TOWARDS TRANSPARENCY IN FINANCE AND GOVERNANCE [1]

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Summary

The study of transparency is increasingly a more topical, broadly relevant, but also more under-researched enterprise. The Asian financial crisis has highlighted not only the welfare consequences of financial sector transparency, sparking a series of yet unresolved debates, but has also linked this relatively narrow problem to the broader context of transparency in governance. Its significance has broadened geographically as well as across different sectors. It has been observed that curtailment of transparency, often on scanty pretexts, is commonplace even in the highly developed countries. This suggests a broad and possibly radical reform agenda. Departing from the urgency of these observations, this paper reviews the existing literature on transparency in finance and governance, indicates remaining knowledge gaps, and offers some hypothesis on the mutual significance of the two issues.

The first two sections of the paper outlines a conceptual framework for defining and measuring transparency that distinguishes among its desirable characteristics; access, timeliness, relevance, and quality. It also suggests methodologies that may produce tractable measures of transparency. Additionally, it places in context debates concerning transparency; its desirability, contingency, complexity and regulation. Reviewing critiques of objections against disclosure, the chapter advances a general preference for transparency, not only in the developing but also in the developed world. Nevertheless, it emphasizes the need to weigh the costs and benefits of more transparency in designing regulatory policy. In general, while consequences of information imperfections are well recognized, the solution is not simply a matter of more information.

The third section treats the role of transparency in promoting greater financial stability, acknowledging exceptions to the general preference expressed earlier, in relation to financial stability. It treats as priority policy issues the following problems: developing institutional infrastructure, developing standards and accounting practices, improving incentives for disclosure and balancing countervailing regulations to minimize perverse incentives generated by safety net arrangements such as deposit insurance. An important suggestion is that since institutional development is gradual, relatively simple regulations such as limits on credit expansion, may be best tailored to developing countries. Implicit in this section is the notion that there are absolute limits to transparency, in particular for lack of adequate enforcement.

The last section elaborates on the concomitant link between financial markets and governance, discussing select consequences of transparency for national-level and local governance, identifying some policy implications and suggesting further research issues. As illustrated by the case of Indonesia, it argues that financial reform may be predicated on broader public sector reforms. Again, because formal institutions take time to develop, it highlights three principles of reform to promote incentives for openness: harnessing private sector participation in service provision, promoting exit and contestability, and encouraging "voice" and public participation. These are now increasingly being integrated to new innovative data collection and analysis techniques, and to particular dissemination methods promoting collective action to improve governance and enhance transparency. The chapter concludes by outlining the difficulties of implementing greater participation and voice.

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I. Case for Transparency

We are concerned about transparency because it enables two interlocked engines of welfare and development, namely governance and economic markets. More openness and information sharing enables the public to make informed political decisions, improves the accountability of governments, and reduces the scope for corruption. Greater transparency is also essential to the economy: it improves resource allocation, enhances efficiency and increases growth prospects. Information imperfections in markets increase transaction costs and give rise to market failures. Though market failures hamper the working of all markets**,** they especially affect capital markets. In the recent financial crises literature, several references[2] are made to "*lack of transparency*"[3] as one of the factors that either caused or contributed to the prolonged crises.

Despite this, today even most ostensibly open and democratic societies lack sufficient transparency in governance and finance. As argued by Stiglitz (1999) there is little reason for this. Arguments against more transparency, while merited in a few instances, are often not only limited in application, but simply wrong. This essay departs from this observation, elaborating the means of studying and implementing transparency.

Despite the perceived importance of transparency there has been little theoretical or empirical effort to study it – for example its role in enhancing long run growth prospects or improving stability of markets and averting short/medium term crises. In both former respects complex questions and challenges present themselves. It has been argued that increased transparency may improve financial stability and reduce market volatility. Yet, conceptual work [4] suggests that increased transparency need not be welfare enhancing and furthermore may increase market volatility. Understanding the conditions under which more transparency may improve or worsen outcomes will therefore refine our knowledge and will help shape better policy.

Empirical work is lacking partly because of data problems. These arise from the difficulty of measuring "transparency" given that it deals with agents who are hiding information. Therefore a key empirical challenge is to define a measure of transparency that is empirically tractable. Such an exercise will highlight the requirements of the data as well as enable us to assess its determinants and evaluate its impact on the outcomes of interest.

With these considerations in mind**,** this paper reviews the existing literature on transparency, points to remaining knowledge gaps and suggests some hypotheses linking transparency to finance and governance. From the banking and finance literature, we focus on the role of transparency in promoting greater financial stability. The important challenges to this are the following: meeting infrastructure needs-developing standards for quality as well as compliance/enforcement, addressing regulatory needs- improving

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[2] Such references are primarily in popular magazines and newspaper articles

[3] Examples : mutual guarantees, of firms' and banks' true net worth, and insider relations masked poor investments etc.

[4] Refers to the information economics literature, and literature on information revealed by prices in rational expectation models

incentives for better disclosure, and installing countervailing regulations to minimize perverse incentives, such as created by insurance or bailout schemes.

As such, it will also discuss the role of international organizations in facilitating the implementation of transparency, as increased globalization and integration of world financial markets as well as growth of innovative financing mechanisms demand a greater scope for disclosure requirements.

We will conclude by relating transparency to the broader role of transparency in promoting good governance. They may also circumscribe the former – a lack of transparency in governments may affect efforts to improve transparency in the institutions that govern markets. To this end the paper will address the place of press freedom**,** freedom of information legislation and an independent judiciary, and the use of innovative grass roots efforts to use "voice" as a mechanism to improve people's access to information. It will also discuss the importance of data and its analysis, and the dissemination of such practices through various channels as a mechanism to make participation a potent force in achieving transparency and accountability.

II. Transparency in Context

The following section attempts to elaborate an understanding of how transparency may be defined and measured for policy purposes. It then provides a framework outlining the implications of such an understanding. This framework informs subsequent sections, which address in greater detail the specific problems of improving transparency in the context of financial markets and in matters of governance more broadly.

Defining Transparency

For the purposes of this paper, transparency describes the increased flow of timely and reliable economic, social, and political information; about private investors' use of loans and the creditworthiness of borrowers; about government service provision, monetary and fiscal policy; as well as about the activities of international institutions. Contrariwise, a lack of transparency may be described as someone – whether a government minister, a public institution, a corporation, or a bank -- deliberately withholding access to, or misrepresenting information or failure to ensure that the information provided is of adequate relevance or quality.

Hence, a working understanding of transparency should encompass the following attributes: acccess, comprehensiveness, relevance, and quality and reliability. They are detailed below:

Access. Laws and regulations ensure, at least in principle, that information remains available to all. But information must also be accessible. In part, this is aided by the institutions and venues that facilitate its flow. They include media such as newspaper, radio, TV, public information notices, the Internet, and word of mouth. Lack of education is detrimental to transparency - it limits the ability of an individual to access, interpret and use information. Strong equity considerations attend the need for access. Information should be accessible to all on equal terms. However, it is often profitable to delay or limit

access to useful information, in which case access becomes hostage to ability to pay. Therefore there is a need to enforce timely, equitable dissemination of information**.**

Relevance- Information must be relevant. Ensuring this is difficult, first because information is subjective; depositors need information to ensure safety of deposits; investors need information about liabilities and risks; and the public about current economic conditions, policies, and so forth. Second as sources of information such as the Internet proliferate, paradoxically information overload threatens to dilute relevance.

Quality and Reliability - Information should be of good quality and reliable, timely, complete, fair, consistent and represented in clear and simple terms. Standards for quality must be ensured, possibly through verification by external agencies or auditors or standard setting organizations. Consistency in the use of processes to obtain information and in the formats of information disseminated ensures comparability and so allows assessment of changes over time. The criteria and methodologies used to assess information, as well as changes in such methodologies, should be fully disclosed. Such measures are an important way of preventing deliberate withholding or distortion of information - lying. Dishonest reporting is deterred by the presence of various "watchdog" institutions ranging from professional accountants or agencies, credit bureaus, an independent press, stakeholder feedback, to even academic researchers.[5] Furthermore, assuring quality and reliability often requires going beyond integrity: rigorously evaluating signal-to-noise ratios in a piece of data is often a methodological and empirical challenge even for institutions and individuals of the highest standards of probity.

Measuring Transparency

These various aspects of transparency invoke specific policies and institutional arrangements. In order to evaluate these policies, we must able to measure transparency – a difficult task in part because of the complex understanding of transparency that we have adopted. Conceptually, a statistical measure of transparency is the precision of the information that is obtained, in turn a function of it relevance and finally, its quality. "Lack of transparency" in the case of accounting information for example, may be measured by comparing officially disclosed balance sheet information with the assessments of auditing agencies that investigate firms for credit approval. Highly transparent firms will have little discrepancy between the officially disclosed information and that assessed by auditors. An important prerequisite for such measurement is that the data of such evaluations is accessible.

Recent attempts to measure transparency have used proxies such as “weak rule of law” and “corruption” that are associated with lack of transparency but do not fully reflect all the above considerations. A refinement of this approach is to formulate an index using proxies for the characteristics outlined above. An attempt to construct an index of

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[5] (See Kane:1999, for specific details in the context of financial information)

financial transparency is described in section III. However, a serious impediment to measuring transparency is poor data quality- detailed information on publicly disclosed information, the various disclosure standards, evaluations by independent auditors of the categories of information disclosed. With improved data, one can systematically measure transparency, identify its determinants, and quantify its impact on the relevant economic variables. An attempt to measure accounting transparency using data from Indian firms and assessing its impact on investment activity is currently underway. (Bertrand and Mullianathan: MIT 1999)

Limits to Transparency?

Before proceeding from measuring transparency to implementing it, it is necessary to assess if transparency always desirable. Proscriptions against disclosure abound in all societies. Is there sense in these proscriptions?

As argued by Stiglitz (1999), on the whole societies' preference should be in favor of greater openness and transparency. Conceptually, the information economics literature supports the notion that better information will improve resource allocation and efficiency in an economy. Disclosure of financial information directs capital to its most productive uses, leading to efficiency and growth. Lack of transparency can be costly, in both political and economic terms. It is politically debilitating because it dilutes the ability of the democratic system to judge and correct government policy, cloaking the activities of special interests, and creating rents by giving those with information something to trade. The economic costs of secrecy are equally staggering, affecting not only aggregate output but also the distribution of benefits and risks in the economy. The most significant cost is that of corruption, which has a documented adverse effect on investment and economic growth.[6]

Arguments against more transparency while merited in a few instances, are often not only limited in application, but fundamentally flawed. There is arguably some merit in more philosophical rights-based exceptions on the grounds of privacy and confidentially. Even these however need to counter not only the instrumental benefits of transparency, but also powerful arguments about the intrinsic rights of citizens to know. More dubious are exceptions made on grounds such as national security, stability, non-interference in delicate negotiations, or deference to public unity. Notably, some possible exceptions on the grounds of ensuring stability in financial markets are treated in greater detail in the next section. To the extent that such appeals are are made, they need to be highly limited, and the limits exposed to public debate. Particular scrutiny should be directed at invocations of confidentiality, market stability or national security.

Research to inform such debates is currently inadequate, failing to qualify arguments both for and against transparency. Most concretely, this pertains to debates on the need for financial reform. For example, arguments about the need to limit the transparency of central banks policies are not borne out empirically – though a theoretical

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[6] There is a growing literature on the relation between corruption and growth in particular, initiated by Mauro (1995). More broadly for a number of governance dimensions, see Kaufmann, Kraay and Zoido-Lobaton ("Governance Matters", 1999b).

literature is willing to entertain the notion, as discussed further on. Theoretically, a greater and less volatile flow of information about its decisions should as likely be able to stabilize and rationalize rather than disrupt and corrupt financial markets. Indeed, it is probably true that the less accountable an agency, such as a central bank, the more transparent it should be. In other instances however, it is not evident that more information will strengthen financial systems. Examples to the contrary, wherein more information may worsen credit rationing or increase price volatility, are documented in Furman and Stiglitz: 1998. Clearly more research, both conceptual and empirical, is needed to resolve this debate, its implications for the behavior and incentives of firms and individuals, and on economic outcomes.

Limits to Voluntary Information Disclosure

Though transparency is often desirable, markets rarely induce socially desirable levels of transparency, not to mention full and voluntary disclosure of information. There are many reasons why this is so.

First, there are costs associated with information disclosure- collecting, organizing, and disseminating information involves resources in the form of effort, time, and money. It is therefore natural to expect that agents will reveal information upto the point where the marginal benefit from disclosure equals marginal cost, which typically entails less than full disclosure.

Second, there may be positive payoffs from non-disclosure – for example when agents interact with each other strategically, revealing more information may result in loss of competitive advantage, in turn lowering the firm's profitability. Also, it allows rent extraction, which in turn leads to ex-ante innovation. For example, it is precisely because hedge funds in the U.S. are not transparent that they are able to generate profits. If others could see their arbitrage strategies, they could be replicated. In fact under such circumstances, disclosure regulation may not be desirable. Instead voluntary disclosure may be socially optimal, given the costs. (see Fishman and Haggerty:1997)

Third, there is a lack of or disclosure because of the presence of externalities. Externalities may arise when firms' values are correlated, so that information pertaining to one firm may be used to value other firms. Theoretical work suggests that because of such information spillovers there is inefficiency- the socially optimum level of information is not attained. (Admati and Pfleiderer: 1998) Externalities also explain why markets may under-supply investments in monitoring and enforcement. Those who monitor and enforce provide a benefit to all, yet receive no return from other beneficiaries. Therefore not enough resources are devoted to these activities.

The public good properties of information suggest a role for government in information acquisition and dissemination. Specifically this may entail creating rules and regulations specifying disclosure requirements about categories of information, frequency of disclosure, the standards for disclosed information and so forth. Moreover, since "perfect" information is rarely achieved even under the best of circumstances, there may be a need for government enforcement. Generally, transparency is limited by the inherent difficulties of obtaining information in rapidly changing environments. For example, sophisticated financial instruments which would make timely assessments of net worth of

banks and firms are unreliable since markets respond sharply to constant changes in external factors. Achieving transparency may therefore not be sufficient. Enforcement mechanisms that ensure accountability by punishing fraudulent behavior, are also essential. In such circumstances, regulations may be necessary to minimize risks and ensure stability. As the following section suggests, such regulations need to balance the costs and benefits from increased disclosure in distinct circumstances.

Regulation in Context

In general, disclosure regulation, which either mandates or encourages transparency, may be justified when there are externalities and information is costly. However, the very decision to introduce disclosure regulation, as well as the specific implementation of such regulation, warrants careful consideration.

First, an assessment should be made as to whether more transparency would necessarily improve economic outcomes, i.e. whether this may be one of the valid exceptions referred to above (Furman and Stiglitz:1998). Some research suggests there are instances where more information may cause speculation and hence greater market volatility.[7] A recent empirical study (Bushee and Noe: 1999) indicates that firms with improvements in disclosure practices[8] experience subsequent increases in their level of stock market volatility. They find that a policy of greater disclosure skews the composition of investors, toward those with a strong propensity to trade in the short run because they value it more than longer-term investors. The result of a greater prevalence of 'fickle' traders leads to greater volatility.

Second, even in cases where disclosure regulation is justified, the design of appropriate disclosure policies requires a careful weighing of the extent of disclosure. This weighting should be sensitive to its costs and benefits. It should consider what information should be disclosed, who provides the information and verifies the quality, what are the enforcement requirements and so forth.

In this regard the literature suggest that in certain circumstances policy should support only certain kinds of disclosure. Authors such as Blinder (1998), argue that transparency of central policies makes the bank reputation more sensitive to the outcomes of its policies. Faust and Svensson (1998) qualify this by arguing that if the central bank's reputation is completely independent of its actions it loses an important constraint on its behavior. Theoretical modeling suggests that the results may be higher than average inflation and more variable inflation and unemployment. This has not however been confirmed empirically. An attempt at striking a balance on this issue is made by the U.S. Federal Reserve Board. It release minutes of open market committee meetings with a six-week lag, as well as deleting confidential information like names of individuals, foreign banks and so forth.

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[7] Whereas there may be none in the complete absence of any information (Hirshleifer: 1971).

[8] Transparency or disclosure is measured by the annual ranking of a firm's disclosure published by the Association of Investment and Management Research (AIMR). This ranking has been used by several authors to proxy for overall levels of disclosure.

Third, having decided on the extent and nature of disclosure, it is important to tailor regulation policies to local circumstances. Accordingly, what disclosure policies are appropriate will depend on the specific institutional and market environment. In developing countries, with weak institutional and legal environments, there is a greater role for the state in providing information. As countries develop, the private sector often evolves to meet information needs. In the U.S for example, screening institutions like the NYSE (a cartel of traders who set commissions and limit entry) subject companies seeking to be listed by the exchange to stringent screening which encourages voluntary disclosure and limits purely speculative or bogus ventures from being listed.

In developing countries, the demand for transparency is outpacing the means to ensure it. While institutional structures that enable transparency take time to develop, globalization and integration of markets have increased the need for greater transparency, prompting intermediary solutions. Governments have undertaken innovative experiments, which, using market-like mechanisms to induce self-revelation of information, as exemplified by the recent auctioning of telecommunication subsidies in Chile (section IV) have proved to be very successful. Also, involving local communities in monitoring government services has been shown to foster transparency and lower corruption. This matter is further discussed in Section 5.

The foregoing discussion suggests that a deeper theoretical and empirical understanding of how transparency affects development outcomes for individuals and for the economy as a whole, will help refine our understanding of how it can improving the effectiveness of policy. In what follows, we use the definition outlined above to examine the role of transparency in promoting financial stability and in improving the accountability of governments and propose policies to effect transparency - surveying existing literature and identifying areas where more research is warranted.

III. Transparency 's role in Financial Stability

Lack of information and uncertainty are inexorable features of finance, since capital markets are engaged in uncertain intertemporal trade not only in money but in information itself. Essential information gathering undertaken by markets include selection of projects, and monitoring of project performance. These present specific challenges. The fact that some firms have better information than lenders about the risk attached to projects, induces asymmetries of information which give rise to problems of adverse selection. The inability of lenders to observe the actions of borrower produce moral hazard. Enforcement or, monitoring is also subject to information problems. In order to elicit behavior by agents to generate a good profile of return, lenders have to design contracts that get around information problem (demand collateral), that provide good incentives and monitor borrowers.

However, information will always be imperfect. No matter how well financial markets perform in gathering information, borrowers will always know more than lenders about how they will spend the loans, about their ability, effort and so forth. To this we attribute a number of persistent problems in financial markets. Under-supply of

information occurs because individuals who monitor the performance of firms or banks are providing a benefit to all shareholders or depositors, but invest resources in this monitoring only to the level of their private benefit, not the broader socially desirably level. Imperfect markets and credit rationing occurs because information is costly; credit rationing because those who are willing to pay higher interest rates may not be those who put the loans to best use. Contagion, as in bank panics, is evidenced when the troubles of one institution 'contaminates' perceptions of the entire industry. Depositors or investors who cannot distinguish individual bank solvency, run on all banks, even solvent ones. The vulnerability of financial systems may worsen these problems. The failure of a financial institution, stock market crashes and recessions, may increase uncertainty, worsen information asymmetries and aggravate adverse selection problems.

The pubic good-like good property of information provides a rationale for government intervention to increase public disclosure of information. But it is not apparent whether such intervention can sufficiently mitigate other adverse consequences of information problems; will more disclosure reduce problems of credit rationing, reduce market volatility or avert banking crises?

Presently, the paucity of theoretical and empirical investigation is at least partly attributable to data problems. We will identify the gaps of understanding in this area both at the conceptual and empirical level, beginning with following section, which summarizes the evidence on transparency and financial crises.

Evidence on the Relation Between Transparency and Financial Crises

The 80s have witnessed a dramatic increase in banking crises in developed and developing countries. The fiscal and economic costs of the crises have been staggering (see Goldman and Turner: 1996, Caprio: 1996). They have sparked heated debates about those policies thought crucial to promoting financial stability. Accordingly, transparency has gained prominence in recent debates on the financial crises.

Lack of transparency has been suggested as one of the factors that contributed to the international financial crises. By now the story is familiar. Typically, it is related to how for instance, limited information about mutual guarantees, of firms' and banks' true net worth, and the use insider relations, masked poor investments. Once a downturn set in, poor transparency made it difficult for investors to distinguish between firms and bank that were healthy and those that were not. Consequently they abandoned them all, forcing bank runs and destabilizing of economies.
However, very few attempts have been made, in this context, to systematically understand the notion of transparency, the underlying causes of lack of transparency and its impact. Several questions still remain: Does lack of transparency cause a crisis or prolong it? Will greater transparency prevent banking crises? Has the need for transparency increased with global financial integration and liberalization of financial markets? And does more transparency lead to greater market discipline, and can it replace regulation-i.e. deposit insurance? Such emerging empirical research suggest that where financial liberalization takes place in an environment where transparency is absent, a

financial crisis is more likely (Mehrez and Kaufmann, 1999). Nonetheless, as detailed earlier, an unambiguous empirical causal link between transparency and financial stability is difficult to establish because the inherent measurement problems for transparency. Hence, the need to expand on the empirical measurement research agenda, as well as implementing rigorous tests of causality.

Corruption may be associated with lack of transparency. However, evidence linking corruption[9] to crises in East Asian countries is weak: there is little justification that it may have caused the crises. (Furman and Stiglitz:1998). Furthermore, low corruption is not sufficient to avert crises. Scandinavian countries that are among the least corrupt suffered banking crises at the beginning of the decade. Also, countries with no corruption may have little transparency in their banking systems if regulations do not require disclosure. While it is plausible that corruption, lack of rule of law make it difficult to achieve transparency, they do not measure transparency, per se.

Caprio et al (1998) go a little further in measuring transparency. In an empirical study to evaluate the role of information and incentives in financial crises they develop a scoring system to compare the regulatory environment in a dozen East Asian and Latin American countries. A ranking of transparency is generated based on whether bank ratings are required, on the number of top ten banks with ratings from international rating firms, and on an index of corruption - see table below**.** The rankings are broadly consistent with the overall raking of regulatory environments.[10]

The study finds that the most crisis-hit Asian economies are those with the poorest overall scores. These also enjoyed lower-than-average levels of transparency in the sample. Singapore, the highest scoring country in the sample, overall and in terms of transparency, was also least affected by the crises. Although the relative importance of the different indicators is not assessed, the evidence does suggest that the quality of the regulatory environment, including its transparency, may be particularly important in the presence of explicit deposit insurance. It also suggests that safety nets tend to increase the moral hazard problem and blunt the incentives for agents to acquire or use information. In addition, it is indicates policies such as capital controls may be rendered ineffective if balance sheet information masks banks' true liabilities.

On the whole, present evidence, subject to the imperfections in the measurement of transparency, does not support the hypothesis that a lack of transparency caused the crises. But the evidence does suggest that lack of transparency may exacerbate the crises. Accordingly bank runs may be averted by better disclosure if investors could discern healthy banks from insolvent ones. In general, the evidence suggests that more information strengthens market discipline, provided the information is timely and reliable and that other regulatory instruments are employed to improve the incentives to provide and use information and enforce compliance.

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[9]As measured by perception surveys conducted by Transparency International, ICRG, World Competitiveness Yearbook

[10] Other Indicators in the regulatory ranking include capital position, loan classification, and liquidity position. In addition they assess the operating environment in which banks function (using strength of property rights, creditors rights, law enforcement as proxies)

The evidence illustrates that there are at least three central means to achieving transparency: improving mechanisms (rules/regulations) for greater disclosure and accounting practices to enforce quality and reliability of information, designing safety nets to limit moral hazard via greater disclosure, and more broadly, instituting regulatory regimes and policies to address the information and incentive problems inherent in financial markets.

Sound Accounting and Auditing Practices

There is a strong case for strict accounting norms. Disclosure alone is not enough to implement transparency. Information must be reliable, based on sound principles and standards that enabling investors and lenders to make consistent assessments of firms' activities and risk profiles. Accounting standards facilitate the interpretation, reliability, and comparability of information across enterprises and make it easier for investors to identify worthy firms and evaluate managers. Conversely, lapses in accounting norms can provide opportunities for misrepresentation as means to divert assets. A prevalent weakness of many accounting systems is the ease with which they can be manipulated to mask the discrepancy between the accounting values of assets and their real value. Discrepancies typically owe to asset attributes such as risk or profitability, which are uncertain or can be misrepresented. For instance, the accounting valuation of long term bonds typically ignores market expectations concerning interest rates. The Chilean financial crisis of the early 1980s and the Savings and Loans scandal in the United States have been cited as owing to such problems[11] In Chile, Central Bank loan guarantees to domestic banks, was perceived as absorbing the foreign exchange rate risk attached to an impeding devaluation. Domestic firms did not enjoy such guarantees. This enabled banks to borrow short term from the international market at 20%, and lend the same money to domestic firms at 50%. This inflated accounting earnings of the banks. However, once the anticipated devaluation arrived, the borrowers defaulted, the banks declared insolvency, and the Chilean government was left to pay off bank depositors and foreign investors. (Ackerlof and Romer:1993)

Challenges to developing countries

If even developed countries, with their often well developed institutions, fail to contain information failures arising from accounting problems, it is important to note that most developing countries have weak accounting systems - owing, in large part, to lack of trained accountants and weak enforcement. This contributes to lack of transparency. Common problems include the following:

<u>Insufficiently rigorous accounting conventions</u> are not enough to prevent banks and borrowers from concealing the true size of their non- performing loans. Even if problem loans are identified, adequate loan loss provisions remain to be established. Goldstein and

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[11] For a detailed account of these examples see Ackerlof and Romer: 1993

Turner:1996 calculate the ratio of loan loss reserves to non-performing loans for a sample of developing countries in 1990s – and find that on average countries with the highest share of non-performing loans (with the exception of Argentina and Malaysia) are the ones with the lowest provision coverage ratios.

Lack of uniform reporting requirements for banks and penalties for publishing false information have seriously impaired the ability of investors to distinguish weak from strong banks. (Goldstein: 1997). Private credit rating agencies such as Moody's Investor service and Standards and Poors, limit coverage to a mere 25 developing countries and serve only the largest banks in those countries.

Poor information systems have exacerbated the problem of assessing the credit worthiness of borrowers. Computer software to assess creditworthiness and track the probability of default is not yet used in many developing countries.

Inadequate supervision and enforcement - credit review process, audit practices exacerbated by lack of access to information about borrower files' results in weak enforcement of accounting rules and hence poor compliance.

Poor accounting standards also render other policies such as capital requirements inadequate. For example, the Basle Capital Adequacy Accord may not be adequate for developing countries with poor accounting and supervision - as documented above - and more volatile environments. Implicit in the Basle standards is the assumption that there is adequate provisioning for bad loans. As documented earlier, with the poor loan loss provisioning and wide prevalence of connected or related-party lending that obtains in many developing countries, the Basle capital requirements provide very little cushion of safety. In light of the discussion above several lessons emerge.

Evidence from countries beset by the recent financial crises suggests that they were affected by accounting failures, specifically, that disclosed financial information did not portraying underlying risks among firms and banks. The following box summarizes the findings of the study**.**

Box 1: Accuracy in Accounting and the Asian Crisis

A 1998 UNCTAD study reviewed accounting practices in five East Asian countries (Korea, Thailand, Indonesia, Malaysia, and Philippines) to assess how actual accounting practices deviated from published accounting statistics– such as related-party-transactions, foreign currency debt, derivative financial instruments and contingent liabilities, to name a few. The findings suggest that the five countries did not follow International Accountancy Standards (IAS) in the above mentioned categories, and that this likely triggered the financial crises. Because disclosed statements of financial transactions did not comply with International Accounting Standards, users of the accounting information were likely misled and were not able to take precautions in a timely fashion.

A number of findings are particularly telling. For instance, only a third of the total number of companies sampled disclosed information regarding related party borrowing and lending- revealing weak enforcement. Also, although 60 percent of the sample revealed foreign currency debt in local currency only 19 percent disclosed foreign currency translation gains and losses, according to IAS. Furthermore, the study observed that appropriate levels of loan loss provisions were not made and therefore that the liquidity

positions of banks due to non-performing loans was not evident. In addition, more than eighty percent of those companies that reported the use of derivative instruments did not disclose the amount of interest and losses relating to derivatives, and the terms, conditions, and policies regarding these instruments. Almost no company disclosed the risks associated with the issuance of derivative instruments. Lastly, with respect to contingent liabilities, less than half recognized such a category without any disclosure of the amount of such liabilities.
Source: UNCTAD Report:1998

Implementing improved accounting practices

First, governments must make every effort to devise national standards for accounting, using internationally acceptable standards and accounting methodologies that are applied consistently over time and cover all relevant transactions. This ensures that information is reliable and improves the ability of supervisors to assess risks and punish offenders.

While provision of reliable information is assumed to be the task of governments (due to the public good nature of information) there may be an important role for the private sector. In the US private firms prepare credit reports on individuals and routinely share them with other investors and help them assess risks. The Working Group Committee report on transparency and accountability (1998) recommends exploring partnerships with private institutions and organizations to help in the assessment of information and its effective utilization.

Second, policies for setting standards for accounting and supervision have to be tailored to the specific infrastructure and regulatory environment of developing countries. As such, the proposal for harmonizing accounting standards across countries in order to institute a uniform international banking standard has led to some controversy- countries may validly wish to maintain some independence in setting national standards based on their preferences for risk or their institutional limitations.

Third, governments must improve enforcement. Sound accounting standards have little use without legal and institutional systems to supervise and enforce their adoption. Devising a supervision system that is effective is quite challenging and requires detailed research into the institutional structure of the regulatory system of a country in order to understand the micro-details of the supervision process and identify its weaknesses. For example, when bank owners and officers happen to be well connected politically, and penalties imposed on offenders are correspondingly nonexistent - a problem of many developing countries - it is important to understand where the exact loopholes in supervision are, what it will take to close them. Such research is currently lacking in many ways.

Fourth, international institutions can and should help in strengthening and implementing accounting standards and ensuring compliance. They can help to identify weaknesses in the accounting systems of developing countries and provide technical assistance to aid in the development of appropriate standards. They can improve compliance with these standards by making provision of loans conditional on adherence to these standards.

Regulation

Information provision and monitoring, as promoted through accounting standards, is not sufficient if appropriate behavior is not enforced. Designing appropriate regulations for financial markets is a complex matter - indeed regulation may not always be warranted. Why do financial institutions need to be regulated in the first place? Should there be any controls imposed on their borrowing, the maturity and risk structure of their assets and liabilities, or on their loan provisioning ?

Information asymmetries in financial markets complicates efforts to devise appropriate regulatory policies that mitigate perverse incentives and stabilize markets. If information was perfect there would be no incentive problems - indeed any need for banks or financial regulation. Financial risk is chosen by individuals and institutions, and is induced by the information and regulatory environments that individuals and firms face.

Deposit Insurance and Disclosure: A trade off?

Safety net provisions such as deposit insurance, which mitigate the consequences of contagion in the bank industry and thus avert bank runs, may also have destabilizing effects. Prominently, it endows banks with a form of limited liability that induces two particular forms of incentive problems. The first is that it encourages over-investment in risky projects – a moral hazard problem. The second is that it induces a form of behavior described as `looting' or `bankruptcy for profit' which allows owners and managers to divert corporate assets in the form of personal dividends and salaries. In the case of insolvency the cost of both these problems is borne by the government in the form of insurance payouts and bailouts. (Akerlof and Romer:1993). These two incentive problems are often complementary, and it may be difficult to distinguish between them, especially as causal precipitants of adverse shocks.

While these problems may be mitigated by better disclosure of information – for instance through better accounting requirements - the very presence of deposit insurance may reduce incentives to use that information, and to punish banks accordingly by lowering deposits or demanding higher deposit rates. Design of such safety nets therefore requires a right balance between protecting against liquidity crises and avoiding the moral hazard problems that give rise to imprudent banking practices.

At one end of the spectrum are frameworks which presume that full disclosure can replace the need for a safety net. Since 1996, New Zealand has been subscribing to such a framework. It provides no deposit insurance, and has abolished prudential ratios except for capital requirements and ratios on connected lending. Meanwhile it mandates the most extensive disclosure requirements in the world. Full firm disclosure is required, as are frequent external audits and credit ratings disclosures. To give these laws teeth, it has legislated personal liability and accountability for managers of financial institutions. (Cordella and Yeyati: IMF Working paper,1997).

However, there at least three prominent conditions for the success of this market-reliant approach to financial system management. First, incentives for market discipline may depend on whether a no-bailout position in the event of bank failure is credible. In

Venezuela, political pressure forced bailouts of banks despite a prior commitment to the contrary. (de Krivoy: 1995). In Japan, regulatory forbearance (implicit insurance) stands in for unpopular explicit bailouts. (Calomiris: 1997). Indeed, there is a debate about whether ambiguity in rules governing safety nets is preferable to transparency. Theoretically, ambiguity reduces the moral hazard by undermining bailout guarantees and may at the same time improve credibility if a "no bailout' position is not viable in practice. Countries have adopted different strategies. In United Kingdom, a 1979 banking act safeguards deposits, credibly commits the Bank of England not to support all banks, but also leaves the Bank with discretionary powers to provide assistance when it sees the threat of systemic failure. (Cordella and Yeyati, IMF working paper: 1997)

Second, whether transparency leads to more market discipline depends on extent to which depositors use information about banks to place their deposits -and whether this, in turn, limits the extent to which banks take excessive risks. Presently, there is no evidence on the sensitivity of the level of deposits or rates with respect to greater information disclosure or the presence of a safety net. In addition, evidence is also lacking on depositors' ability to interpret information when it is available. If this were indeed a limitation for depositors it would call for more transparency in bank activities. Such issues are currently being addressed by a research project undertaken by World Bank Research Project.

Third, the notion that safety net schemes should be replaced by stricter disclosure requirements implies that greater transparency can avert crises/panics. The existing evidence, presented earlier, does not support this hypothesis.

Evidently, more research, both theoretical and empirical, needs to inform future design of comprehensive financial safety nets, including deposit insurance . Such work will help determine the real trade-off of improved disclosure - i.e., whether market discipline is enhanced by disclosure - and the institutional infrastructure that is needed for improving information provision and creating incentives for ensuring its compliance and use. Research should also address other necessary forms of intervention. Such evidence as exists on means of mitigating incentive problems in financial markets illustrates the merit of using combinations of simple, easily implementable policies, including, limits on credit expansion and risk-based capital adequacy requirements. While a treatment of these interventions is beyond the remit of this paper, they are discussed prominently in Stiglitz and Bhattacharya: 1999.

The limits to financial sector reform

The success of reforms that focus on the regulation of financial markets - or any other markets – are in the penultimate dependent on institutions of governance. Thus far, we have assumed that governments will be motivated to increase transparency in the financial sector, where it is feasible to do so. That is, we have discussed a number of implementable measures to promote transparency in a particular sector, but have left aside the issue of whether the government will be interested in undertaking these reforms. This assumption presupposes a different kind of transparency: that relating to the integrity and accountability of governments. Notably, it links implicitly financial sector reform to broader reform of the system of governance. Suppose that government agents have the potential to extract bribes from private-sector organizations in exchange for

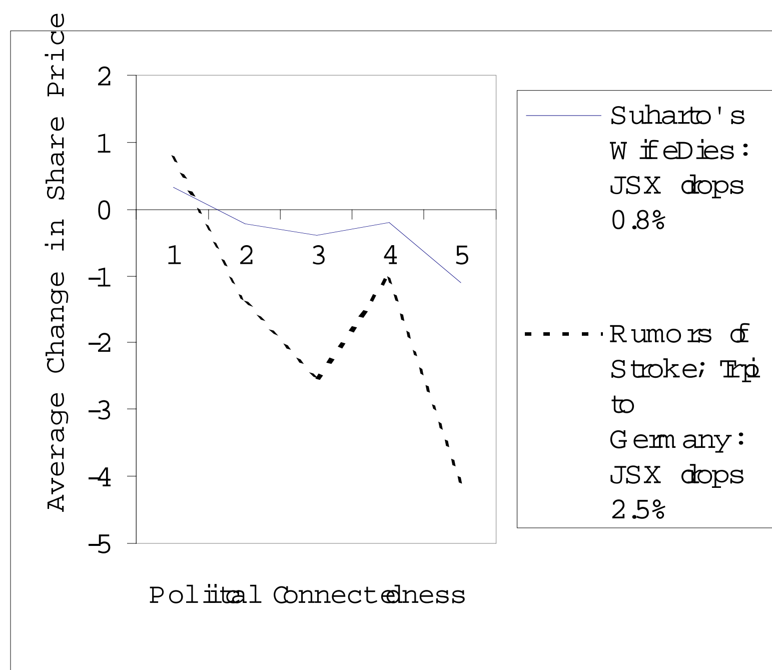
preferential treatment by the government bureaucracy. A system of poor accountability in the financial sector may facilitate such transactions, since it will make it easier for the illicit payments to be hidden from view. In such a world, lack of financial transparency and poor government accountability will be mutually reinforcing, as is illustrated in the following box. This underscores the importance of working to improve transparency in an economy as a whole, rather than in narrow sectors.

Box 2: Governance and Finance: Corruption in Indonesia

One particularly infamous example of what may be viewed as excessively close the business-government ties is the system of patronage that evolved in Indonesia under President Suharto. Many firms reportedly sought the assistance of those with close ties to the President, so as to receive preferential treatment from the government. Of course, Indonesia's financial markets were notoriously opaque, which made it impossible to properly document such misconduct or to hamper that continued purchases of government favors. Thus, those with the potential to do so had little incentive to change the system.

While the opacity of financial transactions makes it difficult to assess the extent of corruption, it may still be possible to do so with some innovative thinking. In the case of Indonesia, Fisman (1999) looks at the reaction of investors on the Jakarta Stock Exchange to news about President Suharto's health, to try to estimate the value of political connections in that country. The results of Fisman’s paper are illustrated by the following graph, which shows the market reaction to news that Suharto's wife had died, and to the announcement that Suharto would go to Germany for a health checkup. Both events raised doubts as to the President's longevity, and in both cases, the value of well-connected firms declined by more than the value of firms without connections. Moreover, Fisman observed that the trip to Germany was perceived to be a much more serious threat to Suharto's health than the death of his wife (note, for example, that the overall market declined by considerably more in reaction to news of the German hospital visit). Accordingly, the adverse consequences for well-connected firms (relative to less connected firms) were more serious in reaction to the trip to Germany, i.e.,. the dotted line is much steeper than the solid line.

Building on these observations, Fisman computes that as much as a quarter of a well-connected firm's value may be attributed to political connections. Thus, using only public information, Fisman is able to estimate investors' valuations of connections to Suharto, by examining the aggregation of these valuations as expressed in market prices. Hopefully, revealing the extent of the problem through this type of exercise will motivate increased pressure to bring about change.



Source:Fisman:1998

As illustrated, good governance may be seen as a predicate for transparency in the financial sector, as well as other areas of economic and social life governed by public institutions. The links between transparency and good governance are treated at greater length in the following section.

IV. Transparency and Good Governance

Information is central not only to markets but also to the design of public policy, including the administration of tax systems, public service delivery, and regulation of the private sector, all activities that affect economic life and social welfare. Consequently, lack of transparency in public administration is a crucial constraint on policy implementation and its economic and social outcomes. Addressing this constraint remains a crucial means of promulgating a consistently successful public policy. A sin-qua -non for doing so is to improve transparency in public institutions and policy-making processes.

For the purposes of this paper we focus on how lack of transparency increases the scope for corruption, by creating informational asymmetries between regulators and regulated entities. Corruption affects all three major areas of public administration: revenue collection as a means of raising public funds; revenue allocation as a means of providing, among other things, public goods; and public regulation as a means of mitigating information failures in markets, and in particular capital markets.

<u>Public revenue collection</u>: Tax laws- especially when difficult to understand or "vaguely" specified - increase the discretionary powers of government in granting tax incentives, assessing tax liabilities, auditing accounts, and reporting tax frauds. Thereby they may increase incentives for corruption, which in addition to undermining trust in government, as discussed below, also has the immediate effect of reducing tax revenues. Analysis using cross-country data suggests that countries with high degree of transparency (as measured by?) also experience very low incidence of tax evasion. (see fig) Dani- please explain the data and insert figure (latest you have)

<u>Public revenue allocation</u>: A lack of transparency n the processes and procedures that determine the allocation of public expenditure can allow investments to be diverted away from much needed education, health programs, toward other purposes, notably those seeking to exploit opportunities for rent extraction. Tanzi and Davoodi: 1997 provide empirical support for the effect of corruption on the size and composition of public expenditure. They find that a wide range of public administrative failures – broadly categorized as corruption – are attributable to inadequate transparency. Opportunities for corruption arise particularly in public services where the discretion exercised by local administrators is very large.

Prominently, lack of transparency and enforcement are the main reasons for investments to be chosen not according to need but according to opportunities for corruption. For instance, while anti-poverty or income support programs occupy a large fraction of the expenditure budgets of governments in developing countries, leakages of benefits to ineligible recipients result in many deserving individuals failing to receive assistance.

<u>Public regulation:</u> A lack of information affects the government's ability to mitigate information failures in markets. As mentioned previously, information failures impede the functioning of all markets, especially capital markets. Governments create rules and regulations, firstly to improve transparency through disclosure laws, and create of standards to verify quality, and second to improve enforcement using penalties for fraud to facilitate credible commitments. Such policies lower information costs and the costs for specifying, negotiating, and enforcing contracts that enable economic exchanges.

Regulations, while essential for improving market efficiency, also concentrate power in the hands of officials who implement them. When regulations are vaguely defined and when execution is non-transparent, they create incentives for corruption. Lack of transparency may be manifest in non-competitive granting of authorization, like licenses. Such distorted incentives defeat the purpose of governments' regulatory role - to improve the performance of markets - and are likely to sustain and even worsen the shortcomings of the market. In addition to the corruption problems outlined above, a lack of transparency undermines the institution of democracy and development more broadly, as discussed earlier (Stiglitz: 1999).

The lesson is not to effect complete deregulation but to devise regulatory policies that mitigate incentives for corruption by increasing transparency and improving

incentives for compliance. Such policies should assist in monitoring and enforcement and limit the discretionary power that regulations grant to the officials implementing them. Institutions should be supported that improve the flow of information, enabling transparency and trust.

More broadly, to devise policies that promote good governance efforts should be made to a) facilitate the collection and sharing of information that is critical to the design of various institutions and policies, and b) limit abuse of power by bureaucrats by enabling a system of monitoring and incentives that promotes openness and accountability. A critical component of a good governance program is data collection and analysis of various indicators which can identify the causes and costs of corruption as well as areas of vulnerability in the public sector. In addition to providing valuable information that can be used in setting priorities for reform, detailed data and methodologically sound and rigorous analysis increases transparency, educates and empowers the public with hard evidence, reduces resistance to reforms by bureaucrats and government official and improves public accountability. (see box below)

Box 3: Transparency through in-depth data analysis, participation and collective action

Over the past year, dissemination, analysis and debate of corruption surveys in Albania, Georgia, Latvia, Ecuador, Bolivia and other countries have improved the momentum and quality of subsequent governance reforms conducted with the help of the World Bank. This has been accomplished by combining rigorous data collection, its analysis and the broad dissemination of data. The implications of detailed surveys of public officials, enterprises and households were discussed in public workshops and disseminated to members of the business community and civil society. The Latvian government organized a workshop on corruption in June 1997, and presented the basic program in June 1998, simultaneously introducing data collection which is still in progress. Survey results were printed on the front page of every major newspaper.

The initiative enjoyed significant results. In Albania, the data allowed the policy debate to graduate from exchanges of vague unsubstantiated accusations to a process focussed on empirical evidence that promoted accountability and action. Crucially, there is indication that the reforms have succeeded in institutionalizing the data collection practices - so that statistics can be collected frequently and disseminated as needed. They have thus managed to sustain the benefits of reform. In the three countries , NGOs helped the process by hiring surveyors who later came to serve as independent monitors of the anti corruption reforms. More broadly, new techniques helped elicit additional information from firms on expected exchange rate volatility that complemented official macro-economic and risk rating agency information. Extracting the additional information through econometric techniques thus became a pro-transparency tool, which when utilized in a timely manner, may mitigate the likelihood of a crisis.

Source: Kaufmann, Pradhan and Ryterman: 1998; Kaufmann, Mehrez and Shmuckler, 1999

Notably, governments have made great strides in fostering policies and institutions that promote transparency and its implementation. Measures that exemplify this trend include the following:

Freedom of information legislation: Institutional arrangements are necessary to help governments achieve transparency. Transparency is enabled by various media channels (TV, newspapers, radio, and public notices). It also requires institutional channels for the citizens to participate – to voice concerns and to provide feedback. Freedom of speech,

and a free press ensure that such channels remain open. To improve transparency, many governments have imposed disclosure requirements on themselves. For example, the freedom of Information Act in the United States, passed in 1972,and similar legislation in other countries, recently in South Africa, Namibia, Mozambique, Malaysia, requires the government to make accessible to citizens an exhaustive array of records of government actions and debates. Collating its findings on such efforts in the area of fiscal transparency, the IMF has developed a code of good practice on Fiscal Transparency. (See box below)

Box4: IMF CODE ON FISCAL TRANSPARENCY

1. *Clarity of Roles and Responsibilities*

- The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined. Additionally, there should be a clear legal and administrative framework for fiscal management.

2. *Public Availability of Information.*

- The public should be provided with full information on the past, current, and projected fiscal activity of government.

3. *Open Budget Preparation, Execution, and Reporting.*

- Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.
- Budget estimates should be classified and presented in a way that facilitates policy analysis and promotes accountability.
- Procedures for the execution and monitoring of approved expenditures should be clearly specified.
- Fiscal reporting should be timely, comprehensive, reliable, and identify deviations from the budget.

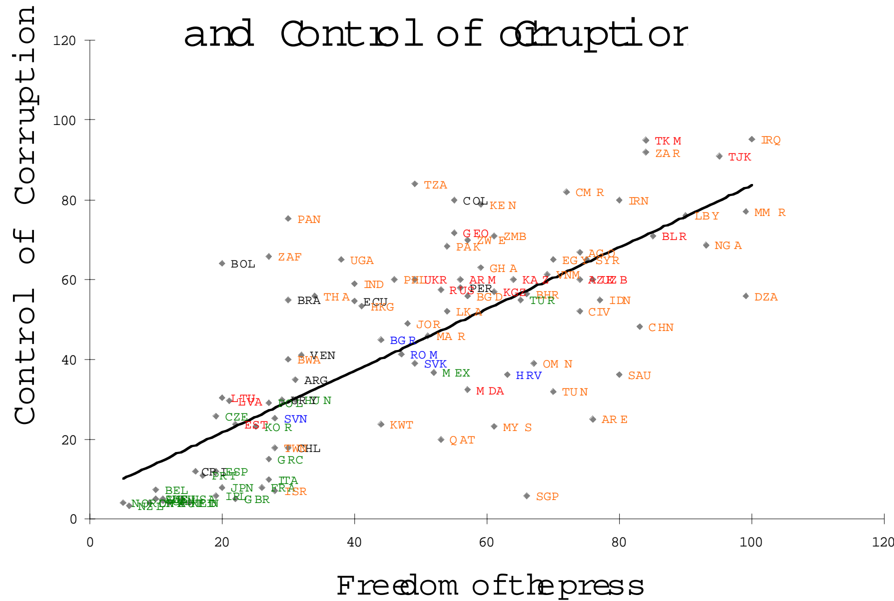
4. *Independent Assurances of Integrity*

- The integrity of fiscal information should be subjected to public and independent scrutiny.

Source: IMF (1998), Public Expenditure Management Handbook: 1998, World Bank.

In some countries, the benefits of information legislation are eroding even well-established privacy laws, which stipulate for example that information about health status of individuals or their taxpayer records is confidential. Recently, experts have recommended violations of privacy in order to use public pressure or the market to enforce compliance among tax payers. Several countries, including Sweden and Japan make lists of tax payers public showing taxes assessed, taxes paid voluntarily, or taxes in arrears. This approach is justified because of its potential use as tool of tax enforcement.

Freedom of Press: As numerous authors have noted, public action is less likely to fail in societies where information can flow freely and public desire for action expressed without fear of official sanction. Accordingly, a free press - newspapers, radio and TV- is essential for promoting good governance and ensuring that social needs are met. Democracy and a free press have been instrumental in preventing major catastrophes. Nowhere is the importance of this greater than in the case of famines. Since independence, India, one of the largest democracies in the world has succeeded in escaping major famines. This is in large part due to a relatively free press, which publicized information about mass starvation and death, prompting action from governments. (Sen 1987, Dreze and Sen: 1995).



More broadly, current empirical research indicates that countries with improved civil liberties are significantly more successful in addressing corruption (see Figure below)—even after controlling for other determinants (Kaufmann and Sachs 1999). A major challenge for countries where civil liberties have not been fully guaranteed is to promote approaches for civil society to operate more effectively.

Notably, there are subtle limits to the efficacy of press freedom legislation. In even the freest countries, the government's ability regulate access to information often forces the media to purchase scarce information with "discretion." i.e to exercise self-censorship for fear of offending their sources, and thus not being able to access information in the future. This is not a repudiation of press freedom however, but merely a cautionary note on its limitations.

<u>Information Infrastructure</u>: The information revolution has reduced the costs of transferring and evaluating information, allowing for sophisticated and rapid dissemination of data and empirical analysis. This can be harnessed to aid transparency. There are many examples of innovative efforts to use such technologies. For example, computerization of tax systems in relatively poor countries has improved information capture and processing capabilities. Computerization can also improve transparency-allowing for extensive cross-checking of information, for computerized selection of taxpayers for audits, for monitoring audit procedures, and enabling timely response to tax payer requests for information and assistance. Computerization, if effectively introduced, can dramatically enhance efficiency of most functions in tax administration. It enables : i) a tamper-proof, paper-free information base on identity of potential tax payers, third party information, accounts and transactions, ii) cross-matching of different sources of information which aids verification of returns filed, iii) greater accuracy in tax collection and recovery operations, iv) selection of audits, v) enhancing taxpayer information and assistance. (Dasgupta and Mookherjee:1998). Successful implementation of computerization in tax administration in Mexico yielded impressive results. Most notable was the elimination of petty corruption and improvement of revenue collection.

More broadly, information technologies also aid budgeting, accounting, and more broadly expenditure management for governments. Increasingly, software packages for computers are available to enable data gathering and sharing among different departments and layers of government. Such technologies also help to engender participation in the design of policies and delivery of policies of services. (See following section on participation) For example, video conferencing is increasingly being used by international institutions such as the World Bank to increase stakeholder participation in development of aid-supported projects

While such technologies provide wider access to information and promote greater information sharing, they do not necessarily create incentives for greater information disclosure, nor do they improve the quality of information and ensure its use. Institutions are therefore still necessary therefore to induce disclosure, ensure compliance and more generally, promote greater openness and accountability. To the extent that such institutions are inadequate to the task, they often require reform. Because of its prominence as a policy question, it is worth considering this field at length.

Legal Enforcement: Rules are only useful to the extent that they are enforced. A sound legal environment is crucial to enforce rules/regulations. Transparency cannot be implemented effectively when compliance is weak. For example, the Comptroller Auditing General (CAG) in India is an exemplary, autonomous institution that renders transparent the expenditure practices of the Indian Government. However it is seldom able to curb mismanagement of expenditure. A crucial impediment to its effectiveness is the lack of power of CAG to impose a sanction- expanding the CAG's mandate to include continuing monitoring of management reforms to be undertaken in response to the weaknesses identified during audits is essential. Merely achieving transparency without attendant mechanisms to impose sanctions or enforce corrective action yields little benefits. And when transparency is costly to achieve and complementary mechanisms for corrective action are not in place, its net benefits of could be negative.

Generally, enforcement mechanisms must be in place to ensure that public servants are accountable for service delivery of outputs in accordance with transparent budgeting and performance targets. Such mechanisms are achieved, to some extent by establishing procedures for stakeholders to assess public service delivery, linking budget allocations to satisfactory service delivery, and making public officials personally accountable for poor quality services. (Das-Gupta: 1999). Providing an avenue for complaints through establishment of an accessible and independent grievance redress mechanism is critical to enforce transparency and accountability.

Regulatory Reform: As illustrated above, an enforcement system that promotes monitoring, improves accountability and punishes offenders is crucial for implementing transparency. But independent and effective legal systems are slow to build. Therefore innovative regulatory reforms may be necessary, devised through cooperation among government, the private sector, and civil society, which encourage greater voluntary information disclosure and promote enforcement.

Notably, reforms should be accompanied by public insistence on having policy decisions justified and regular reviews of the processes and outcomes of policy. Regulations, while essential to safeguarding social welfare also vest discretionary power with regulators. Improving accountability is therefore an important element in the design of regulatory policies.

Experience indicates that among important principles for implementing transparency and improving governance in the public sector, the most useful may be the promotion of partnerships with the private sector in provision and delivery of goods and services. This allows the government to obtain information through market like mechanisms and limit unnecessary public support. Analogously, support for "exit" and "contestability" – providing choices for citizens as consumers of public services may under the right conditions, allow the government to infer information about public preferences and improve accountability. These principles are discussed below.

Harnessing private sector participation: In telecommunication industries, the experiences of many countries like Chile, Ghana, and the Philippines shows that access to services expands rapidly in privatized markets provided there is competition to ensure that state monopolies are not replaced by private ones. In addition, servicing remote areas by using innovative market-like mechanisms to elicit information from the private sector can help determine the extent of government support required and avoid the pitfalls of traditional cross-subsidy schemes that promote rent-seeking.

For example, in many countries, government support is assumed essential to provide access of telephone/communication services to poor areas. An innovative experiment in Chile used auctions to elicit information from the private sector to determine the extent of government support that would be necessary. The government established a special fund to award subsidies competitively to projects providing telephone services to remote areas. Many private providers requested less subsidy than assumed, and in many cases no subsidy at all. If the fund's performance is sustained, then an almost 100 percent coverage in these areas is assured by 2000.

Promoting Exit and Contestability: Where government plays a monopoly role, such as in provision of basic education, to assure accountability and so that both private and public moneys are well used, citizens - both as tax-payers and as demanders -- must have information with which to judge whether services are being provided efficiently by specific institutions. Exit options help in eliciting information and improving accountability.

Use of the principal of exit has particular application in education. Subsidizing consumers, not providers of education can increase incentives for better information and greater accountability. This can be accomplished through routing subsidies either to providers through per-student (capitation) grants in systems in which students can choose which schools to attend, or to the consumers directly through scholarships or vouchers. Compared to the traditional system, in which subsidies are channeled directly to providers with monopoly power, these alternatives have the advantage that they give citizens "exit options." Particularly given information problems related to the provision of education, introducing such choices remain plausible mechanisms for giving

consumers more information and making providers more accountable. Vouchers have been used increasingly for such purposes in both developing and developed economies.

However the costs and benefits of vouchers are still contested. In many instances exit options may not be feasible, i.e., there may be no contestability. For example, in education policy, exit options depend on the availability of choice- whether there are alternative options for consumers to choose from if they are not satisfied with the service, i.e. the education offered. Often, there are no alternative schools within reasonable distance to make exit a credible option.

However, even in such instances, voice mechanisms that solicit community and parent involvement can help safeguard delivery of services. Indeed, as the next section will discuss, "voice" - incorporating public opinions and preferences in policy design, planning, and supervision, should inform both regulatory reforms and policy in general. (Hirshman: 1970)

Transparency through Voice and Participation

In so far as voice is a means of aggregating information within society – and thus furthering transparency – all policy making should be predicated on incorporating the voice and participation of stakeholders in development. World Bank research shows that the greater the participation of private agents in ownership and management, the better is service performance. The obvious challenge is finding means of doing so. When this is possible however, numerous experiences have demonstrated that listening to the voice of stakeholders can have a considerable impact.

In Rajasthan, India, a people's organization entitled Mazdoor Kisan Shakti Sangathan- MKSS held a public hearing where they exposed misappropriation by local governments of development funds intended for local workers. This generated village demand for further insight in the government. Local governments, being under public and press scrutiny, were compelled to oblige. The results were striking- some government officials who had diverted some 56,000 rupees ostensibly for the construction of water channels, promised to return the funds. Partially as a result of the incident, the Government of Rajasthan recognized the people's right to official documents and enacted landmark legislation to that effect in June 1997. (Bhatia and Dreze. 1998)

There are more systematic ways for governments and citizen groups to solicit voice through surveys and data collection. Client surveys can cast light on citizen's experience with government services and to identify performance improvement suggestions. Follow-up surveys can be used to ensure accountability and make sure that improvements are in the desired direction. Generating data and disseminating it widely can be a potent instrument to mobilize civil society and apply pressure on political structures. For instance, well presented and simple comparative charts illustrating findings on corruption can help mobilize and give voice to previously silent and disparate citizenry groups. (See box below)

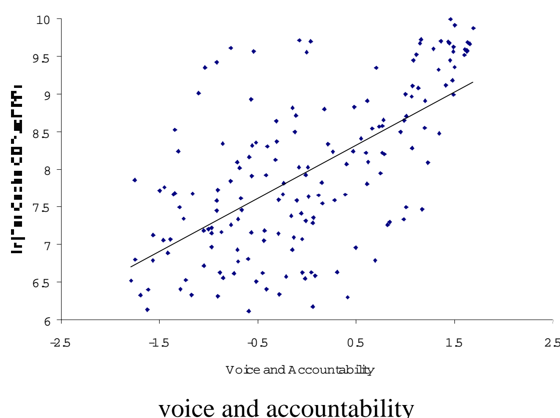
Box5: "Voice" as a mechanism to enforce transparency and accountability

Mechanisms such as client and citizen surveys that incorporate feedback from citizens have helped to improve public sector performance in many countries. The scorecard method pioneered by Sam Paul in Bangalore, India embodies this approach. It entails periodic evaluation by citizens of local municipalities of accounts of public services, and bribery and extortion. Results are disseminated and discussed and influence governance reform at the municipal level. There is some evidence that public agencies in Bangalore have taken concrete steps to improve service delivery. Similar initiatives are now being adopted in other cities in India and elsewhere.

In Mendoza, Argentina, a city noted for its innovative governance reforms, citizens have participated in crafting transparent rules governing public procurement. A number of localities throughout the world have embraced similar participatory process, notably the city of Porto Allegre, Brazil. As part of its pioneering system of participatory budgeting the city holds city-wide assemblies that discuss expenditure priorities for education, health, transport development, taxation, city organization, and urban development. They then elect members to a citywide participatory budgeting council, which in turn decides the city’s investment plan. Although there is no rigorous evaluation of this program, , preliminary evidence suggests that the number of roads paved increased, and the number of students enrolled in primary and secondary school doubled. In 1996 the city’s achievements were recognized by the United Nations.

The results are consonant with the broader understanding that voice and accountability improves welfare, even on a national level. See graph.

GDP per capita - PPP



voice and accountability

Kaufmann and Moreno Ocampo: 1999; Public Expenditure Management Handbook: 1998; WDR: 1998/99; ‘Governance Matters’, KKZ, Vol1

A logical extension of furthering local community participation is to devolve entirely some functions of government service provision – e.g. decentralization. By making officials accountable to local citizens who are in a better position to evaluate the level and quality of services delivered, a decentralized system allows reliable information concerning performance to be generated and utilized for enforcement. Reciprocally, local citizens are better informed about supply conditions, budgets and expenditures for local services, thus reducing the information asymmetry between clients and officials that is largely responsible for corruption. Various examples of such experiments with participatory local governments are emerging around the developing world, as discussed

above. (See box) However, their success are dependent on a number of factors. If local institutions are captured by interest groups or local elites the advantages of decentralization may be negated. While there are isolated case studies addressing this topic, an outstanding research issue is a systematic assessment of decentralization experiments, detailing both successes and failures.

Conclusion

Although the general preference is for more transparency, there are cost and benefits of achieving transparency. Much research is still needed to help us measure and understand the role of transparency in financial markets. Many questions remain: Can more transparency lead to greater markets volatility and if so, under what conditions? Has need for greater transparency increased with globalization? Can more transparency obviate the need for regulation - inducing self-regulation? A systematic inquiry into such issues will help frame appropriate disclosure policies.

Among the financial reform issues under consideration, more research is particularly required in assessing the relative merits of financial safety nets, particularly deposit insurance and disclosure requirements. While the moral hazard problems induced by deposit insurance may be averted by replacing it with more comprehensive disclosure requirements, as is done in New Zealand, the experience of countries such as Venezuela, buttressed by cross country empirical research, suggests that the success of such policies are contingent on a number of factors, including the credibility and independence of central banks and political actors, the behavior of banks and depositors, and the dynamics of financial crises, which are not well understood.

Practical means of improving disclosure when desirable must be part of all development agendas. This includes instituting sound accounting and auditing practices, streamlining reporting requirements, improving information (IT) systems and bolstering institutional supervision. Experience suggests that given their limited resources, developing countries may best address these needs by taking advantage of private sector provision of information and accounting services, building regulatory structures to their best ability, and tailoring supervision and enforcement means to local capabilities and circumstances. This may militate against the institution of uniform international accounting standards currently being debated. Such evidence as exists on means of mitigating incentive problems in financial markets illustrates the merit of using combinations of simple, easily implementable policies as treated for instance in Stiglitz and Bhattacharya: 1999.

Notably, transparency in and of itself is not sufficient without accompanying enforcement mechanisms. There is therefore a need for public institutions to both regulate disclosure and enforce appropriate behavior. Indeed, as illustrated by the case of Indonesia – financial reform may be predicated on broader public sector reforms. Notably, the effectiveness of public institutions affects not only the performance of markets – including capital markets – but also the allocation of public goods and the distribution of risk and other implicit costs in an economy. Subsuming more specific recommendations on transparency in financial markets, made earlier in this paper, are therefore broader imperatives to improve transparency in governance. Implementing freedom of information legislation, instituted freedom of press laws, built legal

enforcement mechanisms, and invest in information infrastructure to improve the gathering and sharing of information. Many governments are already doing this.

Since institutions take to time to develop, successful medium term reforms often entail harnessing supplementary resources. These include soliciting private sector participation to elicit information about necessary levels of public participation, and promoting opportunities for exit in certain areas of service provision in order to give the citizens, as consumers, a chance to indicate their preferences.

Animating many of these reform initiatives is the principle of promoting transparency through public participation and 'voice'. As studies increasingly demonstrate, 'voice,' remains the fundamental means to ensure people's right to information, to enforce transparency and accountability, and to thus improve the allocation of public resources. Empowering the voice of citizens with the necessary evidence through data and data analysis has proved to be successful in implementing transparency and effecting change.

Implementing voice entails addressing unique challenges. Though certain practices, such as decentralization, may encourage voice, they may weaken supervision and thus paradoxically reintroduce opportunities for corruption treated previously. More fundamentally, social and cultural circumstances may limit the ability of certain constituencies - the poor, women, children, from making their voice heard. Again, on this issue, as in the narrower problems treated above, more research is urgently needed.

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