DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

MASTER FILES
ROOM C-525 0451

EBS/96/197

CONFIDENTIAL

December 20, 1996

To: Members of the Executive Board

From: The Secretary

Subject: **The Role of the Fund in Governance Issues**

Attached for consideration by the Executive Directors is a paper on the role of the Fund in governance issues, which is tentatively scheduled for discussion on Wednesday, January 15, 1997. It should be noted that the issues related to the Fund's role in governance are addressed in this single paper.

Ms. Christensen (ext. 38397) or Mr. I. H. Lee (ext. 36763) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

The attached paper includes an appendix dealing with governance in other international organizations, and if Directors agree, it is proposed to transmit the paper to the Asian Development Bank (AsDB), the European Bank for Reconstruction and Development (EBRD), the European Commission (EC), the Inter-American Development Bank (IDB), and the Development Assistance Committee of the OECD, following its consideration by the Executive Board.

Att: (1)

Other Distribution:
Department Heads

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

The Role of the Fund in Governance Issues

Prepared by the Policy Development and Review Department
(In consultation with Legal and other departments)

Approved by Jack Boorman

December 20, 1996

Contents — Page

Appendix I

I. INTRODUCTION

1. Good governance is inextricably linked to issues of central concern to the Fund: the efficiency of resource allocation, incentives for savings and investment, public support for the economic reform efforts of governments, and, thereby, to the sustainability of the adjustment effort. The Fund's involvement in governance issues is not a recent phenomenon. The Fund has long been involved in promoting good governance—either directly or indirectly—in the context of its policy advice and technical assistance to member countries. More recently, governance issues have risen to prominence in Fund activities for a variety of reasons:

- Greater recognition that poor governance can be an obstacle to private sector investment—including foreign direct investment—and economic growth.[1]

- The increasing emphasis of donors on governance in the allocation of aid and its implications for the financing of Fund-supported programs.

- Fund-supported programs have gone off track or roadblocks to economic stabilization have been thrown up in a number of cases as a result of fraud and misuse of public funds in central governments, public enterprises, and central banks.

- Money laundering, which has been estimated at about US$300-500 billion entering the international capital markets every year,[2] has raised increasing concerns for the international financial system.

- The requirements of institution building in countries undergoing rapid transition from state-controlled systems to market economies have brought into sharper focus a number of issues related to good governance.

2. More generally, as members increasingly confront such issues, the question arises as to whether and how the Fund, through its own efforts as well as in cooperation with other institutions, can do more to help countries deal with existing and potential governance problems within the scope of its mandate. In recognition of the significant economic benefits

---

[1] *The Effects of Corruption on Growth, Investment, and Government Expenditure*, Paolo Mauro, September 1996 (WP/96/98).

[2] *Money Laundering and the International Financial System*, Vito Tanzi, May 1996 (WP/96/55). See also *Macroeconomic Implications of Money Laundering* by Peter J. Quirk, June 1996 (WP/96/66). The Financial Action Task Force on Money Laundering—an intergovernmental body set up in 1989—has established a number of recommendations to combat money laundering. It conducts periodic exercises on the compliancy of its members with these recommendations and operates international action against money laundering.

of good governance, the Interim Committee Declaration of September 29, 1996, on "Partnership for Sustainable Global Growth" attached particular importance to:

> *"Promoting good governance in all its aspects, including by ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption, as essential elements of a framework within which economies can prosper."*

3. In recent years, governance issues have also received greater attention in other fora:[3]

—Member governments themselves, whether in industrial or developing countries or transition economies, are expressing growing concern with various aspects of poor governance and are taking actions on a wide front to address those problems.

—Bilateral donors are paying increasing attention to the effective use of aid, partly to reverse the aid fatigue in donor countries related to reports of misuse of funds.

—The World Bank, the Inter-American Development Bank, and the Asian Development Bank are devoting increasing attention to promoting good governance in recognition of its importance for aid effectiveness.

—UN institutions and agencies, and, in particular the UNDP, are increasingly focusing on how they can foster good governance.

—The Agreement on Government Procurement (part of the Uruguay Round agreements), which entered into effect on January 1, 1996, includes provisions on national treatment and nondiscrimination, tendering, selection, and challenge procedures that should improve governance by enhancing transparency.[4] In addition, the final declaration of the December 1996 World Trade Organization Ministerial Conference in Singapore agreed to the establishment of a working group to prepare an appropriate agreement to enhance transparency in government procurement practices and thereby reduce the scope for distortions.

---

[3]There are also several regional initiatives including that of the Organization of American States that adopted in March 1996 the Inter-American Convention against Corruption; the European Union is taking steps to criminalize, within the Union, bribery of EU officials and officials of EU member states; the Council of Europe has embarked on the development of several instruments to coordinate its members' efforts to combat international corruption.

[4]As yet, the signatories are predominantly industrial countries. Most members of the WTO have indicated that they are not ready to accede, because implementation of the Agreement on Government Procurement would require substantial and complex changes in domestic laws and procedures.

—During the Lomé IV mid-term review in 1995, the European Union added good governance to the existing reference to enjoyment of fundamental human rights as an important principle for the European Union's development policy and cooperation.

—The Development Assistance Committee (DAC) of the OECD adopted a new set of DAC Orientations on "Participatory Development and Good Governance" (PD/GG) at the DAC High Level Meeting in December 1993 and established an ad hoc Working Group on PD/GG that completed its work in October 1996.[5]

—Within the OECD, discussions have taken place on how to combat bribery in international business transactions, including the issue of the tax deductibility of bribes to foreign officials permitted under some national tax codes. While OECD member countries have agreed that such tax deductibility should be stopped, this agreement has not yet been implemented in most of these countries.

—In 1996, the Task Force on Multilateral Development Banks (MDBs) of the Development Committee called on MDBs to help create and maintain good governance.

—The G-7 countries emphasized good governance as the foundation of sustainable development and committed themselves to promote good governance at the Halifax Summit in 1995. The importance of good governance, including the role of multilateral development institutions in promoting it, was reiterated at the Lyon Summit in 1996.

—The communiqué of September 1996 of the Ministers of the Intergovernmental Group of Twenty-Four also discussed governance issues.[6]

4. Against this background, this paper responds to a request by the Executive Directors for a staff paper on the role of the Fund in governance issues. Section 2 discusses the Fund's experience in governance issues and briefly reviews the policies of other multilateral institutions in this area. Section 3 discusses considerations for future Fund involvement in governance issues.

---

[5]Five aspects of PD/GG (legal systems, public sector management, decentralization, human rights, and participation) were examined in recipient countries. Follow-up action, including donor coordination, will take place in pilot countries.

[6]While reiterating their commitment to the principles of good governance, Ministers stressed that, in accordance with their charters, the Bretton Woods institutions should proceed with extreme caution in the application of conditionalities in the governance area. They emphasized that the international financial institutions should augment their technical support for the indigenous efforts of the developing countries aimed at improving efficiency and accountability in state institutions.

II. FUND EXPERIENCE IN GOVERNANCE ISSUES

A. What is Governance?

5. While the subject of governance has recently gained prominence as an important issue for sustainable growth and development, recognition of the importance of governance goes back a long way in the history of economic analysis. As emphasized by Adam Smith in *The Wealth of Nations*:

> "*Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay.*"[7]

6. What constitutes good governance is a complex subject involving deep-rooted, political, philosophical and cultural aspects, and, as a result, views on this can be expected to differ across the Fund membership. This being said, there seems to be broad agreement as to a few "best institutional practices" of economic management that are conducive to promoting sustainable growth and prosperity.

7. The OECD's DAC defines governance as the use of political authority and the exercise of control in a society in relation to the management of its resources for social and economic development.[8] The DAC further distinguishes three aspects of governance:

- the form of political regime;
- the processes by which authority is exercised in the management of a country's economic and social resources; and
- the capacity of government to formulate and implement policies and discharge government functions.

8. The first of these aspects of governance, which embraces such considerations as the form and legitimacy of a government, and how control is exercised (e.g., the election process and human rights conditions), generally falls outside the purview of the Fund although the Fund

---

[7]*The Wealth of Nations*, 1776 (New York, The Modern Library, 1937), Book V, Chapter III, page 862.

[8]*DAC Orientations on Participatory Development and Good Governance*, December, 1993. Good governance, together with participatory development, human rights and democratization, are viewed by the DAC as essential elements of sustainable development.

acts within a community of international organizations, some of which have mandates covering such political dimensions. Nevertheless, the political situation has a bearing on Fund relations as the Fund needs to take a view on whether an existing political regime has the support necessary to implement and sustain appropriate economic policies. The second and third aspects involve economic dimensions that are of relevance to the Fund. Economic aspects of governance include management and accountability of public resources—whether of the central or local governments, public enterprises or the central bank—and establishing an economic and regulatory environment conducive to private sector activities. The distinction between political and economic aspects of governance is important in determining the boundaries of the Fund's involvement in various aspects of governance. However, there are clearly practical difficulties in establishing this distinction as the economic and political aspects of governance are often closely interlinked.

B. The Legal Bases for the Fund's Involvement in Governance

9. Fund involvement in governance issues arises primarily in the context of surveillance, use of Fund resources, and technical assistance; it may also arise in other areas, such as in a member's obligation to avoid exchange restrictions.

- **Surveillance**: Article IV, Section 1 of the Articles of Agreement prescribes members' obligations with respect to exchange rate policies and economic and financial policies. A member is required "*to endeavor to direct its economic and financial policies toward the objectives of fostering orderly economic growth with reasonable price stability, and to seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.*" In other words, a member is required to seek to apply sound policies, and a reasonable effort to do so is expected on the part of the member. The existence of poor governance—if sufficient to have a substantial impact on the effectiveness of a member's economic and financial policies—could demonstrate that the member is not complying with its obligations under Article IV, Section 1. Therefore, in exercising its surveillance function under this Article, as a general matter the Fund can consider issues of governance that have a material effect on a member's economic and financial policies. Article IV, Section 3(b) also states that the Fund is to "*adopt principles for the guidance of all members with respect to those policies*" and that the "*principles shall respect the domestic, social, and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of the members.*" This may, in some cases, influence the nature of the Fund's surveillance regarding governance.

- **Use of Fund resources**: Article V, Section 3(a) of the Articles of Agreement states that "*the Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems that will assist members to solve their balance of payments problems in a manner consistent with this Agreement and that will establish adequate safeguards for the* *temporary use of the general resources of the Fund."*[9] If it were clear that Fund assistance for balance of payments support would be misappropriated, the purpose of Fund financing would be thwarted. Similarly, poor governance might have implications for the adequacy of financing assurances for a Fund-supported program or for the sustainability of the adjustment and reform effort. The Fund could insist that measures be taken to deal with poor governance before agreeing to provide the country with resources or that they be taken in the context of use of those resources. The Fund also needs to safeguard the revolving nature of its resources, and in that connection, poor governance in a potential borrowing country has a bearing on the use of Fund resources.

- **Technical assistance**: Article V, Section 2(b) of the Articles of Agreement states that the Fund *"may decide, if requested, to perform financial and technical services . . that are consistent with the purposes of the Fund."* For example, if the objective of Fund technical assistance was an improvement in tax collection, corruption in the tax administration could clearly stand in the way of success, and the Fund could recommend preventive and corrective measures against corruption in that case. Of course, its involvement is constrained by requests from members, and this assistance must be consistent with the Fund's purposes as stated in Article I.

- **Other Examples:** In addition to the obligations regarding exchange arrangements under Article IV, members' obligations in relation to the avoidance of restrictions on current payments and transfers and multiple currency practices (except those grandfathered under Article XIV) are prescribed in Article VIII, Sections 2 and 3. Under Section 2, *"no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions"* and, under Section 3, *"no member shall engage in or permit any of its fiscal agencies . . . to engage in any discriminatory currency arrangements of multiple currency practices . . . . "* Since such restrictions and practices can harbor economic distortion and rent seeking, the exercise of the Fund's jurisdiction in this area has also tended to promotes good governance.

C. The Fund's General Policy Recommendations

10. In its general policy advice to assist the promotion of growth and adjustment in member countries, the Fund has indirectly or directly contributed to promoting good governance in several respects:

- First, as part of its ***policy advice***, the Fund has generally encouraged price decontrol, liberalization of the exchange and trade systems, the creation of systems for market-determined interest rates, and the abolition of direct credit allocation based on ad hoc

---

[9]The reference to "consistent with this Agreement" includes consistency with the Fund's purposes as stated in Article I (Decision No 287-3, March 17, 1948 in *Selected Decisions*, Twenty-First Issue, p. 64).

nonfinancial decisions. Such measures, which have had a beneficial effect on economic efficiency, have also helped curtail the scope for generalized rent seeking (Table 1). The reduction in inflation in member countries, in line with typical Fund policy advice, can also indirectly improve governance. The lowering of inflation can help clarify the incidence of taxation and the factors that affect resource allocation and income distribution. Although the relationship between the size of the public sector and good governance is complex, by advocating leaner and more effective government, Fund policy advice in this area has tended to reduce the scope for discretionary and ad hoc decision making and preferential treatment on taxes and subsidies.[10]

- Second, ***Fund technical assistance*** has assisted member countries in enhancing their capacity to design and implement economic policies and improving public sector accountability. Such assistance has covered a wide range of issues from statistical compilation to setting up a treasury in the Ministry of Finance and restructuring the central bank. In many cases, recommendations from technical assistance missions have been taken up and further pursued by the Fund in the context of Article IV consultations and financial assistance. **Box 1** elaborates on four different areas in which the Fund has provided technical assistance which has contributed to improving policy implementation capacity through changes in the institutional and procedural arrangements.

- Finally, the Fund has promoted ***transparency in financial transactions***, such as inclusion of extrabudgetary transactions and implicit subsidies in the budget, improvements in central bank accounts (including central bank quasi-fiscal activities), bank supervision, and external audits of government, public enterprise, and central bank transactions which can help identify areas of poor governance. Moreover, adherence to disciplined, predictable, and transparent fiscal and monetary policies has fostered a climate that has made policy makers more accountable for their actions and created an environment conducive to good governance.

11. Although general liberalization measures and rationalization of government operations tend to reduce the scope for rent seeking, in many cases important obstacles to a rules based, competitive environment have remained and the problem of governance has been transferred from one policy domain to another. To varying degrees, the old systems may sometimes have been replaced by other networks of informal and nontransparent arrangements between governments and certain vested interests. Typically, this has given rise to tax fraud or exemptions, or to preferential treatment of enterprises that have been privatized or are still

[10]For example, in transition economics, the elimination of state orders in domestic and foreign trade, including trade quotas, helped reduce economic rents and thereby also improve the quality of governance. The establishment of a two-tier banking system also helped improve governance in banking transactions. The elimination of exemptions in taxes and tariffs has reduced the scope for ad hoc decision making.

Table 1. Governance Issues for the Fund and Other Institutions and Donors

Core Fund Activities 1/	Activities of Other Institutions and Donors 1/
Economic Policy Reforms	
o *Liberalization of exchange and trade system*	o *Privatization and public sector reforms*
o *Price liberalization and reduction in inflation*	o *Regulatory reforms*
o *Interest rate liberalization and abolition of directed credits and credit ceilings for individual banks*	o *Financial sector reforms*
o *Tax system reforms*	o *Trade reforms*
o *Expenditure control and management*	
o *Banking reforms*	
Capacity - Building	
o *Treasury*	o *Financial management, accounting, and auditing*
o *Budget management*	o *Civil service reforms*
o *Central Bank*	o *Public expenditure reviews*
o *Tax and customs administration*	
o *Bank and financial sector supervisory and prudential standards*	
Economic Data Management and Transparency	
o *Economic data management, including national accounts, prices, foreign trade, fiscal, monetary and balance of payments data*	o *External debt*
	o *Financial statements of banks and state enterprises*
Judicial and Regulatory Reform	
o *Central Bank and foreign exchange laws and regulations*	o *Business laws*
	o *Commercial codes and investment laws*
	o *Bankruptcy and arbitration laws*
	o *Judiciary reform*
Project-related Activities	
...	o *Public procurement practices*
Political Aspects	
...	o *Human rights*
	o *Election process*
	o *Participatory development*

1/ There are overlapping areas of involvement of the Fund and other institutions, including in economic policy reforms and capacity building.

Box 1. Contribution of the Fund's Technical Assistance to Governance

Below are a few examples illustrating how the Fund's technical assistance has supported capacity building in a few key areas.

Improving tax administration: Recommendations included: (i) the establishment of an independent tax authority not subject to the regular civil service wage structure; (ii) the removal of job security but with a realistic wage structure and a strong disincentive system for poor work performance within the civil service; (iii) the introduction of a single system of taxpayer identification with proper audit and investigative programs and more systematic and frequent inspections; (iv) a revision and consolidation of tax laws; and (v) establishment of an easily accessible appeal mechanism for tax payers.

Enhancing budgetary procedures and control: In more advanced systems, Fund recommendations have included: (i) improvements in the models used to forecast various tax receipts; (ii) shifting the responsibility for monitoring and forecasting revenue to the Ministry of Finance; (iii) reallocating responsibility for monitoring and forecasting expenditure in the current fiscal year to line ministries; (iv) developing an integrated system of forward estimates that effectively constrains expenditure in line with available resources; (v) strengthening monitoring and control procedures; and (vi) enhancing transparency within the budget through the provision of full details of the allocation of revenue and expenditure by category.

Establishing a two-tier banking system: The Fund has assisted member countries to reform mono-banking systems under central planning into two-tier systems in line with a shift toward a market-based economy. The recommendations included laying out concrete steps to separate commercial banking functions from the former state bank and establishing a compact and flexible organizational structure of the central bank. The latter would usually include the audit, research, statistics, and monetary operations departments, with, for example, the audit departments having internal control over other departments according to the internal regulations of the central bank. The establishment of a two-tier banking system usually required the enactment of other related laws.

Enhancing the operation of the foreign exchange system: The Fund has fostered good governance through its efforts to promote exchange liberalization, including the removal of opportunities for discretionary intervention and rent seeking. The Fund has recommended: (i) the liberalization of the regulations governing nonbank foreign exchange dealers; (ii) the consolidation of the system for collecting information on banks' and dealers' foreign exchange transactions firmly under the central bank's supervision; and (iii) the revision of the limits on banks' foreign currency positions by eliminating the limit on their operating balances and introducing prudential limits on their positions in individual currencies.

under government control. In many countries that have completed the first round of liberalization measures, the lack-luster revenue performance is directly related to aspects of poor governance. In market economies, the lack of transparency and absence of a level playing field in regulatory or judicial spheres have been serious impediments to private sector investment and have also provided a breeding ground for poor governance. To address these issues, often a host of measures is needed—many of which fall under the expertise of other institutions, including the World Bank (as illustrated in Table 1)—for example:

- Public enterprise reform involving the downscaling of public enterprises through privatization, liquidation and restructuring, and improvements in the management and in the transparency of financial transactions of the enterprises. The process of privatization itself needs to be carefully managed as it can be a serious source of corruption.

- Public expenditure reviews to improve the transparency of expenditure allocation and foster a decline in unproductive expenditure, coupled with adequate provision for essential government services, including basic social services.

- Civil service reform aimed at improving the structure and the quality of the civil service, as well as its remuneration and, on the central bank side, proper training and remuneration of staff (including in banking supervision).

- Efforts to modernize and enhance the competencies of all arms of government—executive, legislative, and judicial—as a means of removing roadblocks that may have a negative impact on economic decision making.

- Judicial and regulatory reform to clarify property rights, and to provide a legal basis for enforcements of contracts and civil prosecution, including bankruptcy and arbitration laws, to create an appropriate framework for private sector activities.

This being said, genuine reform in these areas requires profound changes in institutions and attitudes, which can take time to take hold.

D. Experience in Dealing with Specific Governance Issues

12. In addition to promoting good governance through its general policy advice, the Fund has in some instances addressed specific economic issues linked to poor governance. Conditionality in the form of prior actions, performance criteria, and benchmarks, has been applied to address a few specific aspects of governance that contributed significantly to poor economic performance. These have included institutional reforms to assure better implementation of policies. **Box 2** presents the diversity of structural benchmarks and structural performance criteria included in recent stand-by arrangements (SBAs), extended arrangements, and ESAF arrangements which have an impact on governance.

Box 2. Structural Measures Related to Governance in Fund-Supported Programs

Fund-supported programs have involved measures that enhanced directly or indirectly the quality of governance. Of the 52 SBAs approved (involving 41 countries) during March 1993-April 1996, programs involving 23 countries contained at least one structural measure (mostly as structural benchmarks or conditions for completing a review) that addressed governance issues directly (see listing below). In the case of extended arrangements, of the 14 programs (involving 13 countries) approved during March 1992-April 1996, programs involving 10 countries included structural measures (largely as structural benchmarks and a few as performance criteria) that have strong governance implications. Of the 32 ESAF arrangements approved during the period January 1993-June 1996, almost all of them contained at least one structural measure (mostly as structural benchmarks, but also as performance criteria) that directly contributed to good governance. Needless to say, these programs may have included many other policy measures that also provided good governance. Close collaboration was maintained with other multilateral institutions, particularly the World Bank, as many of these measures fall under their expertise.

Measures in these arrangements have been aimed at improving the following aspects of governance:

Improving information flows—compiling and publishing data on a regular basis, introducing a program and a law on improving statistics, and gazetting regulations on foreign exchange exposures.

Enhancing transparency of government management process—reducing tax exemptions, reforming the civil service, reducing extra-budgetary funds and integrating all government accounts into the treasury, starting new taxpayer ID numbers, reforming budgeting and expenditure control, reforming government procurement policies, rationalizing the systems of tax penalties, and implementation of public management improvement plans.

Strengthening and monitoring of tax collection—including through hiring of private international inspection companies on a transitional basis, in particular for collection of trade taxes, and setting up a revenue authority.

Public expenditure policies—including reduction in unproductive expenditures and civil service reform.

Strengthening the treasury—establishing regional treasury offices, separating the functions and responsibilities for the treasury and public accounting, reorganizing the State Tax Inspectorate, strengthening the customs and tax administration, and creating within the Ministry of Finance a unit to register and manage external debt guaranteed by the government.

Enhancing the transparency of the banking system—auditing banks by international firms, producing accounts consistent with international standards, strengthening banking supervision, restructuring the central bank, identifying non-performing loans, and banning mandatory credit schemes.

Enhancing the accountability of public enterprises—establishing a monitoring system for public enterprises, imposing hard budget constraints, requiring public enterprises to produce accounts, and, in some cases requiring these accounts to be subjected to external audits, implementing strict rules on payments, clearing cross-debts among public enterprises, and completing tax audits for large enterprises.

Strengthening the rule of law—submitting to national parliaments and implementing various laws and decrees including on land ownership, bankruptcy, company, anti-monopoly, arbitration, and investment.

Promoting private sector investment—deregulating investment procedures, reducing the scope of negative investment lists, and eliminating domestic content requirements.

13. In other cases, preventive measures were incorporated in program design, for example:

- **removal of tax exemptions;**

- **transferring the responsibility for the assessment and control of customs duties to a private certification company and increasing the transparency of operations of public enterprises through improved accounting;**

- **public tendering of procurement contracts and publishing the minutes of the tender board;**

- **separation of the functions and responsibilities for the treasury and public accounting;**

- **eliminating government monopsonies, procurement agencies, and branch ministries; and**

- **completion of independent audit of government agencies and public enterprises.**

14. The involvement by the Fund in specific corruption issues[11] has required a careful balancing of different considerations, including: (i) the existence of clear and credible evidence; (ii) the size of the economic impact; (iii) the mode of Fund involvement (i.e., Article IV consultation, financial or technical assistance); and (iv) uniformity of treatment. In a number of cases involving corruption, programs supported by the Fund have been suspended while the countries put in place remedial measures. These actions often took place under staff-monitored programs aimed at re-establishing a track record of policy implementation. Examples of poor governance practices followed by remedial measures in countries under Fund-supported programs have included:

- **Abuse of the tax system through import tariff exemptions** prompted remedial measures including a review of such exemptions, a strengthening in customs inspection with the assistance of a foreign inspection firm and establishing a revenue authority; removal of key officials found to be at the center of the fraudulent customs or tax practice; and partial recovery of the funds.

- **Misuse of the official exchange market and export subsidies** led to audit of the central bank, management changes, and elimination of trade licenses and export subsidies.

---

[11]Poor or weak governance has many facets, and corruption is only one of them.

- **Lack of transparency in the budgetary process involving external trade** required corrective actions including enhanced monitoring and control measures, and changes in the budgetary procedures.

- **Fraud involving customs and major exporters** led the Fund staff to insist on an external audit report.

15. Fund involvement in governance issues has generally been more direct in cases involving the use of Fund resources than in nonprogram cases.[12] This has applied both to the seeking of information on specific cases of poor governance with a potentially significant macroeconomic impact and to the follow up in terms of policy advice on remedial measures and presentation in staff reports. From the point of view of economic efficiency, there should be no reason for the different treatment. Instead, such treatment has partly reflected differences in the countries' economic situations, e.g., the extent to which systems may already have been introduced to reduce the opportunity for rent seeking, and in the related urgency to address these issues. In addition, in the context of financial and technical assistance, the Fund typically becomes more deeply involved in the members' economic systems in ways that governance issues come to the surface that would have otherwise gone unnoticed. The visibility of the Fund in such cases has also, at times, made it a magnet for information from others on governance matters. Beyond this, the Fund needs to safeguard use of its resources and the efficient use of its technical assistance.

E. Collaboration with Donors and Agencies on Governance Issues

16. The role of the Fund in economic reforms relating to governance issues is largely complementary to that of other multilateral institutions that are involved in other areas of economic reforms and in project lending where a different range of governance issues may arise. The policies of other multilateral institutions are described below; this is followed by a description of the manner in which the Fund's activities are influenced by bilateral donors' attitudes and their responses to governance issues.

Policies of other multilateral institutions and agencies

17. *Policies of other multilateral institutions on governance issues have depended on their* mandates and the nature of their operations (a more detailed discussion is presented in Appendix I). The World Bank, the Asian Development Bank, and the Inter-American

---

[12]Of the total 316 Article IV consultation discussions held during the two years to mid-1996, governance issues were explicitly discussed in 56 cases (18 percent), of which 27 cases (9 percent) involved nonprogram countries (including 12 industrial countries). The discussions focused mainly on lack of transparency in public finance, public enterprise operations, and lack of implementation capacity, and—in the case of industrial countries—transparency in monetary policy implementation.

Development Bank are mainly concerned with economic and social aspects of governance, both for project and nonproject operations. The European Union and the European Bank for Reconstruction and Development have broader concerns involving political aspects of governance such as human rights and democracy. The DAC of the OECD discusses and sets guidelines for bilateral donors on both political and economic aspects of governance.

18. More recently, often in the context of capital replenishments and other such exercises, the scope of these institutions' technical assistance and policy advice has been extended to cover key institutional areas essential for improving governance, such as the judiciary and parliamentary processes. Although these institutions have not generally suspended or canceled their assistance due to evidence of specific issues of poor governance, there is, nonetheless, a trend toward greater emphasis on linking political and economic governance issues to lending operations. This is particularly the case for the European Union since—in the context of replenishment of concessional resources at the mid-term review of Lomé IV—the application of democratic principles, consolidation of the rule of law and good governance have been added to the existing reference to human rights as an important principle for development assistance. In addition, the World Bank has recently taken steps to strengthen the Bank's responses to corruption and fraud by changing the anti-corruption provisions in Bank loan documents, and considering governments' corruption as an issue of development effectiveness.[13] Because of the nature of their operations, the multilateral development institutions are involved in a broader range of activities that pertain to governance, including project-related activities, than is the Fund, but there are overlapping and complementary areas in respect of economic adjustment operations and capacity building. In addition, agencies of the United Nations (including the UNDP) play an important role in the political and capacity building aspects of governance. For instance, in post-conflict cases, the UN agencies assist countries in rebuilding the political and economic policy apparatus.

Collaboration with bilateral donors

19. The role of bilateral donors in addressing governance issues—either promoting good governance or making external financing conditional on governance practice—has been diverse, reflecting differences in the weights placed on, and the approaches to, governance issues in their bilateral relationships with recipient countries. Generally, donors' concern for governance covers a broader range than that of the Fund, including political aspects such as multi-party democratic processes and human rights.

20. With regard to financial assistance, donors' response to poor governance issues has varied across countries and affected financing assurances for programs supported by the Fund. When donors withheld assistance for ***purely political reasons*** and the political factors did not affect the implementation of the adjustment program, when possible, Fund staff assisted in a reformulation of the program taking into account the lower level of external financing. In a

[13]See Appendix I, page 21.

few cases, program negotiations or Executive Board approval have been delayed because of lack of financing assurances related to political governance. In other cases, donors withheld financial assistance primarily because of ***economic aspects of poor governance***. In such cases, and where the Fund's own assessment concurred with that of donors, the Fund typically also interrupted or delayed its assistance until the governance issue had been tackled. Finally, there were several instances where ***bilateral donors continued their assistance notwithstanding poor economic governance***. In these circumstances, the Fund staff have had to decide whether the macroeconomic consequences of poor governance were, in themselves, serious enough, and the weight of evidence and available remedial actions adequate, to warrant an interruption of financial or technical assistance. To varying degrees, these different types of circumstances have required difficult judgements to be made by the Fund and donors concerning the nature and consequences of poor governance. Moreover, the diverse responses of different parts of the international community may, at times, have given conflicting signals to the country concerned.

F. Limitations to the Fund's Contribution

21. When discussing the Fund's direct or indirect contribution to improving governance in member countries, the context and limitations to its contribution should be borne in mind. The primary responsibility for good governance rests with the member country. In both program and nonprogram countries, the Fund has been most effective in promoting good governance where the need for improvement in this area was clearly recognized as crucial for economic growth and stability, and supported by some key members of government. Indeed, in such cases, the Fund has tended to strengthen the hands of those in government that were actively seeking improvements in governance.

22. The Fund's contribution to good governance in member countries is limited to economic rather than political aspects. In this context, its contribution has been constrained by various factors including: identification problems, resource constraints, and a reluctance on behalf of some authorities to discuss governance issues. The Fund staff has relied mainly on information provided by the authorities to identify specific instances of poor governance.[14] In some instances, Fund staff have been able to make use of indirect evidence (e.g., a sudden drop in revenue buoyancy or inconsistency between total export receipts and customs receipts) that, when pursued further with the authorities, has exposed poor governance, including corruption. Such approaches were sometimes ineffective in cases where the authorities were less forthcoming or information available to the staff, including unsolicited information, was of poor or uncertain quality. In some instances, information was unreliable because corrupt practices implicated some government officials. Fund staff has also encountered some resistance on the part of member countries to include discussion of governance issues within Article IV consultations.

---

[14]Other sources have included bilateral donors, other multilateral institutions, and independent inspection firms.

23. The Fund's contribution to promoting good governance has depended on the amount of staff resources devoted to addressing the potential problems in economic management processes, institutional structure, or implementation capacity. Such resources tended to be more intensively applied in program than in nonprogram cases.

24. The Fund has relied on the expertise of other institutions when addressing governance aspects outside the "core" areas of Fund involvement, as depicted earlier in Table 1. The Fund has collaborated with the World Bank, and other multilateral institutions where it lacked expertise. In other instances, the role of the Fund was limited to identifying potential governance problems for other multilateral institutions or bilateral donors to take up (including through the Policy Framework Paper (PFP) process).

III. CONSIDERATIONS FOR FUTURE FUND INVOLVEMENT

25. This brief review of the Fund's experience illustrates the Fund's contribution to good governance from its general policy advice, the diversity of circumstances in which the Fund has been involved, and the limitations due to the Fund's mandate and expertise. It also shows the complexity of the issues involved and sensitivity that is required for the Fund to deal with these issues. The review of policies of other multilateral institutions indicates that governance issues are receiving greater emphasis in their operations, and that there are complementarities between their and the Fund's involvement. The experience points to a number of areas in which the Fund contributes to promoting good governance with a direct bearing on economic performance. Particular policy issues include the treatment of governance issues in program versus nonprogram cases; criteria for Fund involvement; the Fund's involvement in specific corruption cases; and coordination with other multilateral institutions and bilateral donors. In the view of the staff and management, the following points, which represent an evolution of the way in which these issues have been handled in the past, could usefully serve as guidance for future Fund involvement in governance:

26. **Identification of governance problems.** The staff should be alert to aspects of poor governance that would influence the implementation and effectiveness of economic policies. In addition, the staff should pay attention to inconsistencies or improbabilities in the various data and accounts in member countries and bring them to the attention of the authorities. In cases where there are clear indications that poor governance may have a significant economic impact, the staff should seek further information. In such cases, although the staff should continue to rely mainly on information provided by the authorities, the staff should more actively seek information from other multilateral institutions, donors, and other sources. The staff would be expected to seek relevant information both in the context of Article IV consultations and program discussions. The staff will need to be prepared to face some tension in the working relationship with country authorities in the specific cases involving corrupt practices.

27. **The criteria for Fund involvement.** The involvement of, and response by, the Fund to governance issues, including specific cases of corruption, should continue to be guided principally by: (i) the existence of clear and credible evidence; (ii) the extent of the economic effect both in the short and medium term; (iii) the mode of Fund involvement (i.e., Article IV consultation, financial or technical assistance); and (iv) uniformity of treatment. The need to safeguard its resources gives the Fund a particularly clear mandate to be involved in program cases and the Fund should continue to address these issues as in the past. Where poor governance with a significant economic impact is evident and brought to its attention in the context of its surveillance activities, the staff should discuss the issue with the authorities and subsequently report to the Board where relevant; but clearly the role of the Fund remains circumscribed by its mandate and should not become one of an investigative agency.

28. **General policy advice.** In Article IV consultation discussions and program negotiations, the staff should pay greater attention to reforms that contribute to the promotion of good governance (e.g., reduced state intervention in the economy in ways that help curtail the scope for generalized rent seeking, discretionary decision making, and preferential treatment on taxes and subsidies, transparency in accounting, establishment of new organizational structures, public expenditure composition, civil service reform, accounting and control systems, and auditing by internationally recognized institutions) in countries where governance issues are important for economic performance. If possible, these issues should be addressed early in the reform effort. In the case of international transactions that involve corruption, the Fund will pay equal attention to both sides of corrupt transactions and would urge that such practices be stopped if they have a significantly distortive economic impact (e.g., the tax deductibility of bribes in member countries or operations of official export credit agencies).

29. **Technical assistance**. The Fund's technical assistance programs should pay greater attention to the promotion of good governance. This would apply to areas of Fund expertise, including budget management and control, tax and customs administration, central bank laws and organization, bank and financial sector supervision and prudential standards, and foreign exchange laws and regulations.

30. **Conditionality.** The use of conditionality related to governance issues emanates from *the Fund's concern with macroeconomic policy design and implementation.* Financial assistance from the Fund should be suspended or delayed on account of poor governance if it seriously affects short- and medium-term economic developments, threatens the successful implementation of the program, or puts in doubt the purpose of the use of Fund resources. Corrective measures should be prior actions for resumption or Fund support and, if necessary, certain key measures could be structural benchmarks or performance criteria.

31. **Coordination with Bilateral Donors and Other Multilateral Institutions.** Given the commonality of interest with other multilateral institutions, the Fund should seek to strengthen its collaboration with them, and in particular with the World Bank, to improve the

effectiveness of its contributions to improve governance in member countries. This could be achieved through the exchange of information on country-specific governance issues, and, in certain cases, coordination of action to improve governance.

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

- In cases where bilateral donors or creditors withhold or interrupt external support because of concern over political and/or economic aspects of governance, the staff should examine whether the governance aspects significantly affect economic developments in the short or medium term. If this is the case, the Fund should seek to assist the member country concerned through policy advice and technical assistance in areas of its expertise and coordinate as appropriate with donors with a view to helping to address the governance issues before giving or continuing its financial support. If this is not the case, but donors continue to withhold support, the Fund staff should seek to reformulate a program with greater internal adjustment and reduced external financing. Only if this were not feasible because of lack of financing assurances should the Fund withhold its own financial support as a last resort. The choice would depend on country-specific circumstances and, inter alia, take into account the extent to which the reduced external financing would threaten the medium-term sustainability of the program.

- In cases where governance issues are of significant importance for short- or medium-term macroeconomic viability, but donors and creditors continue their financial assistance to the country concerned and do not assist the government in improving governance, Fund staff should nonetheless discuss the governance issue with the authorities with due regard to the sensitivity of the matter. Fund staff should also, as appropriate, report to the Board on such issues. In addition, Fund staff may raise its concerns with donors and creditors, including at Consultative Group meetings and in Round Tables to increase awareness of the problems. However, there are clear limitations to what the Fund's contribution to improvements in governance in member countries can achieve without active support from the international community.

* * * *

Directors may want to comment on whether the points regarding Fund involvement in governance issues outlined above are broadly appropriate, or whether more or less should be done and—if so—what and in what specific areas.

Governance in Other International Institutions

A. World Bank

1. **Scope:** The World Bank's concern with governance reflects its commitment to economic and social development, with poverty reduction being the overarching objective.

2. **Mandate**: The World Bank's involvement in governance issues stems generally from the recognition that successful pursuit of economic and social development depends on effective government institutions and a favorable legal environment. Another reason for the Bank's involvement is its fiduciary responsibility under its Articles of Agreement, which requires it to ensure that the proceeds of each loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency (Article III, Section 5(b)). Governance emerged as an important focus in the Bank's work in the late 1980s prompting several discussions by the Board of Executive Directors in the last few years. In 1991, the General Counsel of the World Bank provided an interpretation of the legal framework within which Bank operations could deal with governance issues.

3. **Operational implications**: The Bank's involvement in governance issues may be grouped into three broad categories: (i) improving accountability, transparency, and capacity within government and civil society through policy reforms and institutional development; (ii) ensuring competitive and transparent procurement processes for purchases financed by Bank loans and credits so as to achieve economy and efficiency while preventing fraud; and (iii) ensuring that Bank staffs observe the highest standards of ethical behavior. Actions under each of the three categories are summarized below.

4. **Improving accountability, transparency, and capacity:** Structural adjustment programs and conditions associated with a number of projects have supported reforms to eliminate unnecessary economic legislation, streamline cumbersome administrative procedures, and generally increase the scope of the market in economic activities. Although aimed primarily at improving economic efficiency, these reforms, by reducing the scope for administrative discretion and rent-seeking behavior, have made important contributions to improving transparency and accountability in borrowing countries. More directly, the Bank has contributed to improved governance in borrowing countries by helping to: improve capacity in the civil service; strengthen public expenditure management; improve regulations and supervisory capacity in financial systems; develop legal and accounting frameworks for private sector development; strengthen judiciary systems; and provide economics training to parliamentarians and journalists. It has also encouraged community-based participation in Bank-sponsored programs, such as social investment funds.

5. **Procurement:** The Bank has systems in place to ensure that contract awards under each loan or credit comply with its procurement guidelines. These systems are reinforced by systematic Country Procurement Assessment Reviews (CPARs) that the Bank undertakes

periodically in borrowing countries. CPARs assess public procurement laws, procedures, and institutions in borrowing countries to ensure there are no fundamental conflicts with Bank procurement guidelines, and to decide on the acceptability of local procedures for contracts which are appropriate for national competitive bidding. Where institutions are weak or procedures are inefficient, the Bank frequently assists governments in preparing competitive and transparent public procurement laws as well as standard bidding documents. The Bank's loan documentation (procurement and consultants' guidelines and general conditions) were recently amended to reflect the Bank's determination to proceed forcefully against any manifestation of corruption in the context of Bank operations.

6. **Bank staff ethics:** Staff rules on outside interests and disciplinary measures (i.e., Staff Rules 3.01 and 8.01) have been strengthened. In addition, in 1994 the Bank issued a "Code of Professional Ethics" which calls on staff to observe the highest standards of ethical behavior.

7. In addition to the areas mentioned above, governance issues are now discussed in Bank Country Assistance Strategies, in Consultative Group meetings chaired by the Bank, and in Bank research and other publications.

B. Asian Development Bank

8. **Scope:** The Asian Development Bank (AsDB) is concerned with the economic and social aspects of governance. It identifies basic elements of good governance as accountability of the public sector, participation of the private sector, predictability of the regulatory/legal framework and public policies, and transparency in terms of information provision and clarity of rules and policies.

9. **Mandate:** Article 36 (2) of the Charter notes that "the Bank ... shall not interfere in the political affairs of any member, nor shall they be influenced in their decision by the political character of the member concerned." Only economic considerations shall be relevant to their decisions. It was indicated by the Bank's shareholders (e.g., the understanding related to the Asian Development Fund (ADF) VI and General Capital Increase V exercise) that greater emphasis should be given to development performances as a criterion for the use of ADF resources (where relevant, they should also be applied to operations financed from ordinary capital resources). Development performances were defined broadly as: (i) sound economic management; (ii) efforts toward growth with equity and poverty reduction; and (iii) efforts toward sustainable economic and social development. In October 1995, the Board approved a policy paper on governance, integrating governance dimensions into its operations. To the extent possible, Bank-supported programs and projects are to be designed such that they raise governance quality in the sectors concerned. In late 1997, a Board paper is to be prepared, analyzing the Bank's experience with governance and capacity building activities, proposing modifications to the operational approach, as necessary, and indicating more specific resource implications.

10. **Operational implications:** The Bank carries out performance assessments annually for major borrowing countries and once every two years for other developing countries, which involve, to a considerable extent, assessment of the quality of governance as components of the above-mentioned development performance criteria are applied. In addition, governance issues are addressed in: (i) the Country Operational Strategy Study, with a view to addressing them in the Country Assistance Plan; (ii) loan-related economic and sector work, including assessment of the institutional capacity of borrowing entities; and (iii) technical assistance in support of privatization and reforms in the legal framework.

11. More specifically, the Bank's lending to the public sector has been accompanied by technical assistance for institutional strengthening, progressing from the provision of ad hoc advisory inputs to a more focused, long-term support to specific institutions. Consistent with the growing emphasis on the equity issue, there has also been a shift from engineering intensive projects to beneficiary-involvement projects. Unlike projects in the former category where project parameters are reasonably well known in advance, the details of individual components are worked out subsequently in close consultation with groups likely to be positively or adversely affected, providing an opportunity to improve project design or suggesting ways of mitigating adverse impacts. NGOs are invited as consultants, financial intermediaries, contractors, or implementation monitors.

12. Governance issues are not directly a part of the Bank's conditionality for its lending operations. However, the Bank intends to cover governance aspects in policy dialogue and policy-intensive lending operations. In addition, best practices and success cases in the region and elsewhere concerning governance will be compiled to serve as an information source for good governance for its member countries.

C. Inter-American Development Bank

13. **Scope:** The Inter-American Development Bank (IDB) is mainly concerned with the economic aspects of governance and the implementation capacity of the governing body. Special attention is paid to restructuring the state consistent with the economic reforms adopted in countries in the region during the 1980s, from a pattern of excessive intervention to ensuring the effective functioning of competitive markets. This would involve *modernization of government and strengthening of civil society, transparency, social equity,* participation, and gender equity.

14. **Mandate:** The objective of the IDB is "to contribute to the acceleration of the process of economic and social development of the regional developing member countries" (Article I, Section 1). In the context of the Eighth Replenishment agreement reached in April 1994, the IDB received a mandate to support the process of social investment and reform; to reduce poverty and promote equity; to incorporate the poorest members of the society into the production process; and to foster a new culture of work and investment. Priority is to be given to efforts to modernize and integrate political and civil society, which include actions to

modernize the state and promote conditions for democratic governability. More recently, the Executive Board approved a framework for the future role of the IDB relating to programs for modernization of the state and strengthening of civil society.

15. **Operational implication:** The IDB has engaged in important operations consisting of loans and technical-cooperation funding for institutional strengthening and reform of the state, especially in the executive branch, approving several sector loans since 1990. In more recent years, the Bank supported reform, modernization, and strengthening of judiciaries, legislative branches, and other nontraditional institutions of state reform programs, such as public records systems, agencies to oversee and audit the workings of government, and mechanisms for protecting citizens' rights. In addition, the Bank has helped strengthen civil society organizations and support political reform programs.

16. Based on the recently approved framework, the Bank will: (i) include issues relating to modernization of the state and strengthening of civil society in its country studies and programming processes; (ii) involve all social agents concerned to ensure the long-run sustainability of the Bank's formulated operating programs; (iii) consolidate mechanisms for cooperation with other multilateral organizations to modernize government and strengthen civil society, especially under those programs that might fall outside the Bank's sphere of actions; and (iv) provide from the Multilateral Investment Fund, through its three windows, resources to strengthen the transfer of economic responsibilities from the state to civil society organizations and the private sector.

D. European Bank for Reconstruction and Development

17. **Scope:** The European Bank for Reconstruction and Development (EBRD) is concerned with political and economic aspects of governance. In particular, political aspects cover multiparty democracy, pluralism, and human rights issues.

18. **Mandate:** The purpose of the EBRD is to "foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism, and market economies. References to human rights are found in the Preamble. In May 1991, the Board of Directors approved a paper outlining procedures that the Bank should adopt to implement the political aspects of its mandate. In particular, it proposed to assess political and economic progress together annually in the Bank's country strategy papers (CSPs), rather than on a project-by-project basis.

19. **Operational implications:** EBRD activities in member countries are guided by the CSP, issued to the EBRD Board every two years and updated in the interim years. Attached to each CSP is an assessment on the country's political orientation. In principle, a country's access to EBRD's resources can be suspended if the political orientation is not appropriate (i.e., if it

does not comply with the principles of multiparty democracy). So far, no country has been found to be in violation of the political orientation for access to resources.

20. On the economic aspects of governance, the EBRD has provided technical advice and assistance to strengthen the institutional framework of the executive branch and the judiciary system. These efforts have promoted the transition to market-oriented economies. The Bank has also encouraged public participation and consultation in the preparation of infrastructure projects and assisted the establishment of consumer protection bodies as part of public sector projects.

21. The EBRD conditionality is related to project lending and has included implementation of measures such as passing laws on accounting procedures, privatization of public utilities, and putting in place regulatory framework conducive to private investment that promote good governance.

E. European Union

22. **Scope:** The European Union, particularly in the context of assistance under Lomé IV for African, Caribbean and Pacific (ACP) countries and under its Mediterranean Basin initiatives, is concerned with the political, economic, and social aspects of governance. Particular attention is paid to human rights and fundamental freedoms, recognition and application of democratic principles, and consolidation of the rule of law and good governance.

23. **Mandate:** In addition to the European convention for the protection of human rights and fundamental freedoms signed on November 4, 1950, the European Communities have made a joint declaration (1977) that they attach prime importance to the protection of fundamental rights and that they respect and will continue to respect these rights in the exercise of their powers. On November 28, 1991, a resolution was adopted by the Council and Representatives of the Governments of the Member States meeting in the Council, on Human Rights, Democracy and Development, in which good governance has also been recognized as an important principle to be taken into account in the context of the development policies and cooperation of the European Community, and of the Member States. More recently, during the Lomé IV mid-term review, application of democratic principles, consolidation of the rule of law and good governance have been added to the existing reference to enjoyment of fundamental human rights as an important principle to which the European Union's development policy and cooperation is to be closely linked. Furthermore, the Fourth Lomé Convention (Article 5, par. 3) provides for the possibility to allocate ("programmable") financial resources to the promotion of human rights in the ACP States, at the request of the ACP States. During the mid-term review of the Convention, this provision has been broadened, in order to include" (i) the possibility to allocate financial resources also to measures aimed at democratization, a strengthening of the rule of law and good governance; and (ii) the possibility to use the specific resources provided for in the Second Financial

Protocol for this purpose (ECU 80 million), to complement the measures taken by the ACP States concerned, within the framework of its indicative program.

24. **Operational implications:** Good governance, along with the recognition and application of democratic principles and the consolidation of the rule of law, is an important principle to which the European Union's development policy and cooperation are to be closely linked. In particular, democratic principles and consolidation of the rule of law have been designated as an "essential element" of the Convention (Article 5, paragraph 1), which states that the European Union will take steps to remedy the situation if an "essential element" as noted above is flouted. The relevant procedures in Article 366a of the amended Lomé IV agreement essentially consist of a machinery of consultation, which should not last for more than 30 days. In cases of failure, special urgency or refusal of consultations, the party which invoked the failure to fulfil an obligation may take appropriate steps, including the partial or total suspension of the application of the Convention to the party concerned. Whereas aid suspension was possible before the amendment, the new element is that the suspended amounts can be reallocated to other countries. Although suspension is expected to be a measure of last resort, the European Union has currently suspended its development cooperation program, partially or completely, with some seven African countries, owing to political conditions in the countries. While awaiting the ratification of this amendment, provisions are made for the ACP-EC Council of Ministers to adopt any transitional measures that may be required until the amendment comes into force.[15] The positive measures which can be financed in accordance with Articles 5, paragraph 3, and 224, paragraph m, aim to prevent a situation in which the need arises to apply the above-mentioned consultation and suspension procedures.

25. Since 1990, the European Union has also begun extending assistance to third countries, mainly those of Central and Eastern Europe, with a view to support their political and economic reform efforts. These operations have been responding to various principles, including political pre-conditions; this assistance is provided to third countries with which the Community maintains close political and economic links, taking into account their geographical proximity, provided they fully respect effective democratic mechanisms.

F. Development Assistance Committee

26. **Scope:** The Development Assistance Committee (DAC) is concerned with the political, economic and social aspects of governance. Governance issues are discussed under the broad headings of participatory development, human rights, democratization and good governance. Good governance denotes the proper exercise of control in a society in relation to the

[15]The transitional measures referred to are laid down in Decision No. 6/95 of December 20, 1995 of the ACP-EC Council of Ministers, which enumerates those provisions of the Agreement amending the Fourth Lomé Convention, which are applicable as of January 1, 1996, including Article 366a.

management of its resources for social and economic development. It is concerned, inter alia, with the rule of law, public sector management, controlling corruption, and reducing excessive military expenditure.

27. **Mandate:** In December 1989, the Committee adopted, at its annual meeting of development ministers and heads of aid agencies, a policy statement on development cooperation in the 1990s, which called for a broader participatory development and observed a vital connection between open, democratic and accountable political systems, individual rights, and the effective and equitable operation of the economic system. Thereafter, general guidelines on participatory development and good governance were developed, leading to the adoption of a new set of DAC Orientations at the High Level Meeting of December 1993 ("*Participatory Development and Good Governance*," Development Co-operation Guidelines Series, OECD, 1995). The continuing top-level policy concern with these issues among DAC members was evident in their prominent place in the DAC Policy Statement on "*Development Partnerships in the New Global Context*" adopted at the 1995 High Level Meeting and again in the DAC's major report in May 1996 on "*Shaping the 21st Century: the Contributions of Development Co-operation*." These reiterated that democratic accountability, the protection of human rights and the rule of law are key elements of integrated development strategies and that the investment of development resources in democratic governance is conducive to development progress. DAC members set these qualitative objectives firmly among the forward-looking strategies and committed themselves to continue to address them in dialogues with partner countries and in their cooperation policies and programs.

28. In December 1993, the DAC also established an ad hoc Working Group on Participatory Development/Good Governance (PD/GG) to exchange information on this new agenda. The Working Group, which had a three-year mandate, has completed its five reports on the legal system, public sector management, decentralization, human rights, and participation. DAC members will follow up with action on the ground in selected countries.

29. **Operational implications for DAC members:** DAC members assess country situations on a case-by-case basis and are guided by the following principles: (i) as recalled by the 1993 Vienna Declaration on Human Rights, the human being is the central subject of development; (ii) the developing countries themselves are ultimately responsible for their own development; (iii) external cooperation efforts in participatory development and good governance should help strengthen those promising trends which emerge in individual countries; and (iv) a deepened and strengthened policy dialogue with development partners is the most important vehicle for advancing these concerns at the policy level.

30. In line with the orientations and adopted DAC policies, DAC members are expected to promote good governance through the design and implementation of aid programs and projects, and the provision of technical advice. In their dialogue with partner governments, they stress the importance of participatory development, including the need to create conditions enabling NGOs to fully play their role; support the democratization process by such

positive measures as strengthening respect of human rights, enhancing the rule of law with special attention to the independence and effectiveness of judicial systems, the development of a pluralist civil society with due attention to free media and the promotion of gender equality; where necessary, provide financial support for economic reforms to facilitate sustainable democratization; and assess the efficiency of control procedures in place in donor and recipient countries to ensure probity in the conduct of business and the use of aid funds. In cases of grave and persistent violations of human rights, DAC members will consider appropriate responses, including reducing or suspending aid, although DAC members will endeavor to maintain their humanitarian assistance for the most vulnerable population groups.

31. Discussions on governance issues are to be integrated into existing in-country coordination fora. Specific mechanisms for ongoing in-country coordination based on the individual country context, will be fostered so that this complex long-term agenda receives greater attention and visibility. A policy note to this effect was endorsed at the High Level Meeting of May 1996 ("*Policy Note on Strengthening Country Level Co-ordination for Participatory Development (PD) and Good Governance (GG)*"). The policy note affirms that the process of developing in-country coordination on these issues should itself lead to improvements in PD/GG to establishing coordination fora such as Consultative Groups (CG) and Round Tables (RT). The output of the CG and RT meetings should be monitored through in-country coordination mechanisms and reviewed in the next CG and RT meetings. The basis for PD/GG discussions should be a process of in-country assessment of the status of these issues as defined in the DAC Orientations, bringing together in-country stakeholders to discuss priorities and propose strategies. A major goal is the development of capacity in host-country governments and civil societies for assessing progress on PD/GG issues, along the general lines set out in the policy note.

32. DAC is currently working on the selection of "pilot" countries for launching in-country PD/GG coordination. The DAC ad hoc Working Group has held meetings and workshops seeking "best practices" in such areas as legal systems reform, civil society, human rights and democratic decentralization, and has also reviewed the status of members' policies and programs regarding PD/GG and human rights. A final report will be available by early 1997.