationality of the bribe-payer; and (iii) ensure that investigations and prosecution of offenses under the Convention are not influenced by political considerations.

**The Convention establishes an open-ended, peer-driven monitoring mechanism, overseen by the OECD Working Group on Bribery in International Business Transactions, to ensure its implementation.** Under this mechanism, parties are required to go through multiple phases of monitoring. Specifically, Phase 1 evaluates the adequacy of the legal framework to implement the Convention. Phase 2 assesses the effectiveness of each party’s application of its legal framework, including the institutional structures in place. After Phase 2, each party would be subject to a permanent cycle of peer review, and the first cycle of review, known as Phase 3, began in 2010 and is focused on an up-to-date assessment of each party’s enforcement effectiveness. Phase 4, which began in 2017, reviews cross-cutting issues on detection, enforcement, outstanding recommendations from earlier evaluations, and any relevant legal or institutional changes. Phase 4 takes a tailor-based approach, considering each country’s unique situation and challenges, and reflecting positive achievements and good practices. Almost all parties—with the exception of more recent signatories—have completed Phases 1, 2, and 3.

**The monitoring process is subject to specific agreed-upon procedures and principles.** In each phase, each party conducts a self-assessment, which is subject to examination by two other parties acting as lead examiners and the OECD Secretariat, leading to a provisional report. Starting with Phase 2, all reviews would also include a country visit. The provisional report is then evaluated by the OECD Working Group on Bribery. A final report is adopted after each phase and is published, even if the evaluated country objects to publication.

**Between its entry into force in 1999 and 2016, 443 individuals and 158 legal entities have been sanctioned in criminal proceedings for foreign bribery, where at least 125 individuals were sentenced to prison.** At least 53 individuals and 95 entities have been sanctioned in administrative and civil proceedings for foreign bribery in four Convention members, and at least 121 individuals and 235 entities have been sanctioned in criminal, administrative and civil cases for other offences related to foreign bribery, such as money laundering or false accounting, in 8 Convention members.<sup>4</sup>

<sup>1</sup> See OECD Convention on Bribery, 1997. The OECD Council has also adopted a series of recommendations against transnational bribery, including those designed to deny tax deductibility of bribe payments and to prevent foreign bribery in officially-financed projects (e.g., through official development aid and officially supported export credits). Unlike the Convention, these recommendations are not legally binding. However, in practice they carry great moral force as representing the political will of OECD member countries and other non-OECD members adhering to these recommendations. See <https://www.oecd.org/legal/legal-instruments.htm>.

<sup>2</sup> Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

<sup>3</sup> Argentina, Brazil, Bulgaria, Colombia, Costa Rica, Lithuania, Russia and South Africa.

<sup>4</sup> See <http://www.oecd.org/daf/anti-bribery/countrymonitoringoftheoecdanti-briberyconvention.htm>. However, as of end 2017, the OECD reported that 23 signatory countries have not yet concluded a foreign bribery enforcement action.



### Box 7. UNCAC Provisions on Bribery of Foreign Public Officials

**UNCAC, which entered into force in December 2005 and has 183 state parties as signatories, includes provisions on the bribery of foreign public officials.** Article 16.1 requires state parties to adopt measures to criminalize the promising, offering or giving of a bribe to a foreign public official or an official of a public international organization. Article 16.2 provides that state parties should consider adopting measures to criminalize the solicitation or acceptance of a bribe by a foreign public official or an official of a public international organization.<sup>1</sup>

**The implementation of the UNCAC into domestic law by states parties is evaluated through a peer-review process known as the Implementation Review Mechanism (IRM).** The IRM involves the evaluated country's responses to a questionnaire and a peer review conducted by two other state parties, one being from the same regional group. In its capacity as the IRM secretariat, the United Nations Office on Drugs and Crime (UNODC), organizes and coordinates the review process. The first cycle of the IRM began in 2010, covering the UNCAC chapters on criminalization and law enforcement and international cooperation. The second cycle, which was launched in November 2015, covers the chapters on preventive measures and asset recovery. A country review report may only be published with the agreement of the evaluated country; however, an executive summary prepared by the review team is automatically published on the UNODC website. As of February 2018, the first cycle resulted in publication of 162 executive summaries and 78 reports, and the second cycle has so far resulted in 4 executive summaries and 1 report.

<sup>1</sup> See UNCAC Article 16.1 and 16.2, available at <http://www.unodc.org/unodc/en/corruption/uncac.html>

## Other Forms of Facilitation

49. **With respect to facilitation that arises through certain AML/CFT vulnerabilities, including the use of non-transparent corporate vehicles and entities provided by the private sector, public officials should be denied the ability to abuse them both domestically and internationally to conceal the proceeds of their corrupt acts.** The AML/CFT framework offers a number of elements of relevance that operate at both the domestic and international level. First, are the Customer Due Diligence (CDD) requirements, including the enhanced scrutiny and reporting of suspicious transactions related to “politically exposed persons” (foreign and domestic) by financial institutions and designated non-financial businesses and professions, designed to undermine the ability of public officials to conceal the proceeds of corruption. Second, is the requirement to have adequate and accurate beneficial ownership information of legal persons and arrangements that can be obtained in a timely fashion so as to prevent their misuse. Third, is the requirement to effectively prosecute money laundering and corruption activities to dissuade public officials from carrying out corruption crimes and money laundering. Finally, is the requirement to deliver appropriate information and evidence through international cooperation to facilitate action against criminals and their assets (Box 8). The Fund has been engaged in assessing countries on compliance with the Financial Action Task Force (FATF) standard, discussing these issues in surveillance, and in providing technical assistance in this area.

## A Framework for Fund Engagement on Facilitation

50. **In light of the above, in circumstances where corruption is judged to be macro-critical in a member country, the Fund's assessment and policy recommendation with the authorities of that member would need to include an in-depth focus on the adequacy of the AML/CFT**

**framework—as already proposed in Section III(A).** As noted previously, strengthening the framework in this area would both address the domestic “supply side” issues (arising from, for example, organized crime) and the problems arising from the concealment of the proceeds of crime.

51. **Beyond the member that is experiencing systemic corruption, however, the question arises as to how to engage with those jurisdictions which, irrespective of whether they experience systemic corruption themselves, have weaknesses in their legal and institutional frameworks that might: (a) facilitate the bribery of foreign officials; or (b) facilitate the concealment of the proceeds of corruption of foreign officials.** In the context of surveillance, a country that, although it does not experience systemic corruption itself, hosts firms that might engage in bribery of foreign officials or which facilitates the concealment of proceeds of corrupt practices, could not be required to have these issues addressed in its Article IV discussions unless: (a) it could be demonstrated that its failure to address these weaknesses would, in and of itself, undermine its own domestic or balance of payments stability; or (b) these weaknesses give rise to systemic spillovers within the meaning of the ISD.

52. **Notwithstanding the above, given the importance of these “supply-side” and “concealment” issues, it would be appropriate for the Fund to urge members—irrespective of whether they experience systemic corruption themselves—to voluntarily agree to have their systems assessed by the Fund in the context of surveillance, both with respect to their anti-bribery frameworks and those aspects of their AML/CFT frameworks that seek to curb concealment of the proceeds of corruption by foreign officials.** Such an approach would be similar to the approach utilized in the context of the discussion of the withdrawal of correspondent relationships, where certain members (i.e., United States and the United Kingdom) agreed to include a discussion in their Article IV consultations on the impact that their own AML/CFT compliance efforts might be having on the availability of correspondent banking services in other jurisdictions.

53. **If a member volunteered to be assessed with respect to ‘supply-side’ and “concealment” issues, the basis of the assessment would depend on the standard that is adhered to by the member in question.** With respect to bribery, to the extent the member is a signatory to the OECD Anti-Bribery Convention, the Fund’s assessment would be based on that Convention, in particular on the monitoring conducted by the OECD. With respect to all other members, the Fund’s assessment would be based on the work done by the UN under the UNCAC. Regarding concealment, the assessments would be based on the FATF AML/CFT standard. To the extent possible, staff would rely on the analysis that has already been provided by the relevant assessor body. Given that this is a voluntary process, while the coverage would be guided by the issues identified in paragraphs 45, 46 and 48 above (bribery of foreign officials, and concealment of the proceeds of corruption by foreign officials) the precise scope and modalities would need to be agreed upon in advance with the member in question.<sup>27</sup> Finally, in the event that many members volunteer, there may need to be some prioritization to take into consideration resources constraints.

<sup>27</sup> For example, in the event that there has been a considerable passage of time since the most recent assessment of the FATF standard, an agreement would need to be reached as to whether and how this information would be updated.

This prioritization would take into account, inter alia, the relevant significance of the jurisdiction in question with respect to these issues, including, inter alia, the magnitude of financial flows (relevant for bribery) and the size of its financial sector (relevant for concealment).

### Box 8. AML/CFT Requirements Relevant to the Facilitation of Corruption

This framework is designed to assess the extent to which jurisdictions have an effective AML/CFT system designed to prevent corrupt foreign public officials from laundering their ill-gotten proceeds. The elements below would be assessed in the context of the effectiveness of the overall AML/CFT regime.

**1. The misuse of legal persons (e.g., companies) and arrangements (e.g., trusts) for money laundering and corruption should be prevented, and information on their beneficial owners<sup>1</sup> should be available to competent authorities without impediments.**<sup>2</sup> Measures should be in place to prevent the legal persons and arrangements from being used for criminal purposes, to make them sufficiently transparent, and to ensure that accurate and up-to-date basic and beneficial ownership information is available on a timely basis.

**2. Private entities should adequately apply preventive measures to report suspicious transactions related to money laundering and proceeds of corruption.**<sup>3</sup> Financial institutions and designated non-financial businesses and professions (DNFBPs)<sup>4</sup> should identify and verify the identity of their customers—both natural, and legal persons (e.g., companies) and arrangements (e.g., trusts)—and their beneficial owners. CDD results in reporting suspicious transactions related to money laundering and corruption. CDD measures are enhanced when the customer or the beneficial owner is a domestic or foreign Politically Exposed Persons (PEPs).<sup>5</sup> Financial institution secrecy laws should not inhibit the implementation of these measures.

**3. Money laundering and corruption offences and activities should be investigated and offenders prosecuted and subject to effective sanctions.**<sup>6</sup> Money laundering activities, and in particular corruption offences should be investigated; offenders successfully prosecuted; and the courts should apply effective, proportionate and dissuasive sanctions to those convicted.

**4. International cooperation should deliver appropriate information, financial intelligence, and evidence, and facilitates action against criminals and their assets.**<sup>7</sup> Constructive and timely information or assistance should be provided when requested by other countries in order to locate and extradite criminals; and arrangements should be in place to identify, freeze, seize, confiscate and share assets and provide information related to money laundering and corruption.

<sup>1</sup> Beneficial Owner refers to the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person (e.g., company) or arrangement (e.g., trust).

<sup>2</sup> Such assessment would rely on findings from Immediate Outcome 5 under the fourth round, and related Recommendations 33 (legal persons) and 34 (legal arrangements) under the third round.

<sup>3</sup> Such assessment would rely on findings from Immediate Outcome 4 under the fourth round, and related Recommendations 4 (financial secrecy), 5 (CDD), 6 (PEPs), 13 (reporting of suspicious transactions), and 22 (DNFBPs) under the third round.

<sup>4</sup> Lawyers, accountants, real estate agents, casinos, dealers in precious metals and stones, trust and company service providers.

<sup>5</sup> PEPs refer to individuals who are or have been entrusted with prominent public functions domestically, by a foreign country, or by an international organization, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. The definition is not intended to cover middle ranking or more junior individuals but covers family members and close associates.

<sup>6</sup> Such assessment would rely on findings from Immediate Outcome 7 under the fourth round, and related Recommendations 1 and 2 (criminalization of money laundering) under the third round.

<sup>7</sup> Such assessment would rely on findings from Immediate Outcome 2 under the fourth round, and related Recommendations 35 to 40 (international cooperation) under the third round.

## IV. NEXT STEPS

54. **It is proposed that the Executive Board adopt the text set forth in Annex 1, entitled “Addressing Governance Vulnerabilities—A Framework for Enhanced Fund Engagement”,** which distills the key elements that are discussed in depth in this paper and also seeks to carefully build on earlier discussions with Executive Directors.

55. **When considering how the Framework for Enhanced Fund Engagement, once adopted, would be implemented, it is important to recognize that governance issues—including issues relating to corruption—are already being integrated into both surveillance and use of Fund resources in a number of countries, consistent with the general direction provided by the 1997 Guidance Policy** (see Box 4.) The key purpose of the Framework for Enhanced Fund Engagement is to ensure that these issues are addressed systematically, effectively, candidly, and in a manner that respects uniformity of treatment. While the specificity of the guidance set forth in the Framework for Enhanced Fund Engagement will play an important role in achieving this objective, Management is keenly aware that the way in which this guidance is actually implemented by staff will also be critical. To that end, if the Framework for Enhanced Fund Engagement is approved, Management intends to initiate a centralized, institutional process to ensure that similarly-situated countries (in terms of their governance vulnerabilities) are treated similarly in the context of both surveillance and the use of Fund resources.

56. **This centralized assessment process will be implemented by a standing Working Group on Governance, comprised of representatives of all Area Departments and the relevant Functional Departments.** While assessments of governance vulnerabilities will be done on a member-by-member basis with key input from both the country desk and the relevant Functional Department, the final judgement on whether—and how—to address vulnerabilities would be made by the Working Group in the context of a review of a group of countries, thereby ensuring that similarly-situated members are treated similarly. In surveillance, the groups would be determined by the calendar (e.g., all members whose Article IV missions are scheduled in a particular quarter). Input will also be sought from the World Bank during this process, particularly where the identified vulnerability falls within the Bank’s expertise. While this process will be initiated immediately, the specific timing of the engagement with each member will be determined by both: (a) the timing of the relevant Article IV consultation and the program approval/review; and (b) the availability of the information needed to apply the Framework in an effective manner.

57. **As is discussed in Section III(B), once a determination is made that weaknesses are sufficiently severe to merit inclusion in surveillance, there would be some limited flexibility as to the timing of the discussion of these issues.** Consistent with the approach taken with other longer-term issues (aging and inequality), a determination would need to be made as to when and how frequently a comprehensive discussion of the issue should take place within a medium-term surveillance strategy for the country (normally within three years). This determination would be based primarily on the urgency of the problem in terms of its impact on balance of payments or

domestic stability, in addition to a country's specific circumstances and other competing policy issues.

58. **It is recognized that information gaps are inevitable due to the lack of universal coverage of several existing exercises.** Over time, however, these information gaps will be reduced as the Fund engages with its members in both surveillance and use of Fund resources more systemically on these issues. Importantly, over time, previous Article IV consultation reports will constitute a key source of information.

59. **Management intends to assess the resource implications of the application of the Framework for Enhanced Fund Engagement in the context of the consideration of Administrative Budget for FY 2020.** Accordingly, until then, departments would implement the Framework within their existing budgets.

60. **Finally, it is proposed that the implementation of the Framework for Enhanced Fund Engagement be reviewed by the Executive Board within three years of its adoption.** This early review relative to the normal five-year period will enable the Board to assess if the objective of ensuring both greater effectiveness and uniformity has been achieved.

## References

- Alam, M. Shahid, 1989, "Anatomy of Corruption: An Approach to the Political Economy of Underdevelopment," *The American Journal of Economics and Sociology*, Vol. 48, Iss. 4, pp. 441-456.
- Barro, Robert, 1991, "Economic Growth in a Cross Section of Countries," *The Quarterly Journal of Economics*, 106(2): 407-443.
- Barro, R. J., and Sala-i-Martin, X., 1995, *Economic Growth*, McGraw-Hill: New York.
- Borenstein M., Larry Hedges, Julian Higgins and H.R. Rothstein, 2009, "Introduction to Meta-Analysis" John Wiley & Sons, U.K.
- Buffie, E., Berg, A., Pattillo, C., Portillo, R., and L.F. Zanna, 2012, "Public Investment, Growth and Debt Sustainability: Putting Together the Pieces," IMF Working Paper 12/144.
- Chaikin, David, and J.C. Sharman, 2009. *Corruption and Money Laundering: A Symbiotic Relationship*. New York: Palgrave MacMillan.
- Department for International Development (DFID), 2015, "Why Corruption Matters: Understanding Causes, Effects and How To Address Them", available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/406346/corruption-evidence-paper-why-corruption-matters.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/406346/corruption-evidence-paper-why-corruption-matters.pdf)
- Gaspar, Vitor, Paolo Mauro and Tigran Poghosyan., 2017, "Lessons from the Old Masters on Assessing Equity and Efficiency: A Primer for Fiscal Policymakers." IMF Working Paper 17/214., available at: <http://www.imf.org/en/publications/wp/issues/2017/10/03/lessons-from-the-old-masters-on-assessing-equity-and-efficiency-a-primer-for-fiscal-45289>
- Gounev, Philip and Tihomir Bezlov, 2010, "Examining the Links Between Organised Crime and Corruption," Center for the Study of Democracy commissioned by the European Commission.
- International Monetary Fund (IMF), 1997a, "The Role of the Fund in Governance Issues—Guidance Note," July, available at: <http://www.imf.org/external/pubs/ft/exrp/govern/govindex.htm> [last visited May 8, 2017]
- , 1997b, "The Role of the Fund in Governance Issues—Guidance to the Staff," April, 05/21/1997 <http://www.imf.org/external/pubs/ft/exrp/govern/govern.pdf>.
- , 2002, "Guidelines on Conditionality," September 25, as amended, available at: [https://www.imf.org/external/pubs/ft/sd/index.asp?decision=12864-\(02/102\)](https://www.imf.org/external/pubs/ft/sd/index.asp?decision=12864-(02/102)) [last visited March 8, 2018]

- , 2012 “Integrated Surveillance Decision”, adopted July 18, 2012, available at: <http://www.imf.org/external/np/exr/facts/isd.htm> [last visited March 8, 2018]
- , 2016, “Corruption: Costs and Mitigating Strategies,” Staff Discussion Note 16/05, May, available at: <http://www.imf.org/external/pubs/ft/sdn/2016/sdn1605.pdf> [last visited March 8, 2018]
- , 2017a, “The Role of the Fund in Governance Issues – Review of the Guidance Note – Preliminary Considerations” August, available at: <http://www.imf.org/en/publications/policy-papers/issues/2017/08/01/pp080217-the-role-of-the-fund-in-governance-issues-review-of-the-guidance-note> [last visited March 8, 2018]
- , 2017b, “The Role of the Fund in Governance Issues – Review of the Guidance Note – Preliminary Considerations – Background Notes”, Staff Supplement, August <https://www.imf.org/~media/Files/Publications/PP/2017/pp080217-the-role-of-the-fund-in-governance-issues-review-of-the-guidance-note.ashx>.
- Johnsøn, J., Taxell, N., and D., Zaum, 2012, “Mapping evidence gaps in anti-corruption,” Anti-Corruption Resource Centre, available at: <http://issuu.com/cmi-norway/docs/u4issue-2012-07-mapping-evidence/3?e=0>
- Magnus, J.R., Powell, O. and Prufer, P., 2010, A comparison of two averaging techniques with an application to growth empirics. *Journal of Econometrics* 154: 139–153.
- Mankiw, N. G., Romer, D., and Weil, D. N., 1992, “A Contribution to the Empirics of Economic Growth”, *Quarterly Journal of Economics*, Vol. 107, No. 2, pp. 407-437.
- Organization of American States (OAS), 2013, General Secretariat, “The Drug Problem in the Americas”.
- Organisation for Economic Co-operation and Development (OECD), 1997, OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, 21 November.
- , 2000, “The Fight Against Bribery and Corruption”, Policy Brief, September.
- , 2014, “Foreign Bribery Report: An Analysis of the Crime of Bribery of Foreign Public Officials”, December.
- , 2016, “Recommendations of the Council for Development Co-operation Actors on Managing the Risk of Corruption,” available at: <http://www.oecd.org/corruption/anti-bribery/Recommendation-Development-Cooperation-Corruption.pdf>
- Rose-Ackerman, Susan and Bonnie J. Palifka, 2016, “Corruption and Government: Causes, Consequences, and Reform,” 2nd edition, Cambridge University Press 2016, pp.294-315.

- Sala-i-Martin, X., Doppelhofer, G. and Miller, R.I., 2004, "Determinants of long-term growth: A Bayesian averaging of classical estimates (BACE) approach." *American Economic Review* 94: 813–835.
- United Nations Development Program (UNDP), 2015, User's Guide to Measuring Corruption and Anti-Corruption, UNDP Global Anti-corruption Initiative (GAIN), September 2015.
- United Nations' Naples Political Declaration and Global Action Plan Against Organized Transnational Crime, 23 December 1994, A/RES/49/159, available at <http://www.un.org/documents/ga/res/49/a49r159.htm>
- United Nations Office on Drugs and Crime (UNODC), 2011, "Estimating illicit financial flows resulting from drug trafficking and other transnational organized crimes.", August 2011.
- United Nations General Assembly, 2003, United Nations Convention Against Corruption, 31 October, A/58/422.
- World Bank, 2012, Public financial management reforms in post-conflict countries: synthesis report, Washington, DC: World Bank, available at: <http://documents.worldbank.org/curated/en/945231468340162289/Public-financial-management-reforms-in-post-conflict-countries-synthesis-report>



## Proposed Decision

The following decision, which may be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board.

The Executive Board approves the text of **“Addressing Governance Vulnerabilities—A Framework for Enhanced Fund Engagement”**, which is set forth in Annex 1 to SM/18/55.

## Annex 1. Addressing Governance Vulnerabilities—A Framework for Enhanced Fund Engagement

### Introduction

1. The Fund has completed its review of the 1997 Policy on the Role of the Fund in Governance Issues (1997 Governance Policy). While the 1997 Governance Policy remains an appropriate basis for the Fund’s work in this area, further guidance from the Executive Board is needed to ensure that the objectives of that policy are achieved. Experience has underscored the critical impact that these governance issues can have on the ability of the Fund to implement its mandate. In particular, there is considerable evidence that systemic corruption can have a particularly pernicious effect on a country’s ability to achieve sustainable, inclusive economic growth. Accordingly, the framework set forth below (“A Framework for Enhanced Fund Engagement”) is designed to promote more systematic, effective, candid and evenhanded engagement with member countries regarding those governance vulnerabilities, including corruption, that are judged to be macro-critical.

2. The Fund’s engagement on governance issues will continue to be guided by the principles set forth in the 1997 Governance Policy and, more broadly, by the Fund’s overall mandate. Specifically:

- First, the Fund should engage with its members on their governance vulnerabilities in the context of bilateral surveillance and the use of Fund resources when these weaknesses are judged to be sufficiently severe to be relevant to these activities.
- Second, when they become relevant for surveillance and use of Fund resources, the Fund’s assessment of governance vulnerabilities should not be limited to only those associated with corruption.
- Third, where a relevant governance vulnerability falls outside the area of the Fund’s expertise, the Fund should rely on the work of other international institutions, particularly the World Bank.
- Fourth, an effective strategy requires action to curb the facilitation of corrupt practices by private actors, particularly in the transnational context.
- Fifth, when engaging on these issues, the Fund should continue to avoid interfering in individual enforcement cases.
- Finally, the Fund should continue to avoid interference in the domestic or foreign politics of a member or expressing views on the design of a particular political system.

## Elements of the Framework for Enhanced Fund Engagement

3. The Fund will assess the severity of members' governance vulnerabilities in a systematic manner. This will include an assessment of the extent to which the state functions that are most relevant to economic activity are undermined by governance vulnerabilities. Subject to the availability of information, the state functions to be assessed – and the specific issues to be covered – will normally include the following:

(a) Fiscal Governance—The primary focus will be on the quality of the institutional framework and practices that support revenue administration, public financial management, and fiscal transparency for the public sector.

(b) Financial Sector Oversight—An assessment of the quality of financial sector oversight will include examination of the capacity and effective autonomy of the supervisory agency. The assessment will also cover those aspects of the design of the regulatory and supervisory framework that are most relevant to safeguarding the integrity of financial system and minimizing opportunities for corruption.

(c) Central Bank Governance and Operations—This assessment will include: (a) the adequacy of the mandate, decision-making structure and autonomy of the central bank; (b) the adequacy of the accountability and transparency framework; and (c) the effectiveness of the internal control environment.

(d) Market Regulation—The assessment in this area will focus primarily on the extent to which the complexity and opacity of the regulatory environment creates rent-seeking opportunities, and more generally, hinders the operation of private business.

(e) Rule of Law—The focus of this assessment would be on those aspects of the rule of law that support the protection of property and contractual rights, including the predictability and timeliness of the enforcement of those rights.

(f) Anti-Money Laundering and Countering the Financing of Terrorism—This assessment would focus not only on the adequacy of the legal framework, but also on overall institutional capacity and effective implementation.

4. The assessment of severity of governance vulnerabilities will also include an examination of the severity of corruption, given its particularly pernicious impact on a member's ability to achieve sustainable, inclusive growth.

5. The Fund will be guided by several principles when selecting and using the information that will be needed to make the assessments under paragraphs 3 and 4 above.

(a) First, to the extent possible and where relevant, the Fund should rely on information it has already obtained in the context of existing Fund activities, including discussions with the authorities.

(b) Second, in areas that are not typically within the remit of the Fund, the Fund should rely on information provided by other institutions, especially the World Bank.

(c) Third, the assessments should be holistic, relying on both quantitative and qualitative inputs. If third-party indicators are used, their use must be consistent with the Fund's policy in this area. As such, third-party indicators will be used to complement—and not displace—the analysis of Fund staff and other international organizations, including the World Bank.

The Fund will not publish country rankings of its assessment of corruption or other general governance vulnerabilities.

6. The Fund's assessment of the economic impact of the governance vulnerabilities that have been identified pursuant to paragraphs 3, 4, and 5 above will be guided by the applicable standards for surveillance and the use of Fund resources. In particular:

(a) With respect to bilateral surveillance, a determination as to whether a member's governance vulnerabilities significantly affect its prospective or present balance of payments or domestic stability within the meaning of the Integrated Surveillance Decision will be based on an assessment of the severity of these vulnerabilities, taking into account the application of the assessment framework described in paragraphs 3, 4 and 5 above and the overall circumstances of the member. Consistent with the treatment of other long-term issues, if a determination is made that governance vulnerabilities are sufficiently severe to significantly affect prospective or present stability, there will be flexibility on the timing of its inclusion in the Article IV process. More specifically, the timing of its inclusion will primarily take into account the perceived urgency of governance vulnerabilities relative to other concerns, but could also consider other factors such as the availability of information needed to apply the framework in an effective manner. At a minimum, however, these vulnerabilities, when sufficiently severe to be relevant for surveillance, would be substantively discussed within the context of a medium-term surveillance cycle (normally within three years).

(b) To determine whether reforms to address governance vulnerabilities should be a condition for the use of the Fund's resources, the Fund will assess (i) the severity of governance vulnerabilities; and (ii) whether addressing the identified vulnerabilities is of critical importance for achieving the goals of the member's program.

7. Where governance weaknesses, including corruption, are judged to be sufficiently severe to be relevant for bilateral surveillance and use of Fund resources, the Fund's policy advice would be guided by its diagnosis of the nature of the weaknesses in the country in question. With regard to engagement on corruption, experience demonstrates the need for the implementation of a multi-pronged strategy that requires not only anti-corruption measures but also broad-based regulatory and institutional reforms. Since weaknesses may exist in areas that are outside the Fund's expertise, the Fund should collaborate closely with other international organizations as appropriate. The Fund's technical assistance will be prioritized to take into consideration those areas of governance reform that are deemed to be of critical importance in surveillance and use of Fund resources.

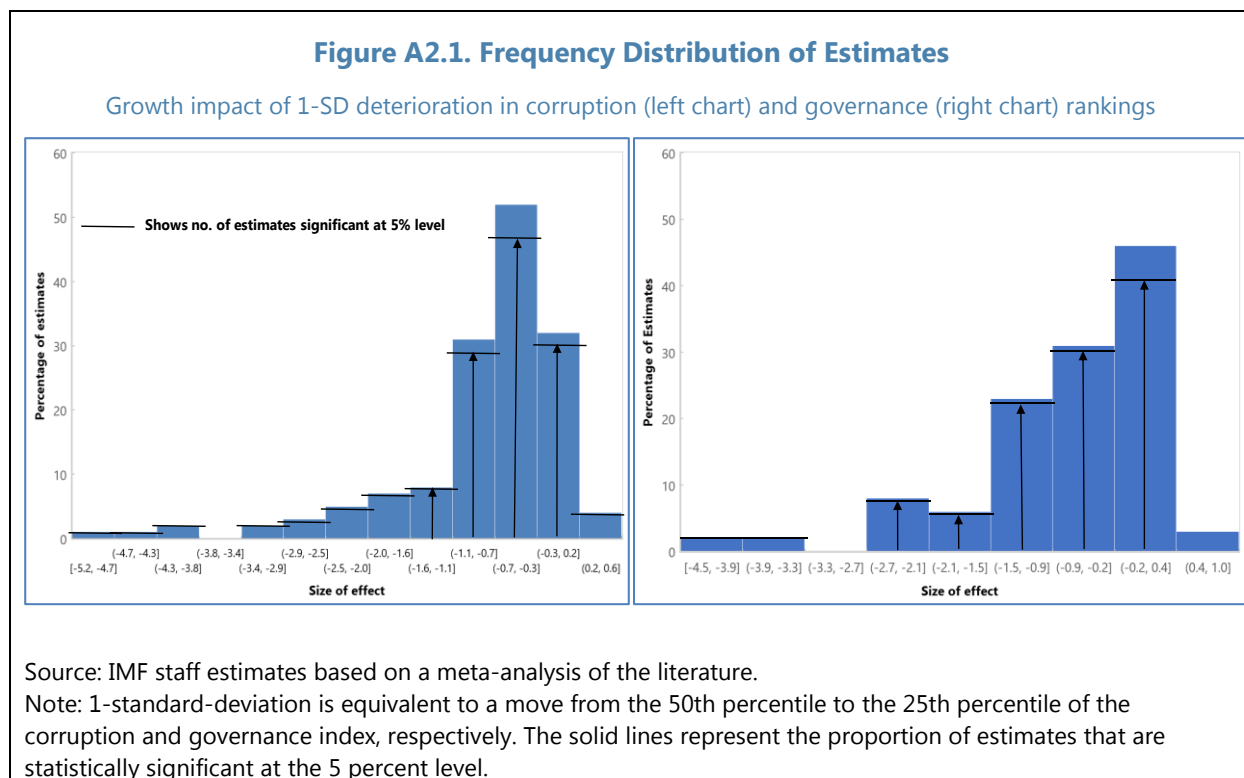
8. In order to address corruption, it is imperative that members implement measures to prevent private actors from offering bribes or providing services that enable the proceeds of corrupt acts to be concealed. This is particularly relevant in the transnational context. Accordingly, irrespective of whether a member is experiencing severe corruption itself, the Fund urges all members to volunteer to have their own legal and institutional frameworks assessed in the context of bilateral surveillance for purposes of determining whether: (a) they criminalize and prosecute the bribery of foreign public officials; and (b) they have an effective AML/CFT system that is designed to prevent foreign officials from concealing the proceeds of corruption.

9. Experience with the application of this Framework will be reviewed within three years.

## Annex 2. A Meta-Analysis of the Impact of Corruption and Quality of Governance on Growth

**Staff conducted a meta-analysis of a broad set of the literature linking corruption and weak governance to economic growth.** The meta-analysis covers 26 studies focusing on the growth impact of corruption (providing 149 estimates) and 17 studies on the growth impact from weak governance (125 estimates). Some studies apply cross-section or panel data analyses to obtain the direct impact of corruption or governance quality on growth along the line of Barro (1991), Mankiw and others. (1992) and Barro and Sala-i-Martin (1995). Some also estimate indirect effects on growth through channels such as investment, human capital, or public finance. These studies were selected based on a consistent and rigorous set of criteria. Staff included only studies that investigate these effects, use widely-recognized indicators of corruption and governance, address issues of endogeneity, and are published in high-quality journals.

**The analysis indicates that corruption and weak governance are associated with slower growth.** For example, the bulk of the per-capita growth impact estimates from a one-quartile increase along the corruption index are distributed between -0.3 and -1.1 percentage points. Roughly 90 percent of the estimates are negative, and 80 percent of those are statistically significant. Similarly, the distribution of the growth impact estimates from a one-quartile deterioration in the governance index are mainly distributed between -0.2 and -1.5 percentage points. This finding is robust across different measures of corruption and governance quality, estimation techniques, and controls for institutional quality.



### Box A2.1. Methodology

Staff used the random-effect (RE) meta-analysis model to derive synthesized estimates of the effects of corruption or governance quality on growth.<sup>1</sup> The RE model is efficient when the original estimates are drawn from different populations. Staff then calculated and reported the following statistics: (i) the weighted mean effects of the reported estimates,  $M = \frac{\sum_{i=1}^k [1/(v_i+T^2)]\theta_i}{\sum_{i=1}^k W_i/(v_i+T^2)}$ , where  $\theta_i$  denotes the series of reported effects ranging from 1 to k (the number of estimates),  $v_i$  denotes the within-study error variance, which is unique to each study, and  $T^2$  is the between-study variance, which is common to all studies<sup>2</sup>; (ii) The  $I^2$  statistic ( $I^2 = T^2/(T^2 + v_\theta) * 100$ ), a measure of heterogeneity, which is independent of study size; (iii) the standard error of the combined effect,  $SE_M = \sqrt{V_M}$ , and its 95 percent confidence interval,  $M \pm 19.6SE_M$ ; and (iv) the Z-statistic to test the null hypothesis that the mean true effect size is zero, where  $Z = M/SE_M$  with a one-tailed p-value given by  $p = 1 - \Phi(\pm|Z|)$  and a two-tailed p-value given by  $p = 2[(1 - (\Phi(|Z|)))]$  and where  $\Phi(Z)$  is the standard normal cumulative distribution.

<sup>1</sup> For details, see Borenstein and others (2009).

<sup>2</sup> Following Borenstein and others (2009),  $T^2$  is computed as  $(Q - df)/C$ , where  $Q = \sum_{i=1}^k W_i(\theta_i - M)^2 = \sum_{i=1}^k (\theta_i - M)^2/V_i$ ,  $df = k - 1$ , and  $C = \sum W_i - \sum W_i^2/\sum W_i$ , where  $W_i = 1/(v_i + T^2)$ .

**On average, a one-quartile deterioration in the corruption index is associated with a ½-percentage-point loss in per-capita growth, with somewhat larger loss in the case of low income countries**

**(LICs.)** The overall mean effect is statistically significant at -0.438, with the confidence interval of -0.388 to -0.487 (Table A2.1). Most of the observed variance in the estimates is due to differences in studies, with little owing to sampling error ( $I^2$  close to 100 percent). Studies based only on LICs data or with regional focus tend to have larger effects than the overall mean (Table A2.2).

**Table A2.1. Summary Statistics from Meta-analysis on Corruption Effects**

Number Studies	Effect size and 95% confidence interval					Test of null (2-Tail)	
	Point estimate	Standard error	Variance	Lower limit	Upper limit	Z-value	P-value
149	-0.438	0.025	0.001	-0.487	-0.388	-17.289	0.000
Heterogeneity				Tau-squared			
Q-value	df (Q)	P-value	I-squared	Tau Squared	Standard Error	Variance	Tau
1986.806	148.000	0.000	92.551	0.049	0.022	0.000	0.221

**Table A2.2. Estimates by Country Groups**

Country Groups	No. of Estimates	Statistics for each study						Point estimate and 95% CI	
		Point estimate	Standard error	Lower limit	Upper limit	Z-Value	p-Value		
AMs and EMs	6	-0.336	0.121	-0.573	-0.099	-2.780	0.005		
Latin America	4	-0.585	0.130	-0.840	-0.331	-4.502	0.000		
LICs	7	-0.879	0.100	-1.075	-0.682	-8.770	0.000		
Mixed	120	-0.335	0.025	-0.383	-0.287	-13.615	0.000		
SSA	12	-0.733	0.070	-0.870	-0.596	-10.469	0.000		
Overall	149	-0.407	0.022	-0.450	-0.364	-18.581	0.000		

Studies that used mixed-country samples, including those using only AEs and EMs data, tend to report estimates that are lower than the overall mean effect. The direct effects of corruption tend to be larger than the indirect effects coming from either total investment or FDI (Table A2.3).

**Table A2.3. Direct and Indirect Effects of Corruption Effects**

Channels	No. of Estimates	Effect size and 95% confidence interval				Test of null (2-Tail)	
		Point estimate	Standard error	Lower limit	Upper limit	Z-value	P-value
<i>Studies reporting direct effects only:</i>							
Direct	91	-0.610	0.039	-0.686	-0.534	-15.756	0.000
<i>Studies reporting both direct and indirect effects:</i>							
Direct	24	-0.587	0.060	-0.705	-0.470	-9.808	0.000
Indirect							
Total Investment	9	-0.209	0.067	-0.340	-0.079	-3.145	0.002
FDI	4	-0.486	0.090	-0.663	-0.310	-5.402	0.000

### The significant growth effects are robust across different modifiers.

The estimates do not appear to depend on the measure of corruption used in the various studies. The between-study variation due to different indicators is not significant ( $Q$ -value = 3.5, with 2 df, and  $p$ -value = 0.169). The estimates do not appear to depend on the estimation technique used ( $Q$ -value = 1.633, with 3 df, and  $p$ -value = 0.651). There is also no evidence that the choice of instruments used in the estimation technique mattered. They do not vary significantly when other measures of institutional quality are included in the regressions. Robustness checks indicate that there may be some element of publication bias, but staff's findings remain robust to this as well.<sup>1</sup> Finally, the size of the impact varies depending on whether they were drawn from studies that used annual panel data estimation (mean effect = -0.85), panels with 5-year averaging (mean effect = -0.23), or cross-section estimation (mean effect = -0.51), and this between-study variation is statistically significant (based on the  $Q$ -statistic of 81.3 with  $p$ -value of 0.00).

### Weaker governance also has a statistically significant effect on growth.<sup>2</sup>

The mean effect across all studies is negative (Table A2.4). Nevertheless, estimates vary across studies based on the indicator used. For example, the Freedom House Index tends to yield larger estimates, followed by the International Country Risk Guide (ICRG) rule-of-law indicator, and Worldwide Governance Indicators.

**Table A2.4. Estimates of Impact of Governance on Growth (Dependent variable)**

Dependent Variable	No. of Estimates	Effect size and 95% confidence interval					Test of null (2-Tail)	
		Point estimate	Standard error	Variance	Lower limit	Upper limit	Z-value	P-value
GDP Growth	6	1.545	0.262	0.069	1.031	2.059	5.889	0.000
GDP per Capita Grow	31	0.992	0.085	0.007	0.826	1.158	11.697	0.000
Real GDP Growth	36	-0.034	0.014	0.000	-0.061	-0.008	-2.515	0.012
Real GDP per Capita (	51	0.115	0.015	0.000	0.087	0.144	7.855	0.000
Overall	124	0.050	0.010	0.000	0.030	0.069	5.029	0.000

### The meta-analysis results indicate that greater corruption or weaker governance is associated with lower GDP per-capita growth, through both direct and indirect channels.

The overall association is larger when the reported estimates are based on LIC data only, though these effects are based on fewer observations. On average, the direct effect is larger than indirect effects operating through investment and FDI. These findings are robust across different measures of corruption, estimation techniques, and control variables for institutional quality.

<sup>1</sup> While the meta-analysis provides a statistically accurate synthesis of the studies included in the analysis, if there are other relevant studies excluded, then the effects derived in the meta-analysis will reflect that bias. More details of the results of these checks are available, and will be part of a forthcoming working paper.

<sup>2</sup> Note that unlike the case of corruption, studies on governance vary considerably on the measurement of growth used as the dependent variable.



## Annex 3. Corruption/Governance and Inclusive Growth: Empirical Analysis

**This section analyzes the empirical association between corruption (governance quality) and inclusive growth.** Two econometric approaches are used. The first is a panel regression framework, which examines the association between short- to medium-term growth and corruption (governance quality). The second applies a model-averaging technique to cross-sections of countries to assess whether corruption (governance quality) is robustly associated with long-run inclusive growth.

### I. PANEL DATA ANALYSIS

#### A. Model Specification and Methodology

**The Panel Regression Specification is Estimated as Follows:**

$$y_{it} = \alpha_i + \lambda_t + \beta CI_{it} + \sum_n^k (\theta_k X_{it}^k) + \epsilon_{it}, \quad (B1)$$

where  $y_{it}$  is annual GDP growth (GDP per capita, investment, FDI or tax revenues);  $X_{it}^k$  is a set of control variables identified in the literature as robustly associated with short-term growth;  $\alpha_i$  and  $\lambda_t$  are country and time fixed effects (FE), respectively.<sup>1</sup>  $CI_{it}$  is an indicator of corruption. The baseline estimates use the Control of Corruption Index scores from the Worldwide Governance Indicators Control of Corruption Index (WGI-CCI), which captures perceptions of corruption. The robustness of the results is checked using the Transparency International Global Corruption Barometer (GCB) indicator—which assesses people’s direct experiences with bribery and details their views on the overall prevalence of corruption in the main institutions in their respective country.<sup>2</sup> Equation (B1) is estimated using the generalized method of moments (GMM) panel estimation. The results are similar using a panel with fixed country and time effects.<sup>3</sup>

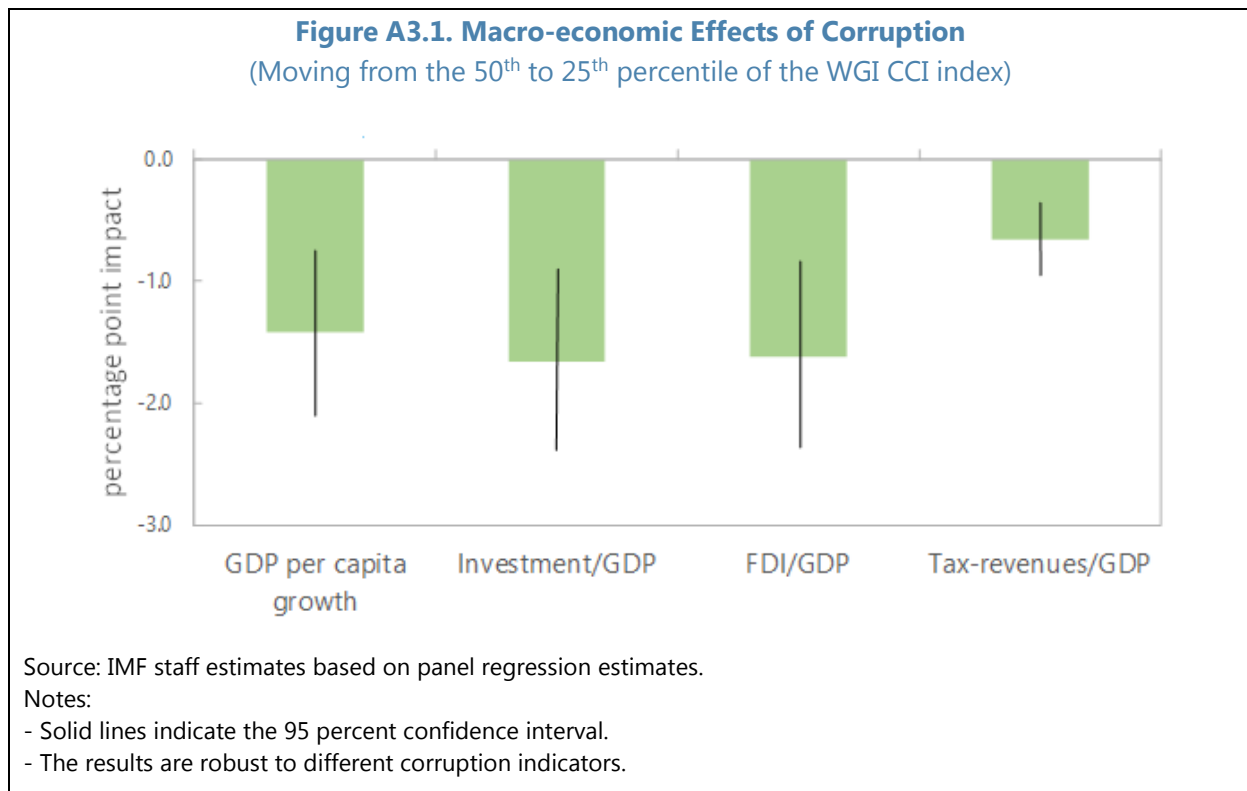
<sup>1</sup> The model is similar to that used in the IMF SDN/16/05 paper, which is the general framework used in the literature.

<sup>2</sup> The WGI-CCI indicator captures perceptions of the extent to which power is exercised for private gain, including petty and grand forms of corruption, as well as “capture” of the state by elites and private interests. It is compiled and published by staff from the World Bank, Brookings Institutions, and Natural Resource Governance Institute, aggregating from more than 30 different surveys of enterprise, citizen, and expert perceptions. The GCB draws on survey feedback from more than 100,000 respondents in about 100 countries. It addresses people’s direct experiences with bribery and details their views on the overall prevalence of corruption in the main institutions in their countries. It also captures their perception of the government’s anti-corruption performances, amongst others. One shortcoming of the GCB surveys is that they capture the experiences of the population at large, which typically relates to street-level corruption, not grand corruption by high-level officials. Another limitation is that differences in reported bribery might in part be subject to cultural differences in respondents’ willingness to report it. The WGI-CCI is available annually for 1996–2016 and cover about 200 countries, whereas GCB is available for the period 2003–16 and covers less than 100 countries in each year.

<sup>3</sup> Panel co-integration analysis was also undertaken. The results (not reported, for brevity) suggest that a worsening in corruption is negatively associated with output both in the short and long term.

## B. Results

**A worsening from the 50th to the 25th percentile in the corruption ranking is associated with a macroeconomically significant loss in GDP per capita growth.** Estimates range from -0.7 to -2 percentage points for growth. Estimate also show a decline in investment-, FDI- and tax-to-GDP ratios of 1.6, 1.7 and 0.7 percentage points, respectively. These results are robust to different measures of corruptions. The main findings are summarized in Figure B1 and presented in more details in Tables A3.1-A3.3. Panel estimates based on 5-year or 10-year averages—thus based on a much smaller number of observations—show a smaller, negative association, which is no longer statistically significant.



**Table A3.1. Growth and Corruption—FE and GMM Estimates**

	GDP growth		GDP per capita		GDP growth		GDP per capita	
	Fixed Effects, with CCI	Difference GMM, with CCI	Fixed Effects, with CCI	Difference GMM, with CCI	Fixed Effects, with GCB	Difference GMM, with GCB	Fixed Effects, with GCB	Difference GMM, with GCB
Lagged GDP growth	-0.0992***	-0.0354	-0.106***	-0.0894***	-0.093**	-0.162	-0.159***	-0.041
Δ Exchange rate	-0.0523***	-0.00108	-0.0553***	0.00625	-0.113***	-0.067	-0.102***	0.011
Population growth	0.00206*	0.00272			0.008	0.026		
Inflation	0.0189*	-0.0671***	0.0210*	-0.0518**	0.0189*	-0.0671***	0.0210*	-0.0518**
Δ Trade openness	-0.00426	0.0172	0.00516	-0.0105	0.0504	0.169**	0.045	0.203**
Δ Credit/GDP	0.00392	0.000638	-0.00280	0.000696				
WGI-CCI		0.115**		0.117**				
lagged WGI-CCI	0.0657**		0.0584*					
WGI-CCI*weak		-0.0242		-0.0131				
Lagged WGI-CCI*weak	0.0473*		0.0472**					
GCB						0.088*		0.070***
Lagged GCB					0.035*		0.047*	
GCB*weak						0.065		0.041
lagged GCB*weak					-0.037*		-0.0327	
<i>N</i>	3406	3140	3406	3112	485	303	485	303
<i>Num. Countries</i>	174	159	174	159	101	159	101	73

*t* statistics in parentheses. \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

**Table A3.2. Investment, FDI, and Corruption—FE and GMM Estimates**

	<u>Total Investment/GDP</u>				<u>FDI/GDP</u>			
	Fixed Effects, with CCI	Difference GMM, with CCI	Fixed Effects, with GCB	Difference GMM, GCB	Fixed Effects, with CCI	Difference GMM, WITH CCI	Fixed Effects, with GCB	Difference GMM, with GCB
lagged Investment/GDP	0.658***	0.673***	0.610***	0.582***				
Δ Terms of Trade	0.000236**	0.000819*	0.0000478	0.0000592	-0.0000489*	-0.000161	-0.000108	-0.000850
Population growth	0.00215*	0.00680	0.00636	0.0000603	0.000378	0.0034	-0.00109	0.0478
Inflation	-0.00227	-0.0869**			0.00379*	-0.0120	0.0841**	-0.138
Δ Trade openness	0.0326*	0.0396	0.0166	0.0815	0.00492*	-0.00158	0.0871***	0.0901
lagged FDI/GDP					-0.0427	0.659***	0.592***	0.241
WGI-CCI		0.137**				0.134***		
Lagged WDI-CCI	0.0652**				0.0191*			
WGI-CCI*weak		0.132				0.0362		
lagged WDI-CCI*weak	-0.00549				-0.0164			
GCB				0.0656**				0.0738
Lagged GCB			0.0713**				0.0298*	
GCB*weak				-0.0164				-0.0726
lagged GCB*weak			0.0117				0.0111	
<i>N</i>	3166	2988	302	463	2783	2609	537	293
<i>Num. Countries</i>	155	146	73	155	156	147	102	71

*t* statistics in parentheses. \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

**Table A3.3. Tax Revenue and Corruption—FE and GMM Estimates**

	with CCI		with GCB	
	Fixed Effects, with CCI	Difference GMM, with CCI	Fixed Effects, with CGB	Difference GMM with
	<b>Tax revenues /GDP</b>			
Agriculture/GDP	-0.0300	-0.059	0.0370	-0.225
Δ Trade openness	0.015*	0.061***	0.055***	0.037*
GDP per capita	0.045***	0.054***	0.083**	0.201*
GDP per capita Square	-0.003**	-0.003***	-0.004*	-0.011*
Inflation	-0.002*	-0.001*	-0.001	0.006**
WGI-CCI	0.073***	0.054***		
WGI-CCI*weak	-0.017	-0.030*		
GCB			0.024*	0.057*
GCB*weak			0.003	-0.008
lagged Tax revenues/GDP		0.301**		0.065
<i>N</i>	2766	2426	439	217
<i>Num. Countries</i>	158	158	92	40

*t* statistics in parentheses. \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

## II. CROSS-SECTION ANALYSIS

### A. Model Specification and Methodology

**Staff undertook a cross-sectional analysis, using model averaging techniques to control for model uncertainty.** An important limitation of cross-sectional analysis is the difficulty to control for model uncertainty, or uncertainty regarding the types and the number of control variables to be included in the specification (see, e.g., Magnus and others., 2010, and references therein). Model averaging helps to address this limitation. This approach entails estimating all possible candidate models and then computing a weighted average of all estimates of the coefficient of interest—governance quality and corruption in this case—where the weights are based on measures of goodness of fit of each model.<sup>4</sup>

#### The Following Specification is Estimated:

$$y = X_1 \beta_1 + X_2 \beta_2 + \varepsilon \quad (\text{B2})$$

where  $y$  is a vector of  $n$  observations—for example, the average growth rate of GDP per capita for each country  $i=1\dots n$  over the period 1995–2015),  $X_1$  is a matrix containing explanatory variables always included in the model (“focus” regressors) and  $X_2$  is a matrix of additional explanatory variables to be tested (“auxiliary” regressors). Equation (B2) is estimated using WALs. As discussed by Magnus and others. (2010), WALs is theoretically and practically superior to standard Bayesian

<sup>4</sup> With model averaging, the confidence bands associated with the estimated coefficient tend to be wider than those based on standard approaches. In identifying robust correlates using weighted-average least squares (WALS), the literature suggests to classify variables with a  $t$ -statistics in absolute value larger than one as significantly robust. The intuition behind this is related to well-known property of the adjusted R-square, which increases if and only if the  $t$ -statistics associated with an added regressor is greater than one in absolute value (see Magnus and others. 2010, for a discussion).

model averaging (BMA) because the prior is “neutral” and minimizes the risks of reject criterion. The space over which model selection is performed increases linearly rather than exponentially in size, making the technique more practical.<sup>5</sup>

Two versions of equation (B2) are estimated. The first specification (Model 1) includes as focus variables the proximate determinants of the Solow model (initial GDP per capita, investment to-GDP ratio, education, life expectancy and population growth) plus a constant. The second specification (Model 2) includes only the constant as focus variable—that is, all explanatory variables are treated as auxiliary regressors.

**Beyond per-capita growth, staff examined empirical associations with investment, revenue performance, and inclusive growth.** Equation (B2) is estimated for the following dependent variables: (i) GDP per capita growth; (ii) investment-to-GDP ratio; (iii) revenue-to-GDP ratio; (iv) inequality (measured by the Gini coefficient of disposable income); and (v) the growth in Equally Distributed Equivalent Income (EDEI)—a proxy of inclusive growth.<sup>6</sup> These variables are averaged over the period 1995–2015. The number of countries (71) is determined by data availability for the auxiliary variables.

## B. Results

**Results suggest that corruption (weak governance) is robustly and negatively associated with economic growth.** While corruption (governance quality) and long-run per capita growth are weakly correlated in a bilateral specification, WALs results point to robust and statistically significant association with growth. The partial associations between corruption (weak governance) and growth are negative in a large set of possible models. A worsening in the corruption (governance) indicator from the 50th percentile of distribution to the 25th percentile of distribution is associated with a fall in long-run per capita growth of 0.3 (0.5) percentage point (Figure A3.2, Panel A).

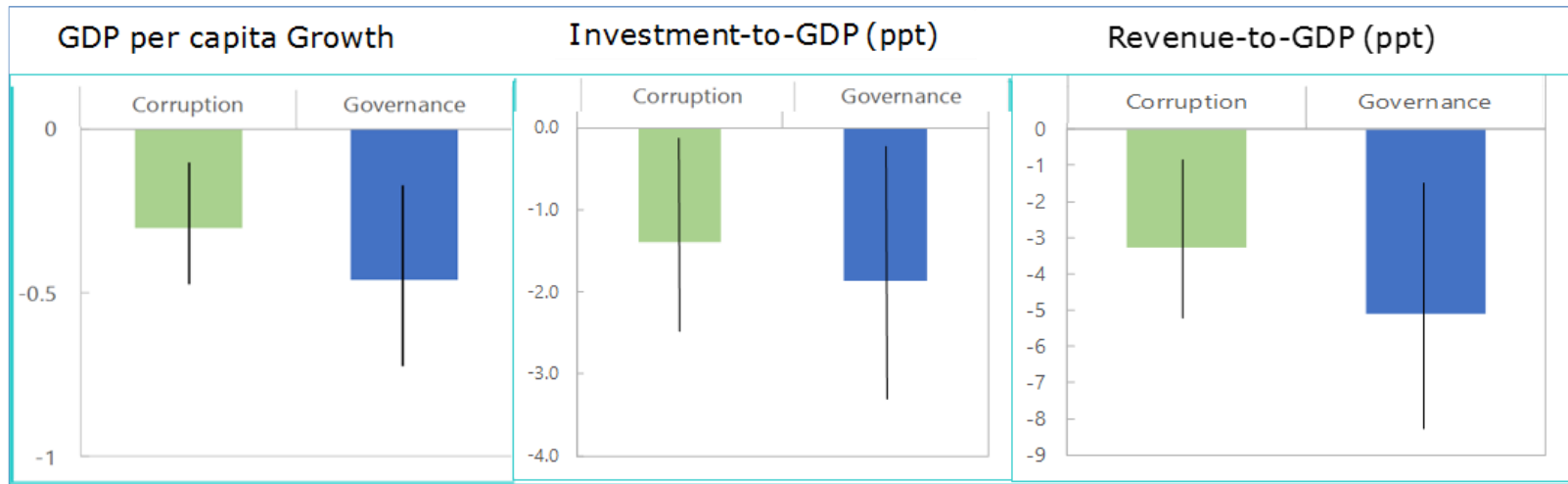
**Deterioration in corruption or governance quality is also associated with lower investment and fiscal revenue (Figure A3.2, Panel B and C), higher inequality, and worse inclusive growth performance (Figure A3.3).** In all cases, the magnitude of the association is economically significant

**The results hold for a battery of robustness checks.** These include: (i) alternative choices of auxiliary regressors; (ii) alternative time periods of the dependent variables (1980–2015; 1990–2015); (iii) including additional variables as in the original BMA exercise of Sala-Martin and others, (2004); (iv) alternative data sources for growth and investment (World Development Indicators and Penn World Table); (v) excluding corruption from the composite measure of governance; (vi) ordinary least squares (OLS) and WALs approaches based on a more restricted set of variables (which increases the sample size to about 90 observations).

<sup>5</sup> Unlike BMA, WALs relies on preliminary orthogonal transformations of the auxiliary regressors and the parameters. For example, with 60 regressors the computing time of standard BMA is of the order  $2^{60}$  while computing time of WALs is of the order 60.

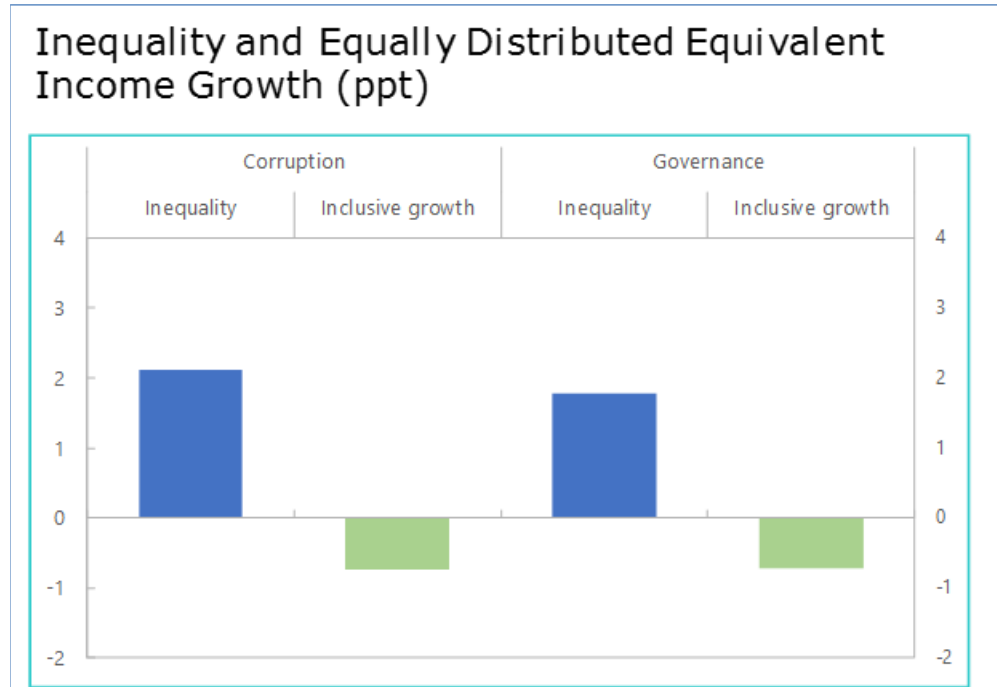
<sup>6</sup> See Gaspar and others, 2017.

**Figure A3.2. Association Between Corruption (Governance) and Long-run Per Capita Growth, Investment, and Revenue**  
(In percentage points)



Note: The bar denotes the average growth (investment, revenue) differential from increasing the corruption (governance indicator) from the 25th percentile of distribution to the 50th percentile of distribution. Solid lines indicate one standard deviation interval. Governance is defined as the average of the WGI indicators: (i) government effectiveness, (ii) rule of law, (iii) regulatory quality; (iv) voice and accountability and (v) corruption. Estimates based on WALs, controlling for about 40 potential regressors.

**Figure A3.3. Association Between Corruption (Governance) and Inequality, Inclusive Growth**  
(In percentage points)



Note. The bar denotes the average loss in growth, revenue, equity and inclusive growth from moving the corruption indicator (governance indicator) from the 50th percentile of distribution to the 25th percentile of distribution. Solid lines indicate one standard deviation interval. Governance is defined as the average of the WGI indicators: (i) government effectiveness, (ii) rule of law, (iii) regulatory quality; (iv) voice and accountability and (v) corruption. Estimates based on Weighted Average Least Squares, controlling for about 40 potential regressors. Inclusive growth computed as the growth rate in Equally Distributed Equivalent Income (see Gaspar and others, 2017).

**Table A3.4. Variables Used in Cross-Sectional Analysis**

<b>Variable Description</b>	<b>Source</b>
Log of average population attended/completed secondary school	Barro-Lee
EDEI (average 2003-2015)	Gaspar et al. 2017
Average per capita GDP growth rate (1995-2015)	Penn World Tables v.9
Log of initial per capita GDP (1999 for 2000-2004 period)	Penn World Tables v.9
Average ratio of investment to GDP (1995-2015)	Penn World Tables v.9
Log of average population growth	Sala-i-Martin et al. 2004
Average CPI inflation	Sala-i-Martin et al. 2004
Income group (WB-classification)	Sala-i-Martin et al. 2004
Dummy variable for East Asia	Sala-i-Martin et al. 2004
Dummy variable for Sub-Saharan Africa	Sala-i-Martin et al. 2004
Dummy variable for Latin American and Caribbean	Sala-i-Martin et al. 2004
Degree of tension due to race, language	Sala-i-Martin et al. 2004
Dummy variable if country legal system is based on French code	Sala-i-Martin et al. 2004
Dummy variable if country legal system is based on UK code	Sala-i-Martin et al. 2004
Executive constraints	Sala-i-Martin et al. 2004
Risk of forced nationalization of property	Sala-i-Martin et al. 2004
Reciprocal of life expectancy	Sala-i-Martin et al. 2004
Log of the total fertility rate	Sala-i-Martin et al. 2004
Percentage of land area classified as tropical	Sala-i-Martin et al. 2004
Percentage of a country's land within 100km of an ice-free coast	Sala-i-Martin et al. 2004
Measure of linguistic fractionalization	Sala-i-Martin et al. 2004
Average extensive margin measure of a country's exports	Sala-i-Martin et al. 2004
Absolute latitude	Sala-i-Martin et al. 2004
Coastal population density	Sala-i-Martin et al. 2004
Capitalism	Sala-i-Martin et al. 2004
English speaking population	Sala-i-Martin et al. 2004
Hydrocarbon deposits	Sala-i-Martin et al. 2004
Malaria prevalence	Sala-i-Martin et al. 2004
Timing of independence	Sala-i-Martin et al. 2004
Oil producing country dummy	Sala-i-Martin et al. 2004
Political rights	Sala-i-Martin et al. 2004
Real exchange rate distortions	Sala-i-Martin et al. 2004
Revolutions and coups	Sala-i-Martin et al. 2004
Outward orientation	Sala-i-Martin et al. 2004
Socialist dummy	Sala-i-Martin et al. 2004
Public investment share	Sala-i-Martin et al. 2004
Average ratio exports + imports to GDP, filtered for the logs of pop and area	Sala-i-Martin et al. 2004
Gini coefficient of disposable income (average 1995-2015)	SWID
Average ratio of government consumption to GDP	WB-WDI
Control of corruption (estimate)	WB-WGI
Ratio of export + imports to GDP	WB-WDI



## Annex 4. Improving Governance: General Equilibrium Analysis Using a Macroeconomic Model

**This annex describes the macroeconomic model and how it was used to analyze the effects of improvements in three key aspects of governance:** (i) a reduction in bribes and other distortions that discourage firms from investing and creating jobs; (ii) an increase in public investment spending efficiency; and (iii) a decline in tax evasion.

### The Model

**The Debt, Investment, and Growth model developed by Buffie and others (2012) is here extended to capture reforms in the areas of governance.** DIG is a real, dynamic, open economy model in which public capital is used as input of production. Its general equilibrium nature makes it possible to analyze the impact of reforms simultaneously on output, private investment, consumption, and fiscal outcomes. Firms optimally choose their private capital and labor inputs. The government levies distortionary taxes to finance public investment. Policymakers are assumed to respond to changes in the debt/GDP ratio with a lag, to return the ratio gradually to its steady-state level: increases (decreases) in the debt ratio are followed by tax rate hikes (cuts). The model is extended to account for three aspects of governance, as follows.

**First, a share of economic output is lost because of weak governance.** Such loss could represent, for example, the time and resources lost by entrepreneurs to bribe government officials to obtain required authorizations. As a result, firms are discouraged from investing and hiring. For simplicity, the loss is assumed to be proportional to the level of production. Let the firm's production function be:

$$Y_t = f(K_t, L_t, K_t^G), \quad (1)$$

where  $Y_t$  is output,  $K_t$  is the stock of private capital,  $L_t$  is labor,  $K_t^G$  is the stock of public capital and  $f(\cdot)$  is an increasing and concave function of the private factors for production and of public capital. The firm's profit,  $\Pi_t$ , is given by:

$$\Pi_t = (1 - \kappa_t)Y_t - w_t L_t - R_t^k K_t, \quad (2)$$

where  $\kappa_t \in (0,1)$  is the percentage of output wasted owing to weak governance,  $w_t$  is the real wage, and  $R_t^k$  is the gross return to private capital. Standard profit maximization implies that the real wage and the return to private capital are equalized to the marginal products of labor and capital, respectively:

$$w_t = (1 - \kappa_t) \frac{\partial f(\cdot)}{\partial L_t}, \quad (3)$$

$$R_t^k = (1 - \kappa_t) \frac{\partial f(\cdot)}{\partial K_t}. \quad (4)$$

Waste caused by weak governance creates a wedge  $(1 - \kappa_t) < 1$  between the real wage and the marginal product of labor, and between the gross return to private capital and the marginal product of capital. For given  $w_t$  and  $R_t^k$ , an increase in  $\kappa_t$  requires  $\frac{\partial f(\cdot)}{\partial L_t}$  and  $\frac{\partial f(\cdot)}{\partial K_t}$  to increase in equilibrium,

and hence the demands for labor and capital to decline, given diminishing marginal returns. This will translate into lower employment, lower investment, and thus lower output.

**Second, weak governance reduces the efficiency of public investment (the fraction of government capital expenditures that translates into productive public capital).** The law of motion of public capital will thus be:

$$K_{t+1}^G = (1 - \delta^G)K_t^G + \epsilon_t I_t^G, \quad (5)$$

where  $\delta^G$  is the depreciation rate,  $\epsilon_t \in (0,1)$  is public investment efficiency and  $I_t^G$  is public investment expenditure. The stock of public capital available at the beginning of period  $t + 1$  equals the stock of capital that has not depreciated up to the end of period  $t$ , plus effective public investment  $\epsilon_t I_t^G$  (weak governance causes a fraction  $1 - \epsilon_t$  of public investment spending to go wasted). Lower public investment efficiency translates into a lower stock of public capital being accumulated and, via equation (1), lower output.

**Third, inefficiencies lead to loss of tax revenues.** A fraction of taxes due fails to reach the government budget. To reflect this point, the law of motion of government debt in real terms may be expressed as follows (for simplicity, the only expenditure is for public investment and the only source of revenue is a consumption tax):

$$B_{t+1} = R_t B_t + I_t^G - (1 - \vartheta_t) \tau_t^C C_t, \quad (6)$$

where  $R_t$  is the real gross rate of interest on government bonds,  $B_t$ ;  $\tau_t^C$  is the consumption tax rate;  $C_t$  is private consumption and  $\vartheta_t \in (0,1)$  is the share of revenue lost owing to weak governance. For a given level of tax revenue, a higher  $\vartheta_t$  would result in higher debt; alternatively, to keep debt at a given level, a higher  $\vartheta_t$  would necessitate a higher tax rate, thus curbing private demand and output.

## Model Calibration and Results

**The model is calibrated to a representative Emerging Market and Developing Economy (EMDE) featuring weak governance in the three channels outlined above.** Indicators of efficiency in tax collection and public investment, both assembled by staff based on systematic questionnaires, are used to calibrate the corresponding efficiencies in the model at the 1<sup>st</sup> quartile of the distribution of emerging market and developing economies. Similarly, the share of output lost to weak governance is calibrated to match the ratio of private investment to GDP at the 1<sup>st</sup> quartile of the same group. All remaining parameters are calibrated as in Buffie and others (2012). The simulations assume that the country gradually improves in the three dimensions of governance from the 1<sup>st</sup> to the 2<sup>nd</sup> quartile of the distribution over 10 years. Specifically, the share of output lost is reduced by an amount that would lead firms gradually to raise the private investment-to-GDP ratio from 12 percent to 16 percent; public expenditure efficiency would rise from 48 percent to 62 percent; and the government's efficiency in collecting taxes would also rise (from 35 to 55 percent for VAT). The implications are traced first for reforming only one aspect of governance at a time, keeping the other two at their initial level; they are subsequently assessed for a comprehensive reform that tackles all the three channels simultaneously.

**Reducing the share of output wasted to weak governance (owing e.g., to corruption, red tape, etc.) leads firms to invest more and thus boosts growth.** Figure A4.1 shows the paths of private investment, private consumption, output, and public debt-to-GDP, following a reduction of  $\kappa_t$ , the parameter representing the distortion to firms' investment and employment decisions. This reform leads real per-capita output to rise by 20 percent over 10 years; private consumption likewise increases. Public debt decreases by 4.5 percent of GDP (from an assumed initial level of 30 percent of GDP).

**Cutting waste in public capital expenditures translates into a larger stock of public capital, with positive effects on growth and the public finances.** Figure A4.2 reports the paths of the same macroeconomic variables as a result of an improvement in public investment efficiency. Such structural reform increases the stock of public capital, which in turn leads to a rise in real per-capita income of 3 percent relative to the pre-reform era.<sup>1</sup> This reform leads also to a crowding-in of private demand (consumption and investment) and a decline in the public debt-to-GDP ratio by 2 percentage points.

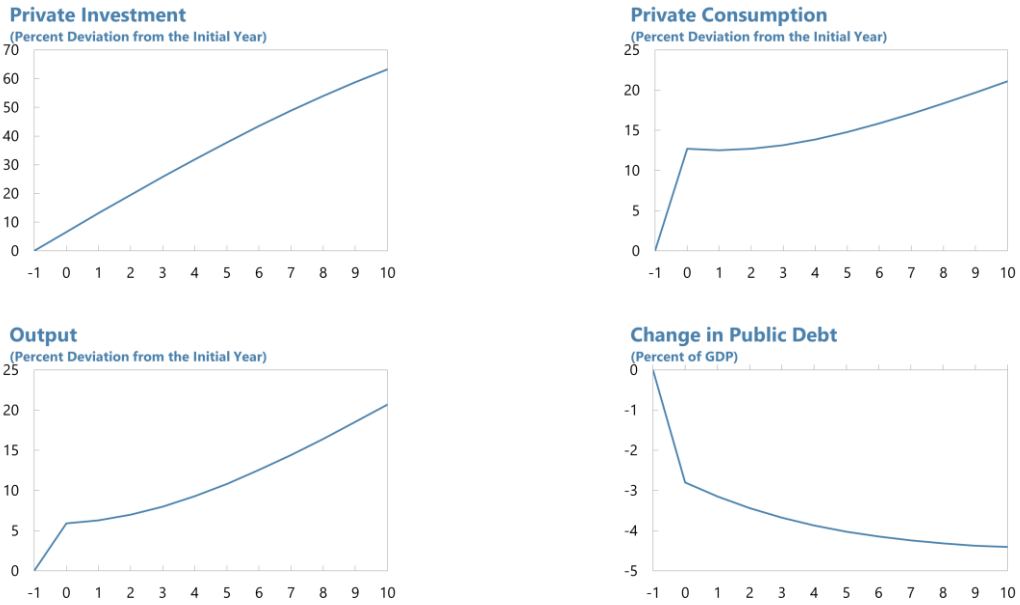
**Widening the tax base via an improvement in tax administration efficiency benefits government debt dynamics, creates space for tax rate cuts, and boosts economic growth.** Figure A4.3 plots the effects of reforms that reduce leakages in revenue collection. Expanding the tax base allows the government to reduce the tax rate, which boosts private consumption, investment, employment and, ultimately, per-capita output (by more than 2 percent). Despite the decline in the tax rate, given the higher tax revenues collection and the increase in output, public debt falls by 9 percent of GDP after 10 years. The decline in public debt would be stronger if the tax rate were to be kept fixed at the pre-reform level.

**A comprehensive reform package improving all three aspects of governance delivers even higher growth and further expands fiscal space (Figure A4.4).** Private investment is 70 percent higher after 10 years in real terms; output and private consumption increase by about 30 percent. Public debt falls by almost 15 percent of GDP after 10 years, allowing the tax rate to fall (in line with the assumed fiscal reaction function) and to stimulate private demand further.

---

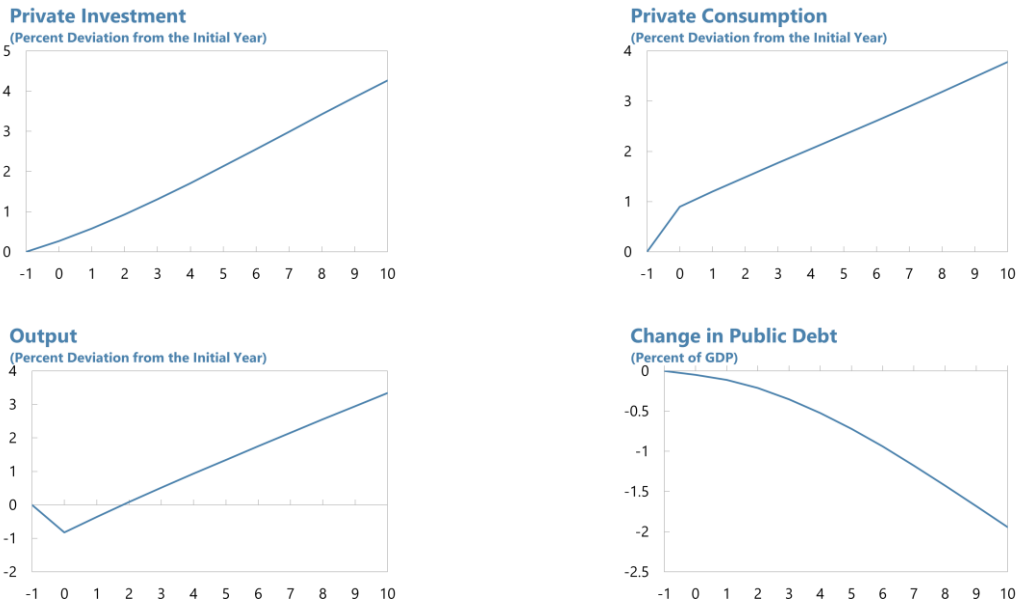
<sup>1</sup> The reform causes output to decline initially, owing to the large positive income effect on labor supply.

**Figure A4.1. Effects of Reducing Firms’ Distortion**



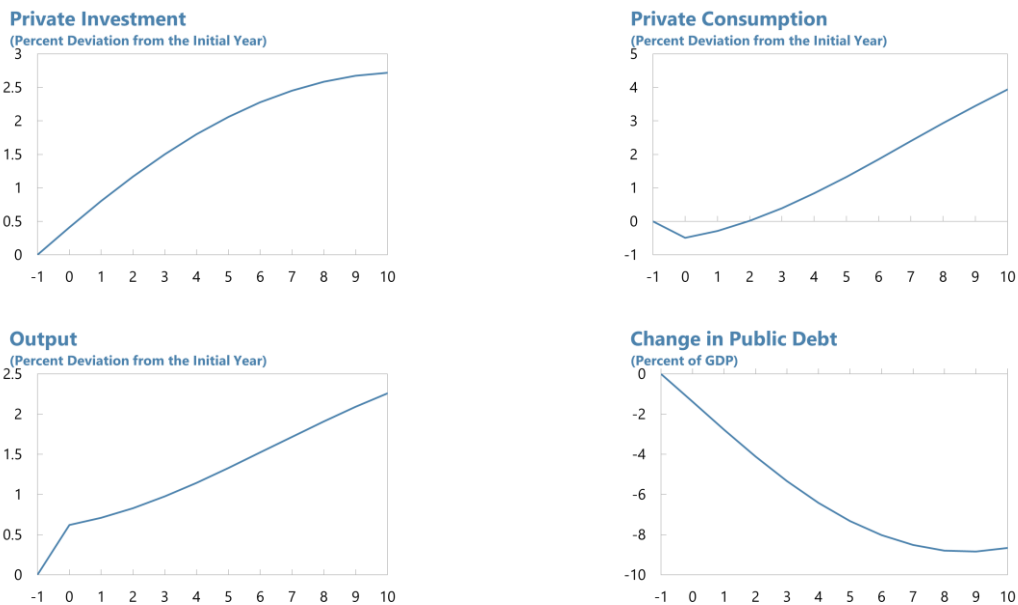
Note: x-axes in years. Policy changes occur in year 0. Sources: DIG simulations and IMF staff calculations.

**Figure A4.2. Effects of More Efficient Public Investment**



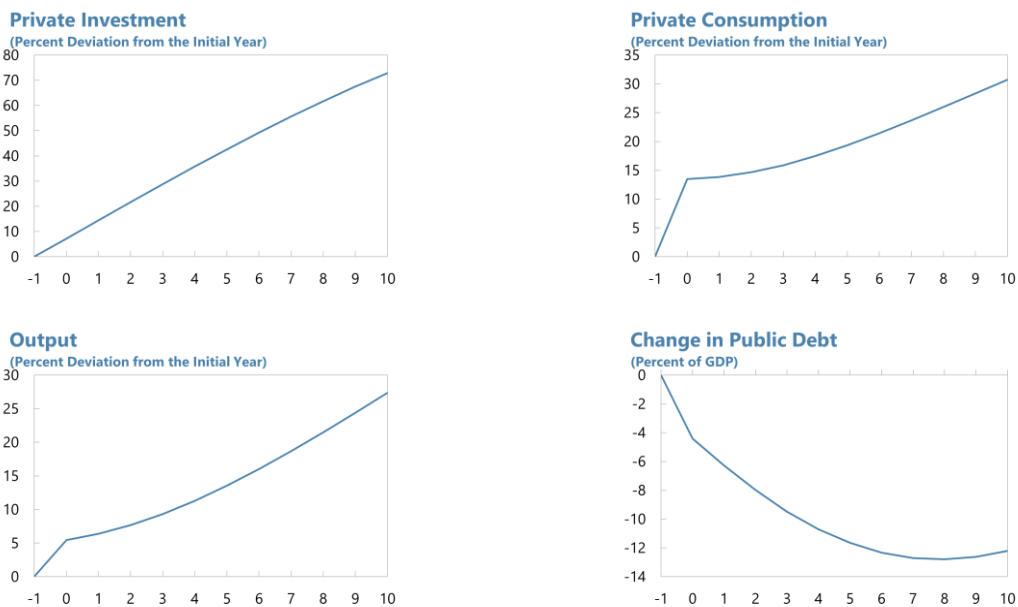
Note: x-axes in years. Policy changes occur in year 0. Sources: DIG simulations and IMF staff calculations.

**Figure A4.3. Effects of Improving Revenue Mobilization**



Note: x-axes in years. Policy changes occur in year 0. Sources: DIG simulations and IMF staff calculations.

**Figure A4.4. Effects of Reforms in All Areas of Governance**



Note: x-axes in years. Policy changes occur in year 0. Sources: DIG simulations and IMF staff calculations.