



Russia: Bank Assistance for Public Financial Accountability

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ACRONYMS AND ABBREVIATIONS

CAE	Country Assistance Evaluation
CAS	Country Assistance Strategy
CBR	Central Bank of Russia
CDF	Comprehensive Development Framework
CEM	Country Economic Memorandum
CFAA	Country Financial Accountability Assessment
CMDP	Capital Markets Development Project
CPAR	Country Procurement Assessment Report
CPFA	Country Profile of Financial Accountability
ECA	Europe and Central Asia Region
ESW	Economic and Sector Work
FARAH	Financial Accounting, Reporting and Auditing Handbook
FIDP	Financial Institutions Development Project
FMA	Financial Management Assessments
FMS	Financial Management Specialist
FMTF	Financial Management and Training Project
GAO	General Accounting Office
GDP	Gross Domestic Product
IAD	Internal Audit Department
IAS	International Accounting Standards
IDA	International Development Association
IDF	International Development Fund
IGR	Institutional and Governance Review
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
LACI	Loan Administration Change Initiative
MFTP	Management and Financial Training Project
MOF	Ministry of Finance
OCS	Operational Core Services
OED	Operations Evaluation Department
OEDCR	Operations Evaluation Department–Country Evaluations & Regional Relations Unit
PAD	Project Appraisal Document
PER	Public Expenditure Reviews
PFA	Public Financial Accountability
PIU	Project Implementation Unit
PREM	Poverty Reduction and Economic Management
PSD	Private Sector Development
PSR	Project Status Report
QAG	Quality Assurance Group
RFMA	Regional Financial Management Advisor
RFTA	Regional Fiscal Technical Assistance
ROSC	Report on Observance of Standards and Codes
SAL	Structural Adjustment Loan
SSSP	State Statistical System Project
TA	Tax Administration
TAP	Tax Administration Project
TI	Transparency International
TOR	Terms of Reference
USAID	United States Agency for International Development

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Preface

This review is one of the background papers prepared as an input to the Russia Country Assistance Evaluation (Task Manager, Gianni Zanini) by the Operations Evaluation Department (OED) of the World Bank. The paper is based exclusively on a desk review of key documents made available to the team (see Annex C for a list of the main documents reviewed).

This paper addresses three main questions while reviewing the Bank's assistance for Public Financial Accountability in Russia:

1. What is the nature and extent of *knowledge* that has been built to date by the Bank on the key components of the country's capacity for sound financial accountability? How has this knowledge influenced the Bank's assistance strategy?
2. How *relevant and effective* are the Bank's past and current *actions* (in lending and non-lending services) in building capacity at the "country" and "project" levels?
3. Does the Bank have *reasonable assurance that public funds* are spent only for the purposes intended in the budget with due regard for economy and efficiency?

The focus of the evaluation is on *Bank* performance—not Borrower performance—as of September 2000. The desk review was supplemented by a limited number of interviews with relevant Bank staff in the Region and with the country team. The team consulted with the relevant financial management staff in the Region and at the Controllers Department. The evaluation team also made efforts to ensure that it would avoid any duplication of efforts in terms of the current work being carried out by International Audit Department (IAD), Quality Assurance Group (QAG) and the International Monetary Fund (IMF) through consultations early on in the process. Where appropriate, the report relies upon OED work underway on Bank-wide efforts to combat corruption. The work of other evaluation agencies outside the Bank was taken into consideration through limited literature search.¹

The authors (Mr. Vinod Sahgal, Lead Evaluation Officer and Ms. Deepa Chakrapani, Research Analyst, working in the area of Public Financial Accountability in the OED Corporate Evaluation and Methods Group (OEDCM)) are grateful for the comments received on previous drafts by the peer reviewers—Ms. Poonam Gupta, Operations Evaluation Department–Country Evaluations & Regional Relations Unit (OEDCR); Mr. P.A. Sharafudheen, consultant in OEDCR; the Country Assistance Evaluation (CAE) task manager; and other contributors to the CAE background work—which have been taken into account in the August 2001 version. However, the views expressed in this paper remain entirely those of the authors, developed in consultation with the Task Manager. They do not necessarily represent the views of the World Bank.

An earlier draft dated August 14, 2001 was sent to the Russian Government for review. No comments were received.

¹ Interviews of the staffs of these agencies (such as the GAO and U.S. AID) were not conducted at this time, based on advice from Operations Core Services (OCS) staff.

Executive Summary

1. The risk of weak *public* financial accountability, fraud, waste, and abuse of public funds has been a major problem in Russia from Soviet times, with significant negative effects for fiscal discipline, the effectiveness of public services, and the legitimacy and authority of public institutions. In Russia, as in most transition countries, the institutions for public financial accountability (PFA)—critical to induce sustained demand for better government performance—are still in their infancy and often rudimentary. Throughout the 1990s, there were, and still remain, many significant gaps in fiscal transparency, extra-budgetary funds, implicit subsidies, contingent liabilities, accounting, independent assurance on the integrity of financial information, and legislative scrutiny. Consequently, there were, and still are, striking needs and opportunities for external assistance to enhance institutional capacity and to improve laws and regulations in all these areas, preceded by a commitment for appropriate remedial action.

2. In the 1990s, up to 1997, the Bank's focus was mainly on improving accounting and auditing systems in the private sector. The Bank informed us that its main concerns were: growing corruption in the privatization process; an unstable and increasingly corrupt financial system; non-payments, both between enterprises and to the government; and capital flight. PFA relating to the public sector was not high on the Bank's agenda. The Bank's knowledge of the systems of "checks and balances" in the public sector, such as the scrutiny provided by the democratically elected Duma and the Chamber of Accounts—the supreme audit institution of Russia—has been growing since the early years of study of inter-governmental fiscal relations and the mid-1990s study of fiscal management, but is still limited at the cutoff time for this review (September 2000). It has been enhanced during the last two years by a number of studies, namely a solid *Country Procurement Assessment* (CPA) and the *Country Financial Accountability Assessment* (CFAA), still under preparation, together with an assessment of standards and codes by the IMF.

3. At the country level, the Bank gave insufficient attention to diagnostic work and the building of key institutions in the PFA area, even during 1996-99, when it provided very substantial quick-disbursing loans for budget support. This was a failure of due diligence. The Bank never established as priorities or pre-conditions of assistance (a) promoting concrete progress towards the preparation of consolidated financial statements with full disclosure of Russia's consolidated assets, liabilities, revenues, and expenditures in accordance with evolving accepted accounting principles for the public sector, (b) the conduct of a comprehensive public expenditure review, (c) strengthening capacity for independent *public audit*, or (d) ongoing legislative scrutiny of government revenues and expenditures by the Duma.

4. In the wake of allegations of misuse of IMF resources after the 1998 financial crisis, the Bank introduced a tracking system in 1999 to ensure that (a) disbursements of its remaining adjustment loan balances would reach the Ministry of Finance's budget accounts or (b) would only be spent directly by the Central Bank of Russia for external debt payments. A feature of this system was the requirement for the government to request the Chamber of Accounts of the Russian Federation to furnish to the Bank "annual comprehensive audit reports on Federal budget execution." This was an innovation. As for its investment lending, since 1998 Bank staff

implemented diligently the “ring fencing” approach mandated for project financial management under Loan Administration Change Initiative (LACI), and, in addition, took innovative steps to improve the audit quality of Bank-financed projects, including disqualifying incompetent private auditing companies, and to recover ineligible payments. The sustainability of the “ring fencing” approach has some advantages, such as greater awareness of financial management, but also some limitations in situations, such as Russia, where the overall control environment is known to be weak and external auditing arrangements are not strong.

5. However, these measures alone will not suffice to achieve the goal of providing Russian taxpayers and Bank shareholders the reasonable assurance that Russian domestic resources and external loans are spent economically and efficiently and only for the purposes approved by the democratically elected legislature and by the Bank. Given the fungibility of all central bank and government financial resources, only an improved overall decision making, control, transparency, and accountability environment for executing the Russian budget, coupled with strong public oversight agencies, such as the Chamber of Accounts and the Duma, and stronger participation and scrutiny by civil society at large can achieve the goal of providing Russian taxpayers and Bank shareholders reasonable assurance that domestic Russian resources are well managed and proceeds of external loans are spent economically and efficiently and only for the purposes approved by the legislature and lenders such as the Bank.

6. Our *main point* is that the Bank should give *priority* to strengthening primary institutions of public financial accountability in the public sector that would in turn promote demand for improved public sector management and performance reporting, and for more comprehensive financial statement presentation, together with stronger *public* audit of the state’s financial transactions. The Bank’s immediate goal should be to complete promptly the already advanced CFAA, in partnership with independent public finance institutes that can help fill the remaining knowledge gaps and carry the study’s findings and recommendations into the public debate. The Bank should then hold broad consultations on proposed reforms with key stakeholders, such as legislative oversight committees, the Chamber of Accounts, the judiciary, and the growing number of civil society organizations.

7. Time-bound, performance-oriented action plans for strengthening *primary* institutions of public accountability, with realistic performance indicators for measuring progress at both the national and sub-national levels of government, should receive strong Bank and other donor support in the form of technical assistance. Investing in additional internal capacity—the country team’s administrative and professional resources for pursuing reform of institutions of *public* accountability—will be necessary for such an expanded assistance. Without a shared vision for improving PFA, however, the Bank should avoid massive, quick-disbursing loans for general budget support and limit its other lending to lower-risk activities that it can adequately supervise with its existing limited resources. The Europe and Central Asia Region (ECA) management disagrees with this proposition. They point out that decisions of this nature are best made on a case-by-case basis, and accordingly do not support the more blanket-type “shared vision” approach proposed by Operations Evaluation Department (OED) for public financial accountability in relation to the Russian program.

1. Public Financial Accountability (PFA) in Russia

1.1 Transition economies pose special challenges, in that institutions of *public* accountability are often very rudimentary, and actions to strengthen capacity are, therefore, important aspects of economic and social development.

1.2 The Russian governance and accountability context is evolving.² The roles and responsibilities of the stakeholders are not always clear. For example, the public reporting duties of the Russian Chamber of Accounts have not been clearly specified in Law. The World Bank Institute's (WBI) indices of various aspects of governance aggregates data from a wide range of external surveys and is probably the Bank's most comprehensive cross-country estimate of governance standards. Taking the indices together, Russia ranked 36th from the bottom out of 154 countries in overall standards of governance (see Table 1).

Table 1: WBI Indicators of Governance³

Indicators (number of countries ranked)	Russia		Kazakhstan		Poland		Hungary		Bulgaria	
	Rank	Zone	Rank	Zone	Rank	Zone	Rank	Zone	Rank	Zone
Corruption (155)	43	Red	23	Red	113	Green	121	Green	48	Red
Govt. Effectiveness (156)	40	Red	27	Red	125	Green	119	Green	28	Red
Voice & Accountability (173)	71	Yellow	45	Red	140	Green	148	Green	118	Green
Regulatory Burden (166)	50	Red	43	Red	118	Green	141	Green	114	Green

** The larger the rank number, the better placed the country is in relation to the rest.

1.3 Clearly, the governance situation in Russia leaves much room for improvement. The most relevant index from the point of view of this paper is the index on Government Effectiveness, in which Russia is ranked 40th from the bottom out of 156 countries.

1.4 Transparency International's (TI) corruption index provides similar evidence, and corruption is reported to have become endemic.⁴ Corruption and money laundering have received considerable press attention recently in relation to the transfer of very large sums of allegedly illegally earned money through a Bank in New York.⁵ Such fiduciary risks and the related allegations of lack of transparency in government raise the stakes vis-à-vis reputation and development risks for both the Bank and the development community at large.

² The scope of this paper does not call for an analysis of the political economy of Russia or the institutions that govern public financial accountability.

³ *Voice & Accountability* is the process by which those in authority are selected and replaced; included in this category are three indicators measuring the independence of the media. *Government Effectiveness* combines perceptions of the quality of public service provision, the quality of the bureaucracy, the competence of the civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies. *Regulatory Burden* is more focused on the policies themselves, for example, price controls or inadequate bank supervision. *Graft (Corruption)* measures perceptions of corruption, where corruption is defined as the exercise of public power for private gain.

⁴ Yaroslav Kuzminov (February 2000).

⁵ James Roaf, "Corruption in Russia" Paper prepared for the Conference and Seminar on Investment Climate and Russia's Economic Strategy, Moscow, April 5-7, 2000 (IMF, 2000).

2. The Bank's Knowledge of PFA systems in Russia

2.1 Prior to 1996, the Bank's priority was to encourage the adoption of private sector accounting and auditing standards in the banking sector. The Bank's main interest was in the private sector development process, and it was not sufficiently attuned to strengthening principal financial accountability institutions. Areas of greatest importance to Regional management included: growing corruption in the privatization process; an unstable and increasingly corrupt financial system; non-payments, both between enterprises and between enterprises and government; and capital flight. We were informed that weaknesses in public sector financial accountability systems were not considered as important by the Bank.

2.2 In the period 1992-1995, the Bank's knowledge of public financial accountability systems was rudimentary, both at the country and project levels. Internal capacity for analyzing Russia's *public* financial management and accountability systems was weak, and little was done to strengthen this area until 1998, at which time, ongoing financial management supervision over Bank-financed projects was stepped up, with the appointment of a full-time financial management specialist in Moscow. In the absence of any Bank priority for financial accountability, the receptivity of the government to serious dialogue on issues of primary *public* sector financial accountability is difficult to fully evaluate on an ex-post basis. The Europe and Central Asia Region (ECA) management informs us that the Government of Russia's (GOR) receptivity to strengthening financial accountability was unlikely.

2.3 Serious effort to address the need to examine public expenditure systems and accountability issues across the Russian Federation commenced after fiscal 1995. The early focus was on analyzing the strengths and deficiencies in the budget system and related fiscal management processes. Issues of public financial accountability covered in the Bank's Economic and Sector Work (ESW) during fiscal 1995 and 1996 included controls over a wide range of activities, including cash management, debt management, procurement, financial reporting, and auditing and evaluation practices. A 1995 Bank paper on *Fiscal Management in the Russian Federation* is most instructive. Its primary concern was that the Russian institutional framework for budget implementation did not meet the requirements of a decentralized market-based economy. The need to strengthen the range of *public* financial accountability systems that would cover budget execution, accounting, audit and legislative oversight functions was acknowledged (albeit in a limited way) in the Bank's analyses of public expenditure. The risks associated with expenditure management systems, accounting, expenditure control, revenue collection procedures, and auditing systems were noted. For instance, the internal auditing practices of the Ministry of Finance (MOF) were questioned. The paper raised the need to improve the external audit system. The potential for conflict of interest—such as the role of the Chamber of Accounts in budget formulation and its authority, in certain circumstances, to issue executive orders—was raised. (See Annex B.) However, the analysis was incomplete in several areas. For example, the cardinal issue—the *effectiveness* of the Chamber—was not sufficiently addressed, nor was the Chamber's reporting responsibilities, if any, to the public and its relations with the Russian parliament (Duma), the media, and civil society analyzed in any depth.

2.4 Bank staff has periodically examined budget management issues. A *Fiscal Policy Note* prepared in June 1998, for instance, examines the Budget code that was then in draft and expected at that time to be approved by the Duma later that year. This review reconfirmed the

numerous weaknesses in the budget process, including the role of the legislature. Severe criticisms were levied against the manner in which the budget is formulated, approved and implemented. The report pointed out that extra-budgetary funds accounted for more than half of Russia's cash flow, thereby rendering the formal budget process incomplete and ineffective. The institutional capacity gaps highlighted in this report are striking. They cover almost all aspects of the budget process: formulation, execution, audit, and evaluation. However, it is not clear from the documents provided to OED whether the Russian Government made any response to this report or took any remedial action.

2.5 A 1998 report on *Benchmarking Public Expenditure* examines the size of government, expenditure allocation, and structural features of the evolving fiscal structure that impacted on expenditure outcomes in Russia during the period 1992-1998. It examines public expenditure from a variety of perspectives, with appropriate comparisons from international experience. The report provided to OED estimated that off-budget federal expenditures would range from 1 to 10 percent of GDP at the federal level. The situation was expected to be worse at the sub-national levels. The report also suggested that the effectiveness of public expenditure was being severely undermined by non-cash transactions and the growth of arrears (the non-payments problem). There was concern that growing levels of contingent liabilities facing all levels of government would present a serious risk. The paper observed that deficiencies in budget planning and execution led to wide deviations in outcomes, and undermined and threatened the capacity to implement public policy. The government was reported to lack a clear strategy for restructuring public finances.

2.6 Recent ESW in the area of procurement is even more revealing. The Bank's knowledge of procurement practices is perhaps the most thorough (among all areas of internal control). According to Bank staff members whom OED interviewed, the state of the art in the area of procurement prior to 1994 was most rudimentary. A *Country Procurement Assessment Report* (CPAR) was first conducted in 1996. An International Development Fund (IDF) grant attempted to strengthen public law in 1997, but this initiative was not successful. The Duma did not endorse the results of the proposed law or the institutional framework, which were subsequently found to be obsolete.

2.7 A new CPAR was prepared in fiscal 2000. The draft CPAR (October 2000) expressed concern that institutional capacity for public procurement in Russia remains weak. While much had been accomplished by way of training in procurement, many aspects of the legislation require further development, and there is a pressing need to develop the institutional and human resources to conduct public procurement. The report suggested that public procurement remains characterized by a high level of protection against foreign bidders and widespread discriminatory provisions against bidders from outside the purchaser's own region. These restrictive measures together with excessive use of non-competitive procurement methods and widespread corruption reduce the efficiency of public funds. Based on experience in other countries, Bank staff members associated with the Russia program cite academic research on international experience in stating, "that increasing competition can yield cost savings of 20 percent or more and that corruption has been shown to increase project costs by 25-50%." If these estimates are appropriate, strengthening financial controls in the area of procurement alone could save Russia

billions of rubles.⁶ While such estimates are difficult to substantiate with hard evidence, the potential for a positive impact on project performance has been recognized.

2.8 Recommendations to improve the procurement system include: a clearer and more sustainable legal framework; consolidation into a single federal law complemented by a reduced number of implementing regulations; harmonization between jurisdictions; standard procurement documents; and more clearly defined legislation to facilitate the implementation of externally funded projects. The CPAR also called for clear and effective enforcement mechanisms that would include effective monitoring and oversight functions and strict control procedures, such as close scrutiny of waivers.

2.9 The Bank's knowledge of public financial accountability systems has been enhanced by the work of the IMF in fiscal 2000. The Fund's assessment, called *Report on Observance of Standards and Codes (ROSC)*, suggests that weaknesses in public financial accountability systems run across levels of government, and that the reliability of financial information provided by government is considerably below par.

2.10 The report highlights major concerns with the quality of data, methodology for compilation, and dissemination practices, as well as a need to harmonize data standards at all levels of government.

2.11 It reports that there are at present many gaps in fiscal coverage (notably, the Ministries of Defense and Interior), and that a number of fiscal activities are carried out by agencies outside government (e.g., energy monopolies).

2.12 The report also raises a range of other issues of accountability and transparency, such as:

- The need to modernize the treasury system;
- Unrealistic budgeting and an inadequate accountability framework for enterprises;
- Lack of transparency in the activities of the Central Bank of Russia's subsidiaries, that have quasi-fiscal implications;
- Unfunded federal mandates that reduce the accountability and realism of regional budgets;
- Weaknesses in the budget code that allows little emphasis on performance or the results of spending; and
- The administrative capacity of the tax department.

2.13 Finally, the report also raises the issue of lack of public availability of information and inadequate financial and internal control measures in a number of crucial areas. The excellent IMF analysis presented in this report would suggest that the Bank could benefit from working closely with the IMF to help Russia address some of the major weaknesses. A key missing link in the IMF's knowledge base also relates to the *effectiveness* of the Chamber of Accounts of the Russian Federation. In Operations Evaluation Department's (OED) view, the Chamber could potentially be one important independent source of information on the effectiveness of Russia's

⁶ No research was carried out by the Bank to determine whether these figures also apply in the specific case of Bank-financed projects in Russia.

public financial management and control systems. The capacity of this organization needs to be further monitored.

2.14 The Chamber has informed OED that it is an arm of the Duma and is independent of the executive arm of government. It has broad powers to audit the government and has automatic access to treasury data. It is the supreme audit institution of Russia, staffed by 700 auditors with a range of skills including law, economics, auditing, and accounting. This team of auditors is reported to have completed 1,500 audits per year, a number of which resulted in referrals for criminal prosecution.

2.15 The Chamber has raised serious concerns with the manner in which public funds are managed by the State, including those provided by the World Bank. A Director of the Chamber of Accounts met with senior Bank officials in June 1998 to discuss the work of the Chamber, particularly in connection with audit work on Bank-funded projects, and the impact of corruption in the Russian Federation. The Chamber pointed out that it had conducted audits of two Bank-financed projects, and that a third was underway. There was no indication of misconduct on the part of any Bank staff members, but the Bank was informed that the findings suggested corruption had infected both projects that had been reviewed.⁷ What remains unclear is the nature and extent to which the Chamber's findings have since influenced the Bank's actions and operating methods in Russia. We raise this issue because Regional management has implied, in its response to an earlier draft of the report, that placing reliance on the Chamber for fiduciary assurance was unwarranted at that time.

2.16 The Chamber has the potential to play a key role in promoting public financial accountability. While Bank-financed projects are subject to *private* sector audit, the Chamber nevertheless scrutinizes the performance of such investments/loans at times, because they may have significance to the democratically elected Duma. However, the reports of the Chamber were *reportedly* not routinely made available to the Bank. While there may have been good reasons (such as lack of capacity to undertake financial statement "certification"-oriented audits), it is not clear whether the Chamber should be considered for potentially becoming the duly appointed auditors for some Bank-financed investment projects as are supreme audit institutions in many other client countries. They could always outsource the "certification" part of the audit to the private sector, if that step is considered necessary for capacity considerations.

2.17 The audit staff of supreme audit institutions generally have good knowledge of the business, are expected to be independent of the executive arm of government, and well conversant with the requirements of International Organization of Supreme Audit Institutions (INTOSAI). As further discussed in Paragraph 5.3 below, it is commendable that, in 1999, the MOF agreed to request the Chamber of Accounts of the Russian Federation to furnish to the Bank comprehensive audit reports on Federal budget execution for each year in which adjustment loan disbursements would take place as an integral part of its additional arrangements to safeguard adjustment loan disbursements. The Bank and other donors have been advocating the strengthening of these public institutions in many other countries on the grounds that supreme audit institutions have a public responsibility to provide a degree of assurance on the

⁷ Allegations relating to the Privatization project and the Housing project were identified. Reference was also made to concerns about corruption in the restructuring of the Coal Industry Project.

use of all public funds, whether domestic, donor-provided grants, or borrowed from international financial institutions. As a primary institution for public financial accountability, the effectiveness of the Chamber of Accounts, its capacity to audit/supervise private sector auditors for Bank-financed activities, and its linkage with the Duma's scrutiny processes need to be further researched. The standards of audit being applied at this auditing institution need to be carefully examined, and strengthened as necessary. As previously indicated, the Bank has not examined in any depth the effectiveness of this institution. Nor has it consulted with the Duma on ways to strengthen its role in supporting institutions of financial oversight.

3. The Bank's Strategy for PFA in Russia

3.1 The Russian Federation became a member of the World Bank in June 1992. The Bank's country program was launched with pressure from the G-7 countries to move quickly and substantively. The multilateral institutions, including the Bank, adopted the "big bang" approach, and bilateral donors were part of the burden-sharing arrangement.

3.2 The Bank's stated broad strategy for Russia over the last decade was focused on four objectives:

- Support Russia's transition to a market economy, based on private sector initiatives;
- Protect the poor and vulnerable groups;
- Develop and strengthen institutions; and
- Establish the Bank as a reliable and trusted partner in development.

3.3 In the early 1990s, Russian institutions that could serve a market-based economy, including those in PFA, were in the embryonic stages of development. The need to encourage the reform of and the building of institutions of public accountability and transparency in line with democratic ideals was very clear to the international community.

3.4 In terms of PFA, the overall Bank strategy touched upon selected aspects of financial management, such as project accounting and auditing during the period 1992-2000. However, the Bank did not develop a systematic strategy, framework or long-term action plan to address *public* financial accountability issues. A number of projects had components aimed at improving accounting, auditing, and oversight of the banking sector. The strategy for the banking reform grew out of the private sector development and financial sector development strategy. However, given the now-accepted overall failure of reforms in this sector, the value added by the Bank's investments remains unproven.⁸ Although the Country Assistance Strategy (CAS) mentions the importance of corporate governance (accounting, auditing, and oversight) in both state-owned and privatized enterprises, here again there was no clear Bank strategy or follow-through to address the issue of *public* accountability. Failure of corporate governance should be a matter of *public* concern—government bail-outs in the banking sector for instance can be costly for taxpayers.

3.5 As previously mentioned, prior to 1995, public sector accountability was not on the Bank's list of priorities. We were informed that the relative neglect of institutions in the public

⁸ OED's Audit Report and ICR on SALs I and II.(Internal documents)

sector in the early years was perhaps partly due to the lack of adequate government commitment to reforms in this area, given that the overall agreed emphasis of most donors was on privatization and private sector development.

3.6 Public sector management was given some attention from 1995 to 1997, when the Bank explored the need for reforms in the areas of tax administration and procurement. Although the 1997 CAS did aim to rationalize the budget development process, efforts made to improve Russia's public sector accountability institutions, those aimed at enhancing accountability and transparency for Russia's citizens, have been minimal, despite the opportunities provided by the three successive adjustment-lending operations. This relatively modest level of effort and the limited success can be attributed in part to weak government commitment, as evidenced by the cancellation of the second tranche of SAL III that aimed to deepen public sector institutional reforms (Box 1).

3.7 It was only in 1999 that the CAS for the first time focused on the need to address institutional reforms centered on governance and *public* sector accountability. The Bank's lending and non-lending interventions were geared towards "strengthening system core fiscal management functions in the Ministry of Finance and taxation at the federal level, and regional finance authorities at the sub-national level, and on systemic reforms in public administration (functions and organization structure of the government and civil service)."⁹

3.8 The 1999 CAS states that the Bank did not propose to use instruments such as the Country Financial Accountability Assessment (CFAA), Public Expenditure Review (PER) and Institutional and Governance Review (IGR) at that time, although it was recognized that they had been used in other countries to address the institutional problems that underpin corruption. The "approach proposed here, which focuses heavily on public sector resource management and policy reform while attempting to build a dialogue and common understanding on broader governance and public administration issues, holds greatest potential for substantive progress in the current environment."¹⁰ The emphasis on improving national accountability systems and/or institutions was yet to materialize. The upcoming CFAA exercise could help the Bank to assess the risks involved, determine capacity building requirements that need to be addressed, and identify points of entry for possible Bank support.

3.9 Since fiscal 2000, however, the Bank has increasingly recognized that promoting reforms aimed at strengthening public financial accountability is one way to assist management of public resources. This approach is also seen as a way to mitigate the reputation risk to the Bank associated with fraud, waste and abuse of Bank funds in such a high-risk environment.

⁹ Page 26, Paragraph 59, CAS 1999.

¹⁰ Page 31, Paragraph 75, CAS 1999.

Box 1: Structural Adjustment Loan III (SAL III) and Public Financial Accountability

SAL III, a US\$1.5 billion loan approved in August 1998, aimed to carry forward and deepen among others, the PFA reforms envisaged in SALs I and II. SAL III was designed primarily as a back-loaded operation with progressively larger tranche amounts—the first tranche would release \$ 300 million upon loan effectiveness, the second tranche \$500 million, and the third tranche \$700 million.

The Loan required the Government to undertake some actions prior to presentation to the Board. Among these, two actions addressed PFA: (a) issuance of a resolution mandating the audit of Extra-Budgetary Funds and (ii) issuance of a resolution approving a Concept Paper on sub-national reform.

In the second tranche, the Government was expected to enact and enforce an amendment to the Joint Stock Company Law to provide for adequate protection of minority shareholders. However, most of the significant reforms related to PFA were back-loaded as conditions for the release of the third tranche. These included:

- Adoption and enforcement of the Law on Auditing to gradually transfer regulatory powers relating to auditing from federal bodies to a self-regulating independent auditing profession [and issuance of 33 defining auditing standards that are consistent with international standards for auditing.
- Submission to the Duma of appropriate legislative drafts on sub-national fiscal reforms or issuance of other legal acts to provide for clear assignment of revenue and expenditure responsibilities for each level of government, consistent with the concept papers prepared by the government under the program.
- Government measures to: (a) include all guarantees, other public contingent liabilities or conditional obligations in the definition of public debt applicable to the federal and sub-national level; (b) establish a public debt monitoring system, including a comprehensive system that captures the sub-national debt portfolio; (c) establish prudential regulations to govern sub-national borrowing; and (d) provide for verification by the MOF that sub-national debts adhere to the regulations.

Quality Assurance Group (QAG) rated the quality at entry of SAL III to be less than satisfactory. The Project Supervision Reports for May and December 1999 and June 2000 all rated implementation progress as well as achievement of development objectives to be unsatisfactory. The Loan failed to meet its second and third tranche conditions and was cancelled in September 2000. The Bank contends that, despite the failure of the loan, the loan “contributed, with relatively little additional exposure, to maintaining Russia’s path towards a modern market economy.” However, in the context of PFA, this loan appears to have achieved very little. The amount of timely due diligence exercised by the Bank was negligible.

3.10 The Bank has more recently begun to broaden its focus on the public sector from “management issues” to “accountability” and governance-related institutions. The 2001 CAS Progress Report indicates that the 10-year government reform program seeks to address important aspects of governance, including PFA. It aims to strengthen corporate governance, introduce international accounting standards and strengthen audit, reduce discriminatory regulation (especially at the regional level), strengthen treasury controls and public procurement legislation and practices, and undertake civil service reforms. However, implementation of the agenda to date is reportedly slow, with the exception of a steady pace in treasury reform and the encouragement of initial dialogue on civil service reforms. The 2001 CAS Progress report also suggests that other key institutions in the Duma, such as the Anti-Corruption Commission and the Chamber of Accounts, have increasingly started to focus on public sector governance and fighting corruption.

3.11 In summary, despite knowledge of significant deficiencies across levels of government, specific institutions of PFA were neither prioritized within the overall CAS, nor targeted to areas of highest concern. The Bank has yet to confirm the Government of Russia's (GOR) commitment to and support for the development of a "home-grown" strategy for improving public sector financial accountability. The early pre-1999 CAS documents do not provide evidence of any formal Bank efforts to coordinate with other donor agencies, such as USAID or the British Know-How Fund, that may have been involved in capacity-building for PFA. The need for strengthening public sector accountability has however emerged as an area of increasing attention in fiscal 2000.

4. Building Capacity for PFA in Russia

4.1 Between 1992 and 2000, the Bank undertook 44 projects in Russia. As of June 2000, the Bank had approved an estimated US\$11.8 billion. Adjustment loans amount to \$6.2 billion, or just over 52 percent of the disbursements.¹¹ Of these 44 projects, over 36 percent (16 projects including 1 Institutional Development Fund (IDF) grant) contained at least a small component that aimed to build capacity for sound financial and managerial accountability. This is quite a significant number (for instance, the corresponding figure in Kazakhstan is about 24%).¹² Only three of the development projects have been completed.¹³ In two of the three completed cases, it is too early to comment on outcomes. The other 12 projects are on-going. The most recent Project Status Report (PSR) rates implementation progress for six on-going projects as satisfactory and two others as unsatisfactory. In the case of four projects, implementation performance on the specific financial management component is not clear.

4.2 The Bank's efforts to build capacity for financial accountability and management over the last six years cover four areas: banking sector, financial and corporate sector, public sector enterprises, and, to a modest extent, taxation and public procurement in public sector management.

Banking Sector Reform

4.3 In the very early years (fiscal 1992–94), improving public financial accountability was not on the Bank's agenda. The Bank's emphasis was primarily on Privatization and Private Sector Development (PSD). However, as part of its privatization and PSD efforts, from fiscal 1995 onwards, banking sector reform was a main objective of the Bank strategy. The Bank undertook several projects beginning in June 1994—Financial Institutions Development Project (FIDP), Financial Management and Training Project (FMTP), Enterprise Support Project (ESP), and the Structural Adjustment Loans (SAL) I and II.

¹¹ Of the total \$10.4 billion approved, 88 percent was committed by fiscal 2000 (\$4.2 billion and \$6.2 billion in investment and adjustment, respectively).

¹² 5 out of 21 projects.

¹³ The Management and Financial Training Project was rated satisfactory on outcome, but its sustainability is uncertain. SALs I and II are rated marginally unsatisfactory on outcome. Performance on the small component under the Rehabilitation Program II (Other actions: Enterprise Reform Section) to promote truth in advertising for financial institutions, improve financial reporting, and banking supervision of commercial banks is not clear.

4.4 The *FIDP* aimed at building institutions and corporate governance in the Banking sector through three components: (a) the commercial banking component aimed at strengthening institutions and standards, system modernization and automation; (b) the bank regulation and supervision component aimed at strengthening on-site supervision by the Central Bank; and (c) the Bank accounting component aimed at modernizing accounting standards and practices. Following the financial crises in 1998, the FIDP was restructured and the loan amount was reduced in July 2000. Components to strengthen Central Bank supervision and accounting practices were retained. Support for accounting reform has also been made. The Project Status Report (PSR) for November 2000 *does not clearly* indicate implementation progress on both components. However, the PSR states that the Government has made some progress toward improving the legal framework and has begun an in-depth review of bank accounting reform, including pilot International Accounting Standard (IAS) implementation.

4.5 One of the conditions on the *Enterprise Support Program* was to ensure that credit lines would only be available to commercial banks that undertook an institutional strengthening program under the FIDP and that demonstrated achievement of milestones of prudential standards and performance improvement.

4.6 Following the restructuring, the Bank made some key adjustments in September 2000. The need for FIDP accreditation was replaced by the requirement for participating Banks to demonstrate on-going compliance with pre-determined criteria (Ministry of Finance). Implementation progress was rated unsatisfactory in the PSR for June 2000. The Bank was then also in the process of negotiating conditions to be met by participating Banks.

4.7 The banking sector component of the FMTP provided top-level executives and middle managers training in financial and risk management, and in control systems and credit. Although the training program was rated to be satisfactory, the Implementation Completion Report (ICR) suggests that the Bank and the Government did not pay sufficient attention to the institutional arrangements to ensure sustainability of the training programs. The Government of Russia (GOR) has no stated strategy for promoting management and financial training.

4.8 SALs I and II focused on two aspects of banking reform: (a) improved bank supervision and enforcement (including a failure resolution framework—bank bankruptcy law, enforcement powers, etc.) and (b) support for the bank consolidation process. Within the above, the short-term priority was to devise and implement a program for dealing with liquidation and licensing of banks. Also, the authorities were expected to prepare a medium-term program of supervisory enforcement action targeted at banks not requesting or benefiting from case-by-case restructuring. The focus of the latter would be to address the legal framework issues, as well as the capacity of the Central Bank of Russia (CBR) to review and handle the large volume of bank absorptions and mergers that would be submitted for approval.

4.9 Although the Bank Bankruptcy Law was passed in June 1999, amendments are still pending in the Duma, and implementation and enforcement are weak. The program of supervisory enforcement was established in June 1999 in the Central Bank restructuring agency. But problems related to bank restructuring and consolidation remains—where licenses were revoked, the banks often resorted to the courts to restore them. The CBR did make some progress in strengthening supervision and in the payment system. Although the CBR, with some

Bank support, did conduct an audit of the problem banks under SAL II, this audit report has not been made officially available to the Bank, although a copy of the audit report was published in *Euromoney* magazine. Progress in banking reforms was rated *unsatisfactory*.

4.10 OED's audit reports for SALs I and II clearly states that the Bank's strategy for banking reform was a "complete failure."

Financial Sector and Corporate Governance

4.11 Beginning in fiscal 1996, the Bank's focus in PSD became more broad-based, to include not only banking reforms but also matters associated with corporate governance, capital market development, training in financial management, and promotion of international accounting and auditing standards.

4.12 The **FMTP** aimed at implementing an integrated and comprehensive training strategy for accounting, auditing, and finance. It focused on top-down training, curriculum development, training in computerized environments, cash flow and income-related concepts, and the adoption of international accounting standards. As mentioned above, the training instituted as part of the FMTP, while satisfactory, is unlikely to be sustained.

4.13 **SALs I and II** sought government resolution for greater transparency in privatization. It called for procurement rules for case-by-case privatization to be fully competitive and open, with open and competitively selected financial advisers and valuation procedures in accordance with international standards. Although some progress was made in introducing international accounting and auditing standards during SALs I and II, their approval and implementation were delayed by the Duma.

4.14 The **Capital Markets Development Project (CMDP)** aimed at strengthening corporate governance and promoting international prudential and fidelity standards. Specifically, components were to: (a) build a comprehensive regulatory framework for capital markets development; (b) build core institutional capacity in regulation and enforcement; and (c) increase the efficiency, transparency, and systemic stability of secondary trading, clearance, settlement and registration. However, the Bank and the Government of Russia decided to reassess the project after the banking crisis in August 1998. This assessment raised the need to strengthen corporate governance and investor protection, and to increase transparency and regulation. The project was restructured, and relevant new components included regulatory infrastructure and accounting and taxation reform, as well as a public disclosure component. Although a workshop was held, the status of implementation is *not clear*.

4.15 Although the section on "other actions" under the enterprise and financial sector reform component of the **Rehabilitation II** Program called for truth in advertising for financial institutions and improved financial reporting, the Implementation Completion Report does *not clearly* indicate the outcomes of these components.

4.16 In conclusion, the outcome of the Bank's efforts to build financial management capacity in the private sector is too early to assess. The move toward internationally accepted accounting

standards is visible, but implementation is questionable. Corporate governance reforms are too recent, and whatever progress has been made is not very clear.

Financial Management and Procurement in Public Sector Enterprises

4.17 Small components for improving financial management and procurement were also initiated in a few other cases from fiscal 1995 onwards in large infrastructure monopolies, such as coal, oil, housing, etc.¹⁴ In these projects, financial management was seen as a small component necessary to reform public enterprises and/or privatize them.

4.18 The small components performed reasonably well. In 60 percent of such projects (three out of five), all of which are ongoing, the PSR rates implementation progress in the component to be satisfactory. However, such efforts were not designed to impact the macro systems of public sector financial management and accountability in the country, and therefore are unlikely to have a positive effect.

Public Sector Financial Management and Accountability

4.19 Public sector management, administration, and accountability were not on the Bank's agenda until fiscal 1995. The Bank's initial efforts (fiscal 1995-97) in the public sector focused largely on building capacity in the areas of tax administration and procurement. More recently, since fiscal 1999, the Bank has initiated efforts to improve the quality of financial information and aspects of public sector management at the sub-national level.

4.20 The **Tax Administration Project (TAP)**, approved in March 1995, aimed at revamping the State Tax Service through automation, changes in rules and procedures, training, and institutional capacity building. It also aimed at preparing for nationwide implementation of the reforms. The TAP is near completion, and the last PSR rates performance of all components to be **satisfactory**.

4.21 Part of the fiscal reforms sought under **SAL I and II** included (a) the issuance of a Presidential decree to reform public procurement procedures, requiring standardized, non-discriminatory, competitive, and open bidding procedures, and establishing conflict of interest regulations, and (b) submission of a draft tax code to the Duma. In 1997, the Bank also provided an **IDF grant** for preparing standard bidding documents in order to increase the uniformity and accuracy of procurement practices. However, the Country Procurement Assessment Report undertaken in 2000 states that the IDF grant was very ineffective in terms of impact.¹⁵ While a standard set of bidding documents was prepared, they have become **largely obsolete** and not applicable, due to significant changes in the legislation.

4.22 Recently, the Bank initiated the State Statistical System Project (SSSP) that aims to improve the quality of the Government's financial statistics and compilation of "General Government Accounts" in the National Accounts system. In fiscal 2000, the Bank has initiated its first direct effort to address public sector management, through the Regional Fiscal Technical

¹⁴ Bridge Rehabilitation Project, Coal IAP, Energy Efficiency Project, Portfolio Development Project, and Medical Equipment Project.

¹⁵ See paragraph 2.11.

Assistance (RFTA) project. One of the components the RFTA aims to assist sub-national governments in accounting and budgeting. The second component aims to provide sector Public Expenditure Reviews, with the component on legislation as one of several that aim to analyze the consistency and compatibility of existing legislation on sub-national public finance and inter-governmental relations. A component to strengthen federal monitoring capacity aims to develop and disseminate a Code of Good Practice for regional financial management, and to design financial disclosure requirements for regional and municipal borrowers.

4.23 However, for both the projects mentioned above, it is too early to comment on project outcomes and effectiveness at this time, as implementation has just begun.

4.24 In summary, the Bank's efforts to date have yielded mixed results. Actions required/taken by the Bank to support strengthening the capacity for PFA (a) have so far been very modest and primarily focused at the project component level, and (b) were undertaken either in connection with the banking sector or in the context of private sector development and corporate governance. While some of the actions are recent, and, therefore, it is too early to judge their effectiveness, in many cases, the results so far have been modest. Efforts to improve financial accounting and auditing arrangements at the project level and in procurement are underway, but these efforts by themselves may be insufficient, given that the control environment at the country level remains weak. There is still no clear strategy or framework under which these capacity-building efforts have been undertaken or a defined framework for assessing institutions for building capacity.

4.25 In the absence of an overall framework or specific strategy for capacity building based on an assessment of the risks involved, it is not clear to what extent the Bank's current efforts in the public sector, financial sector/corporate governance, and/or infrastructure monopolies will likely contribute to significant improvements in the country's capacity for sound financial management and accountability. The main concern is that the variety of ad hoc project components, while individually useful, may not collectively help to "make a difference." Given the difficult control environment, a more strategic and risk-based approach is required. The CFAA may be the instrument that the Bank needs to find a well defined way to move forward.

5. Financial Accountability and Control Aspects

Control over Adjustment Loan Disbursements

5.1 Given the widely perceived high risk associated with adjustment lending, the Bank conducted a special review of all past transactions relating to World Bank adjustment loan disbursements to the Russian Federation during 1999. The results of this review confirmed that all past loan disbursements are fully accounted for and have been used fully in accordance with the respective loan agreements. What this means is that the Bank's money reached Russia and was duly recorded in the books of accounts. What this does *not* mean is that there is reasonable assurance being provided that the resources were effectively utilized in the budgetary process to achieve the purposes that may have been intended at the time the loans were advanced. This is not meant to suggest in any way that Regional financial management was deficient for not obtaining such reasonable assurance. Current requirements of Bank policy in this area are

reported to be modest. The special step taken by way of additional arrangements to track the flow of funds go beyond that required by operating policy.¹⁶ OED's main point is that this special initiative, while very commendable, should not give the impression that that the Bank has, as a result of this initiative, reasonable assurance that the equivalent funds in rubles are being used by the Government of Russia economically and efficiently and for the purposes intended by the budget approved by the democratically elected legislature. This is the *development* effectiveness issue of concern, and in OED's view, it is also an important issue from a reputational risk and related value-for-money perspective.

5.2 The Executive Board of the Bank was informed of an additional safeguard—a new channeling arrangement for all future disbursements from the World Bank's adjustment loans to the Russian Federation. This additional safeguard will allow the Bank to monitor on a "real time basis" the movement of funds from and into the special accounts set up by the MOF at the Central Bank.

5.3 Regional management informed OED that ESW, even fiduciary work, cannot provide assurance that funds are "spent economically and efficiently and only for the purposes intended," nor can institutional and policy reform, by themselves, provide it. Such assurance, we were told, can only be provided by ex-post audit. Management points out that "ESW can give insight into the risks that things might or might not happen, while institutional policy reform can reduce such risks, **but only audit can give assurance about what has happened.**" The MOF has requested the Chamber of Accounts of the Russian Federation to furnish annual comprehensive audit reports on the Federal budget execution for each year in which adjustment loan disbursements take place. From this OED has inferred that an independent *comprehensive* audit by the Chamber can be expected to strengthen the financial accountability arrangements for adjustment loans pursuant to the Bank's Article 111.¹⁷ OED has requested from the Bank a copy of any such annual audit reports on budget execution, as well as the Bank's assessment of the linkage between the contents of these reports and the requirements of Bank Article III. However, OED was informed that, at this time, such an audit report from the Chamber is not available. This matter needs to be further pursued with the authorities. In the meantime, no firm conclusion can be drawn on "reasonable assurance" vis-à-vis use of equivalent budgetary funds pertaining to the years in which adjustment loan disbursements took place.

5.4 The Bank and the borrower are commended for seeking assurance on the proper use of adjustment funds from the supreme audit institution of Russia. The extent to which this will strengthen financial accountability will depend upon how effective the audit is in providing

¹⁶ The Bank's Legal Department has also forcefully expressed the strong view that the Bank has no right to seek assurance as to the use made of the local currency counterpart funds generated by the sale of the foreign currency adjustment loan proceeds. The local currency is not "our money"—the foreign exchange is—so the use made of the funds paid into the budget is not our fiduciary concern. The Bank has clear developmental interests in how the budget is planned and executed, but there should be no confusion between these concerns and the Bank's "fiduciary" responsibilities. Also, Regional management endorses the view that it is a defining characteristic of adjustment operations disbursing against a negative list that there are *no* "purposes intended" for the loan proceeds—they may be used for any purpose other than those prohibited by the negative list.

¹⁷ Article 3, Section 5 (b) Use of Loans Guaranteed, Participated in or Made by the Bank: "The Bank shall make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency and without regard to political or other non-economic influences or considerations."

assurance. This initiative, *if successful*, could go a long way to providing greater *assurance* on the use of public funds, including Bank funds, and simultaneously, also promote borrower capacity for improved management of public funds. At this time, it is too early to come to any firm conclusion on this front because the Chamber has not provided any audit information in this area. Also, the Bank can draw no firm conclusion at this time on the effectiveness of the Chamber's audit work in this context. Regional management have further stressed that where the proceeds of adjustment loans are held by the Central Bank (either before or after sale by the government in exchange for local currency), much of the assurance the Bank requires comes from the new safeguard arrangements introduced by the IMF.

5.5 In *summary*, the Bank has developed mechanism for seeking assurance that its fast-disbursing funds reach the Central Bank of Russia and are duly recorded in the federal budget as intended. *However, given the fungibility argument, this mechanism's ability to provide, on its own, reasonable assurance on the end use of such funds is limited.* The IMF may indeed be, as Regional management points out, one source for obtaining fiduciary assurance. In our view, there may be no fully satisfactory alternative for enhancing the level of assurance on the *use* of public funds, i.e., the economy and efficiency of public expenditure, except by helping Russia to strengthen its *public* financial accountability systems at the national and sub-national levels in line with norms and practice that apply to the management of *all* public resources.¹⁸

Control over Investment Loan Proceeds

5.6 The Bank monitors fiduciary controls as related to financial management at two stages of the project life cycle: (a) during appraisal and (b) during supervision, including an annual financial audit. The Bank reviews the implementation of financial management (and, importantly, procurement) arrangements at all stages to ensure that project funds (Bank, external, and counterpart) are used for the purposes intended and with due care for efficiency and efficacy.

5.7 Since the introduction of Loan Administration Change Initiative (LACI), all projects appraised after July 1998 must include an assessment of the adequacy of the financial management arrangements for the project, including those at the implementing agency. Where the project's financial management systems are thought to be inadequate, the Bank is required to work with the borrower agency to develop and implement an appropriate action plan to introduce an adequate financial management system before project commencement.¹⁹

5.8 Of the five investment projects brought to our attention which were appraised in Russia since July 1998, OED reviewed the financial management assessment for two projects.²⁰ The Project Appraisal Documents for the two sample projects reveal "sufficient" financial

¹⁸ Regional managers have a different appreciation of the matter. They state that "Bank adjustment loan proceeds are not 'recorded in the federal budget'." The local currency generated by the sale of the loan proceeds is shown in the budget. Since Russia does not use a double-entry system, the liability to the Bank is not "recorded," other than in separate memorandum records. Further, transfer to the budget does not represent the "end use" of adjustment proceeds under the current interpretation of the Bank Articles by the Bank's Legal Department and the relevant loan agreements. Such strengthening is highly desirable from a developmental perspective, but this is something different from the Bank's fiduciary responsibilities.

¹⁹ In addition, in ECA, the Bank's requirements must be met prior to Board presentation. In keeping with Regional policy, there should be no substantive conditions of effectiveness.

²⁰ Highway Rehabilitation and Maintenance Project II, State Statistical System Project, Sustainable Forestry Project.

management capacity in the Project Implementation Unit (PIU) to implement the project, but the Bank also developed a specific action plan to further improve the system. However, at the time of this draft, we were informed that Internal Audit Department (IAD) will be undertaking work at Moscow to review the documentation on follow-up and implementation on the action plans, as well as the assessment of the adequacy of financial management arrangements during the supervision process. Hence, this aspect is not being further addressed by OED at this time.

5.9 In terms of the audit mechanism, the Bank's guidelines require that investment projects be subject to an annual financial audit in accordance with international standards to ensure that project money is used only for intended purposes and that the Statement of Expenditures and other financial statements present a true and fair view of the financial status of the project. The auditor is also expected to provide an opinion of the effectiveness of the internal control system.²¹

5.10 OED reviewed documentation related to the audit procedure for four sample projects for the calendar years 1998 and 1999, including the Terms of Reference (TOR) for the auditor, the audit reports, management letters, and related Bank correspondence.²² This review indicates that the Bank has complied with the current Bank policy and guidelines in drafting appropriate terms of reference and has adequately followed up on the main issues raised in the audit reports and management letters. Suitable arrangements were made to recover inadmissible expenditures and revise audit reports wherever needed.

5.11 The Bank's guidelines do not call for a penalty—financial or otherwise—for inclusion of inadmissible expenditures. Thus, there is no specific incentive that helps prevent the recurrence of such issues covered in the audit report. However, this is reflective of the Bank-wide policy that is applicable to all countries.

5.12 The external auditor does *not* provide—and is *not* required by Bank policy to provide—an opinion on whether “all project funds *are* used for the purposes intended.” The assurance provided by the auditors is on the accuracy and fairness of the financial statements. The focus is on the “eligibility,” *not* the “appropriateness” of reported expenditures. This is Bank-wide issue reflected in the Russia portfolio as well. Seeking assurance on eligibility is quite in order. What constitutes “appropriateness” can be further debated, since there is no Bank fiduciary policy in this regard. At present, the independent auditors appointed by the government are not expected by Bank policy to provide *this* kind of assurance. At issue is whether the scope of external audits of Bank-financed projects should be broadened to include project performance in line with evolving INTOSAI standards for the public audit function. In the view of the authors, the narrower scope of external audits—i.e., current Bank-wide policy and practice—does not seek to provide reasonable audit assurance that funds are used for the purposes intended with due regard for economy and efficiency.

5.13 Notwithstanding such Bank-wide issues, the country team undertook a review of all 1999 audit reports to highlight cross-cutting issues and systemic weaknesses. The CAS 2000 progress report indicates that no major weaknesses were found. (OED has not conducted a quality review

²¹ As described in the Financial Accounting, Reporting and Auditing Handbook (FARAH) issued 1995.

²² Medical Equipment Project, Land Reform and Institutional Support, Financial Institutions Development Project.

of this exercise.) Furthermore, the country team is also commended for conducting an accreditation of the audit firms eligible for auditing Bank-financed projects, based on their institutional capacity, audit methodology, and audit engagements.²³ The review covered several Russian private sector audit firms. The review did not include an assessment of the Chamber of Accounts, the supreme audit institution of the country. We were informed by the Bank that the reason for this is that the MOF did not ask for them to be included—auditors are appointed by the GOR, not the Bank.

5.14 In summary, although the Bank appears to be in full compliance with the fiduciary guidelines of the Bank on the audit process, the audit process alone, as generally accepted, does *not* provide reasonable assurance on the efficient and effective use of Bank resources. Bank procurement requirements have an important role to play. The “opinion” from the audit process needs to be considered along with the results of IAD’s *proposed* audit of fiduciary compliance during project appraisal and supervision. Hence, at this time, it is *not* possible to come to a definitive conclusion on the effectiveness of all the financial management and internal control arrangements for Bank projects in Russia. Any final conclusion in this area must await the planned IAD Report.

6. Main Evaluation Findings and Conclusions

6.1 The main evaluation findings are:

- (i) **The Bank’s knowledge of Russia’s institutions, systems, and practices of *public* sector financial accountability (national and sub-national levels) has increased since fiscal 1998.** Initially the Bank’s focus was on private sector-related governance (fiscal 1993–96). Massive corruption and misuse of resources in the private sector was reportedly the main concern of Regional management. Efforts to strengthen knowledge of *public* sector financial accountability and related institutions of governance were gradually stepped up during the period fiscal 1996–98. These aspects are now being further addressed during fiscal 2001 (CFAA) alongside fiduciary work at the IMF. This expanding knowledge base provides useful information on the many significant gaps in capacity that will need attention. The CFAA underway has the potential to influence the next CAS. It is becoming clearer that accountability institutions associated with the management and use of public resources at various levels of government will warrant substantial further attention in the years ahead.

²³ The review noted that, while the audit profession was moving towards international standards, its customers often only required a documentary audit to minimize tax risk. Auditors are not encouraged to introduce high-quality work, as it will increase the time, cost, and volume of audit. The major areas for improvement in methodology and engagements for Russian audit firms are as follows: (a) Planning audits based on risk assessment; (b) Reviewing and changing, if necessary, the materiality level during the course of the engagement; (c) Assessment of the independence of the firm and staff; (d) The auditor's responsibility to consider fraud and error in an audit of financial statements; (e) The auditor's responsibility regarding subsequent events; (f) The auditor's responsibility in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements.

- (ii) **The Bank’s knowledge of PFA institutions has so far had limited influence on the Bank’s Country Assistance Strategy.** A key constraint has been the lack of a priority for strengthening Government of Russia’s (GOR) capacity to meet its fiduciary obligations to its citizens. Regional management states that, under the general understanding of the division of labor that existed in the 1990s, the IMF was expected to take the lead in this area. The Bank is yet to fully develop and articulate a specific strategy to help Russia build institutional capacity for public financial accountability at the national and/or sub-national levels. As of September 30, 2000, there was no medium- or long-term strategy, framework, or action plan aimed at primary institutions of accountability and transparency. Management informs us that the Bank has never been able to impose its agenda on Russia, and the notion that it could have done so then or now is false. In our view, given the level of financial support provided to Russia, its country-level institutions of *public* financial accountability needed priority attention.
- (iii) **The relevance and effectiveness of the Bank’s past and current actions in building institutions of public financial accountability remains unclear.** While the Bank has made attempts to deal with specific aspects of financial management and accountability—mainly at the project level and on an ad hoc basis—these efforts have so far produced unclear results in terms of assurance that, in the aggregate, public funds are as well managed as they could be. OED’s main concern is that the variety of project components aimed at capacity building in the public sector, such as project accounting and electronic information systems, while individually useful, cannot collectively help to “make a difference.” The Bank’s fiduciary ESW is insufficient—a CFAA, for instance, has not been completed (as of September 2000) despite the acknowledged high risk of fraud, waste, and abuse. Stakeholders such as civil society and legislators have not been sufficiently consulted. The extent to which such stakeholders as members of the Chamber of Accounts, Russia’s supreme audit institution, were consulted is also unclear. It is difficult to fully assess risk mitigation measures that may be necessary and constraints that may be involved, based on a desk review by OED in Washington. The priority for actions to strengthen accountability institutions should be established in due course in consultation with stakeholders.
- (iv) **More work will be required before the Bank can claim to have reasonable assurance that public funds are being sufficiently protected.** In the past, the priority for due diligence (fiduciary ESW) was low. At the “country” level, the ability to provide reasonable assurance that public funds are spent only for the purposes intended in the budget and with due consideration to economy and efficiency is constrained (as in many other countries) by the weaknesses in the primary financial accountability institutions and systems. The public accounts of the nation (Financial Statements of the Russian Federation), for instance, are reported to be significantly incomplete and unreliable. The effectiveness of the public audit and legislative scrutiny functions is not sufficiently transparent, the nature and extent of follow-up on audit recommendations by the Duma is unclear. Internationally accepted accounting and auditing standards are not widely practiced even in the

banking sector. At issue is the ability of the Bank and the borrower to meet their respective fiduciary obligations.

- (v) **At the “project” level, the Bank has made significant and commendable efforts in recent years to strengthen and improve the audit of Bank-financed projects.** Some good work has been done in this area. Auditing Bank-financed projects for “eligibility of expenditure,” however, is only one element of the equation. This mechanism alone cannot guarantee audit assurance that money was spent economically and efficiently, and only for the intended purposes. These audits are not performance-based and do not examine issues of economy, efficiency, or effectiveness. This mechanism needs to be considered along with the Bank’s up-front arrangements to monitor risk at earlier points in the project cycle, namely appraisal and supervision. As mentioned previously, in order to avoid duplication of efforts with the IAD work already underway, OED did not review the attention paid in Moscow to financial management issues during project appraisal and supervision. A full assessment of the Bank’s internal control system in this regard is pending at this time.

6.2 The opportunities for building institutions of *public* financial accountability and transparency in Russia have been and are considerable. The Bank has been building knowledge of the many gaps in capacity for sound PFA in Russia. What has been missing is a systematic assessment of the risks involved, a clear statement of priorities, and a plan to improve the Bank’s dialogue with GOR on ways to strengthen its primary institutions of *public* sector financial *accountability*. The CFAA underway in fiscal 2001 is intended to assist the Bank in addressing this issue.

6.3 A clear lesson learned from the Bank’s experience is that the strategy of supporting the transition to a market economy based solely on *private* sector initiatives, such as promoting international accounting and auditing standards, has proved to be less than fully effective. The failure of reforms to accounting and auditing processes in the banking sector is a case in point. The Bank did not sufficiently emphasize the need for *public* sector initiatives aimed at areas such as: the accountability of the executive arm of government for a sound regulatory environment; effective utilization of public resources; strengthening the judiciary for effective enforcement of the law; and/or the Duma’s financial oversight function. The weak regulatory environment in Russia calls for further attention to institutions that provide oversight by the *public* (including civil society) and the legislature over a broad range of economic and social activities that goes beyond strictly private sector development.

6.4 The actions required and taken by the Bank to support the strengthening of capacity for PFA have so far been modest. They were aimed primarily at the “project component level” and, further, mostly at the banking sector in the context of private sector development and corporate governance. Strengthening corporate governance is, of course, very important, but it is likely to be insufficient without a strong regulatory environment and institutions of public sector governance.

6.5 Efforts since fiscal 1998 to improve and strengthen the audit of Bank-financed projects are commendable. However, this mechanism alone cannot provide sufficient knowledge on

whether the Bank has reasonable assurance that Bank funds are used with due regard for economy and efficiency and exclusively for the intended purposes. In accordance with Bank policy, the scope of such project audits is limited to compliance with covenants in loan agreements. They are *not* performance audits. As may be true for many other borrowers, the Bank needs to do more work to be able to assess whether Russia has reasonable assurance that public funds are spent only for the purposes intended (i.e., approved by the legislature) with due consideration to economy and efficiency. Both (a) the sizable amount of extra-budgetary funds and hidden subsidies and (b) incomplete accounting policies and practices in Russia at various levels of government complicate this issue. A broader approach to ex-post audit would be one of several possible options worth considering in due course for enhancing the level of audit assurance.

6.6 OED is unable to comment at this time on the effectiveness of the Bank's attention to project-level financial management during appraisal and supervision. The audit work recently proposed by IAD in this area is welcome.

7. Lessons

7.1 The Bank-wide efforts in strengthening PFA institutions point to two important lessons:

- Building institutional capacity in transition economies for *public* sector accountability systems is a long-term initiative that calls for substantial commitment from the leaderships, investment, and time.
- Substantive *commitment* on the part of country authorities is a prerequisite for effective programs in the areas of governance and accountability. Without borrower ownership, the *development risk* is heightened. Expecting quick implementation of reforms in the banking sector is a case in point. The pace of reform should be realistic and should take cognizance of local cultural, social, economic, and governance considerations. The pace and manner of progress cannot be dictated by donors—only broad-based ownership and consultation with all relevant stakeholders, including civil society and legislators, can dictate the success of reforms.

7.2 The Russia country team has acknowledged the relevance of promoting institutions of public financial accountability in the context of good governance. Given that Russia historically has no tradition of *public* financial accountability and transparency, and given the enormity and long-term nature of the cultural and social reforms needed, the Bank and the Russian Government may consider it desirable to begin modestly, with small well-defined steps.

7.3 The Bank faces higher-than-average risks in its operations in Russia. Any agenda for promoting good governance without adequate emphasis on public sector accountability and transparency would lack a key component. The strategy that is now proposed to be developed should keep in mind the distinction between the Bank's fiduciary responsibility to owners and the Bank's role in building capacity to enable the government to meet its fiduciary obligation to its citizens. The latter is even more important. The greatest opportunity for bringing about sustained improvements lies in strengthening regulatory institutions of financial reporting and oversight, including legislative control of the public purse. The Bank's efforts to improve public

financial accountability in Russia have not been commensurate with its sizable investments there. This imbalance will need to be addressed. The “ring fencing” approach, adopted in 1998 as a way to mitigate risk at the “project” level, may have been useful in the short run, but, in our view, may not prove to be fully sustainable without a more determined and significant effort at the national and sub-national levels.

7.4 The challenge for the country team lies in developing a strategy that (a) is grounded in local ownership, (b) is results-oriented, (c) encourages partnerships with local reformers, and (d) focuses on accountability institutions to promote better management of **all** public resources, not only those pertaining to Bank-financed projects.

8. Recommendations

8.1 **Broaden consultation on the need for reform to include key stakeholders, such as civil society and Russian legislators:** One of the important lessons learned in Russia is the need to broaden ownership of the proposed reforms. The draft OED audit report on SALs I and II highlight the fact that the Bank, especially with issues related to structural reform, has worked with a small group of interlocutors. Although some contact was made through the World Bank Institute (WBI) with the Duma and Russian academicians and economists, these key stakeholders have not been actively involved in the development or implementation of Bank strategy and/or operations in the area of governance. However, the reforms proposed by the Bank have required parliamentary support, as witnessed in the case of strengthening procurement laws. While the government has been able to commit to certain reforms, it has not been able to foster the broad consensus needed for implementation.

8.2 The 2001 CAS Progress Report indicates greater government willingness to address such issues, as well as improved attention by the Duma to governance issues. It may, therefore, be timely for the Bank to raise the bar from addressing project financial management and aspects of public sector management to broader aspects of public sector governance and financial accountability. The Bank would need to work with the government and citizens to ensure greater parliamentary support for reforms and may consequently need to design and implement effective outreach initiatives. In the process, the Bank would need to build partnerships with a range of stakeholders other than the executive government, such as the Chamber of Accounts in the Duma, Russian academicians and policy institutes, and civil society.

8.3 **Conduct a comprehensive CFAA in partnership with the Government of Russia (GOR)—determine the priority and entry points for possible capacity building activities (in areas of highest risk) for improved public sector financial accountability:** The Russian public sector (national and sub-national) is perhaps one of the most significant consumers of national resources. Knowledge of weaknesses in the institutional capacity to manage these resources is widespread. It is difficult to decide how to proceed in the weak control environment prevailing at all levels of government without a full assessment of risks and opportunities and a shared vision of PFA. Finding appropriate entry points that are likely to allow the Bank to succeed in helping Russia build institutions of accountability is the main challenge for the Bank today. We suggest that the key risks to PFA must be identified and fully analyzed in consultation with stakeholders in the public and private sectors.

8.4 The proposed CFAA could explore avenues and strategies to strengthen and foster demand for accountability and transparency with the same vigor as it identifies additional weaknesses and capacity gaps. The Bank could also use the on-going CFAA exercise to work with the government to establish benchmarks for specific areas identified for improvement and to subsequently measure progress based on reasonable but well-defined timeframes. Further improving the rights of citizen to access information on government decisions and decision-making processes would be another step in the right direction.

8.5 A risk-based Country Financial Accountability Assessment is required in order to: (1) reconfirm the comprehensiveness and *quality* of fiduciary analyses previously conducted by the Bank and other donors; (2) assess the *effectiveness* of steps that have been taken so far to fill capacity gaps that have been detected; (3) *prioritize* the steps required for further strengthening of those institutions that continue to pose risks to the effective use of public resources; and (4) highlight areas where the *risks* of mismanagement of public resources remains high *and* where the Bank has comparative advantage and could, therefore, propose specific additional lending and/or non-lending activities.

8.6 **Focus on strengthening the capacity of the principal institutions, such as internal control, the Chamber of Accounts and the related legislative oversight function of the Duma:** An important lesson of the Bank's recent experience is that high *fiduciary* risk in countries such as Indonesia, Pakistan and Russia impacts on the reputation of the both the Bank *and* the government. One way to mitigate the risks involved may be to proactively pursue opportunities to assist Russia to strengthen primary institutions of public financial accountability that can provide ongoing performance-oriented information to the public. These include (a) legislative scrutiny, monitoring, and control and (b) evaluation systems that involve public participation and third-party verification procedures, such as those that could be provided by the supreme audit institution of Russia.

8.7 In the first instance, the Bank should build on its knowledge of the workings and *effectiveness* of such mechanisms as the Chamber of Accounts and oversight commissions in the Duma. The Bank should explore the possibility of enhancing the capacity of such institutions, particularly the Chamber of Accounts. In due course, it may also wish to explore the feasibility of the Chamber taking responsibility for periodic, more comprehensive audits of Bank-financed projects managed by Ministries and public sector organizations operating as PIUs under government supervision.

8.8 **Work with other interested donors, such as the EU and USAID, to build consensus and/or a common strategy for promoting *demand* for financial accountability and for building borrower capacity:** The Bank should work with other multilateral and bilateral donors to develop a common understanding of issues and capacity gaps in PFA. The Bank may also wish to use the CFAA exercise to build its own knowledge base of various donor activities in PFA. It could also then explore the feasibility of forming a coalition of donor agencies to develop a common strategy or long-term approach to promote the cause of PFA and to build borrower capacity.

8.9 Strengthen internal capacity—provide adequate resources on a sustained basis for strengthening public sector governance: Given that the risk associated with adjustment lending is widely perceived to be high because of the weak control environment as witnessed in the 1990s, and that Russia is a large and significant client, it would be timely for the country team to review its resource base and priorities to ensure that it has adequate internal capacity to deal with complex PFA issues both at the country and the project level.²⁴ Future lending should be linked to measurable progress in a realistic time frame established in consultation with the Government of Russia and the Chamber of Accounts.

²⁴ It is noted that the U.S. General Accounting Office (GAO) recently examined the Bank's overall internal control system for investment lending in fiscal 2000. A conclusion of this examination was that the Bank's internal oversight activities, among others, need further strengthening. The GAO also suggested that future progress in such areas should be periodically measured and reported on publicly. In this regard, the increased attention by IAD to examinations based on an analysis of risk is noteworthy.

Background on Public Financial Accountability in the World Bank

1. Public Financial Accountability (PFA) is about effective management and use of all public resources. Sound PFA requires the institutions and practices that provide for:
 - A transparent and clear set of rules for the conduct of financial transactions approved by the *Legislature*,
 - Sound management and oversight over the use of all public resources by the *Executive*,
 - Timely public accounting and auditing of government financial and operating performance,
 - Public access to information on government performance and appropriate stakeholder participation in the State's decision-making processes.

2. Increased adjustment lending in the 1990s has highlighted that issues of *good* governance go beyond traditional concerns for budget formulation and allocative efficiency. Better management of *all* public resources calls for an equally strong emphasis on budget execution, evaluation, and independent scrutiny of the financial and operational *performance* of the executive arm of government. The participation of stakeholders other than government—civil society, legislators and citizens—is crucial for public accountability to function effectively in a democratic society. It is now widely recognized that weaknesses in *significant* aspects of *public* financial accountability and management of resources adversely impact development effectiveness. They also limit the benefits of investment in anti-corruption activities.

3. PFA is now well established as one of the important contributors to good governance—in both public and private sectors of the economy. The President agreed to strengthen the Bank's capacity to address financial management and accountability issues in the Strategic Compact in 1996. The 1997 anti-corruption agenda gave recognition to the need for better financial control and fiduciary obligations. The first pillar of the Comprehensive Development Framework (CDF) calls for good and clean government.²⁵

4. Since 1998, the Bank has pro-actively encouraged Regions and networks (particularly Operational Core Services (OCS) and Poverty Reduction and Economic Management (PREM)) to focus on strengthening institutions and practices that promote PFA.²⁶ These include encouraging open budget processes, timely and comprehensive submission and public audit of a State's financial accounts, sound government management and internal control systems (including M&E) for budget execution, a timely and effective external auditing function, effective legislative scrutiny, and effective public rights to information laws and practices. These institutions are considered to be highly relevant to the management of the fiduciary risks associated with public money, including Bank-provided funds.

5. Since fiscal 1998, the Bank has developed (and/or revamped) a variety of instruments to build knowledge of systems of financial accountability both at the "country" and at the "project" levels. The objective of such knowledge-building is to help identify capacity gaps, if any, and to work with the borrower towards strengthening capacity wherever appropriate. Such knowledge is expected to feed into the Country Assistance Strategy (CAS).

6. Instruments that help build knowledge of the control and operating environment at the "country" level include the Public Expenditure Reviews (PER), the Country Profile of Financial Accountability

²⁵ Sahgal and Chakrapani, OED Working Paper Series # 17, Summer 2000.

²⁶ The OCS and PREM networks were expected to induce a more holistic and results-oriented approach to governance programs and activities. These networks have increasingly recognized the roles and responsibilities of governance institutions such as the legislature, external audit institutions, systems of internal control, and the participation of civil society.

(CPFA), the Country Financial Accountability Assessment (CFAA), the Country Procurement Assessment Report (CPAR) and the Institutional and Governance Review (IGR). The 1996 Loan Administration Change Initiative (LACI) aimed to address “project-level” financial management issues. Financial management assessments (FMA) that assessed the accounting, control and auditing system at the project-implementing agency for monitoring the use of project resources and recording lessons learned were required before approval of investment operations. These various knowledge-building instruments taken together allow the Bank to more fully understand the political economy, the formal and informal institutions, the influence of local cultural, and the systems and processes that operate in the country and project control environment.

7. In fiscal 2000, the Bank decided to make the CFAA a part of its country-level fiduciary Economic and Sector Work (ESW). The CFAA and FMAs (at the project level) thus aim to provide valuable information on fiduciary risks involved in the management of public resources. They constitute key elements of the Bank's due diligence associated with its lending operations.

Evaluation Methodology

Purpose

1. This paper will serve as a background note to inform OED's upcoming Country Assistance Evaluation (CAE) on Russia. It will provide a preliminary assessment on the nature and extent of Bank efforts to: (a) build knowledge of PFA institutions; (b) assist Russia to build adequate capacity for PFA in the public sector; and (c) minimize risks of waste and misappropriation of public resources, including those provided in its own lending portfolio. OED's focus is on assessing and improving upon the existing country assistance strategy for enhancing the Bank's contribution in PFA; it does not aim to develop an improvement plan for PFA in Russia.

2. *The CAE Task Manager, OEDCR, is the immediate client of this background work.* The final audience will be the Country Director and country team, as well as the financial management staff working on Russia.

Scope and Criteria

3. The scope (as expressed in the terms of reference) and the criteria for evaluating Bank performance were developed and presented to the CAE Task Manger *and* to the Country Director and the country team at the early stages of the evaluation.²⁷ The objective was to ensure that the proposed criteria are considered to be fair and reasonable, as well as framed in the appropriate context, **before** they are applied. Accordingly, the criteria agreed upon are as follows:

1. The actions required/taken by the Bank to support strengthening capacity for PFA should be prioritized within the overall Country Assistance Strategy. They should be targeted to areas of highest concern, keeping in mind the potential for "making a difference," and bearing in mind the distinction between the Bank's fiduciary responsibility and the Bank's role in supporting the development of the country's fiduciary capacity.
2. The Bank's efforts for capacity-building with clients should be aimed at the principal institutions of *public* financial accountability at both project and country levels.
3. The Bank should be supporting the development of institutions and systems that, over time, will strengthen independent and reasonable assurance that all public funds (including Bank-provided funds) are spent for the purposes intended in the budget, with due consideration for economy and efficiency.

²⁷ The evaluation criteria were consistent with OED's previous efforts to evaluate Bank performance in PFA for the forthcoming IDA review and for the CAEs for India and Kazakhstan.

Approach

4. At the country level, the paper aims to address questions 1 and 2 of the scope on the level of knowledge in the Bank on PFA issues, the Bank's response to its own diagnosis, and its confidence regarding controls and accounting for Russia's public expenditures.

5. The desk review of documents aimed to determine the level of the Bank's knowledge as captured in key documents such as the PER, CPFA, CPAR, CFAA etc. Further, the relevant financial management staff members were also interviewed to determine other informal sources or processes that may have used to build up Bank knowledge. The work done by other donors was reviewed to the extent made available to OED by the country team for consideration. The information obtained was analyzed in terms of the identified capacity gaps, constraints if any, and the Bank's approach to dealing with countrywide deficiencies in public financial accountability systems.

6. The paper evaluates the Bank's lending and non-lending programs in terms of its application of relevant knowledge (gathered through the various ESW) to build capacity for PFA and to minimize the risk of misallocation of Bank funds. Components of projects, technical assistance, World Bank Institute activities and policy dialogue relevant for building capacity for PFA were reviewed to the extent made available. (Not all documents that OED requested were provided by the Region; for example, the "Raghavan Report," prepared for the Loans Department, remains under request). The paper explores the rationale, the levels (country and project) at which significant efforts in PFA have been made, success or progress to date as recorded in Bank documents, and the impact and significance (if any) of the Bank's interventions.

7. In addition, in order to address question 3 of the scope, the paper aimed to review the process by which the Bank monitors financial management of its projects and obtains assurance on the use of project funds. The aim was to determine whether the Bank has adequately met the requirements of Article (III) of Association. OED was informed (mid-way during the review) that IAD is in the process of reviewing the adequacy of the Bank's financial management and control procedures applied at the time of project appraisal and supervision. Thus, OED, in consultation with the Regional Financial Management Advisor (RFMA) for ECA, has decided to narrow the scope of this element designed to address the adequacy of the procedures and arrangements for audit of Bank-financed projects. OED nevertheless reviewed sample audit reports issued by private sector external auditors on Bank-funded projects and the follow-up actions taken by the Bank on concerns expressed by the auditors. It also considered the impact of the same on disbursements and the lending program more generally.

8. The relevance and efficacy of the "real-time" tracking system for adjustment loans and any other country-specific internal controls, such as the operations of the Chamber of Accounts, were also reviewed, to the extent information was available at Washington. An integral part of this paper was to determine the quality and adequacy of the functioning and reporting requirements of the Chamber of Accounts, the supreme audit institution of Russia.

List of Documents Reviewed

Country Level²⁸

1. Fiscal Management in the Russian Federation (November 29, 1995).
2. Russian Federation: Draft Country Procurement Assessment Report. (Draft, fiscal 2001)
3. Russian Federation: Report on Observance of Standards and Codes.
4. Sixth Country Portfolio Performance Review (February 2000).
5. Benchmarking Public Expenditure Analysis in the Russian Federation: Mystery, Mis-Measurement and Mismanagement (Draft 2001).
6. Foreign Assistance to Russia (GAO 2000).
7. Corruption and the Law in Russia.
8. Country Assistance Strategies—1992, 1993, 1995, 1997, and 1999.
9. The CAS Progress Report—1994, 1996, 1998, 2000, and 2001.

Project Level:

Control over Adjustment Loan Disbursements (Memo of December 2, 1999 from Chiekh Ibrahim Fall to Executive Directors and Alternates).

²⁸ Annual Reports of the external audit institution and the Chamber of Accounts of Russia were **not** made available to OED.

Main Messages from Relevant Bank ESW

Fiscal Management in the Russian Federation (November 1995)

1. Serious work on documenting knowledge of public expenditure systems and accountability issues across the Russian Federation commenced in fiscal 1996. The main concern of the report is that the Russian institutional framework for budget implementation did not meet the requirements of a decentralized market-based economy.

2. The need to strengthen the range of *public* financial accountability systems that would cover budget execution, accounting, audit and legislative oversight functions was recognized in the Bank's analyses of public expenditure. The risks associated with expenditure management systems, accounting, expenditure control and revenue collection procedures, and auditing systems were also acknowledged.

3. The paper highlighted that, while much was accomplished towards financial stability, efficient fiscal management was still an issue. The government's capacity to adjust budget management practices was considered wanting. It noted, for instance, the confusion regarding the boundary between the public and private sectors. This report also analyzed the deficiencies of the budget system and recommended ways to improve fiscal management. Areas covered included:

- Intergovernmental fiscal relations: Lack of clarity in expenditure assignments among various levels of government was identified as a serious constraint on financial accountability and transparency;
- The structural, technical, and institutional aspects of the budget system: The need to improve the microeconomic efficiency of government spending and streamlining the budget adoption procedures at the parliamentary stage was acknowledged.

4. Most importantly, this ESW brought to the attention of the Bank the fact that "the quality of new budgeting techniques at the budget preparation stage depends on the quality of budget audits and evaluations, which depend on the quality of the data generated by the *accounting* system." The report warned that lack of control and auditing also reduces fiscal discipline and prevents the realization of potentially enormous financial savings from cash and debt management.

5. Furthermore, the report emphasized that the impact of weak budget management "is particularly damaging for investment projects, which suffer costly delays . . . In the end everybody loses: Parliament loses real budgetary oversight because actual spending allocations diverge widely from voted appropriations and the administration loses credibility and efficiency."

6. Thus, issues of public financial accountability covered included controls over a wide range of activities: cash management, debt management, procurement, financial reporting, and auditing and evaluation practices. The internal auditing practices of the MOF were questioned. The need for improving the system of external audit was raised forcefully, including the need to address issues of potential conflict of interest, such as the role of the Chamber of Accounts in the budget formulation process and its authority, in certain circumstances, to issue executive orders.

Benchmarking Public Expenditure Analysis in the Russian Federation: Mystery, Mis-Measurement and Mismanagement (1998)

7. A 1998 report on Benchmarking Public Expenditure examines the size of government, expenditure allocation, and structural features of the evolving fiscal structure that impact on expenditure outcomes in Russia over the period 1992-98. It examines public expenditure from a variety of perspectives in light of international experience, with appropriate comparisons. Topics covered include: civil service reform, defense expenditures, reforms in intergovernmental transfers, and contingent liabilities.
8. The Report makes significant observations. It suggests that comprehensive measurement of public expenditure is not possible, due to data deficiencies and large areas of missing coverage. The paper estimates off-budget federal expenditures to range between 1 percent and 10 percent of GDP at the federal level. The situation is expected to be worse at the sub-national levels. The government is reported to lack a clear strategy for restructuring public finances.
9. The report also suggests that the effectiveness of public expenditure is being severely undermined by non-cash transactions and the growth of arrears (the non-payments problem). The report alleges that most of the inefficiency left in government is found at the sub-national level, while, at the federal level, defense appears to be the only major remaining “black hole.”
10. The paper observes that deficiencies in budget planning and execution have led to wide deviations in outcomes, and that they undermine and threaten capacity to implement public policy. There is concern that the growing levels of contingent liabilities facing all levels of government present a serious risk. Reforms in tax administration and customs procedures have been acknowledged.

Country Procurement Assessment Review – Volume I (Draft October 2000)

11. A new CPAR was conducted in fiscal 1999, and an early draft was made available to OED for this review.²⁹
12. The Bank has developed considerable knowledge of federal procurement legislation and practices and has complemented this with analyses of legislation and practices in a number of regions and municipalities. The practice of competitive public procurement has begun to spread throughout much of Russia, and many laws have been enacted at all levels of government. Most government purchasing is now regulated in some way. The CPAR reports that there are two major laws, a presidential decree, and a proliferation of regulatory instruments at various levels of administration. It is estimated that open tendering, the most competitive procurement method available under the legislation, accounted for 53 percent of public expenditures on goods, works and services.
13. The report expresses concern that institutional capacity for public procurement in Russia remains weak. While much has been accomplished by way of training in procurement, many aspects of the legislation require further development, and there is a pressing need to develop the institutional and human resources to conduct public procurement.
14. The report also suggests that the overall approach to legislative reforms has been piecemeal. It reports, “Confusion is caused by serious gaps and conflicting provisions present in the legislation and by

²⁹ The CPAR assesses the procurement environment in both public and private sectors and provides useful feedback to the borrower on the strengths and weaknesses of the public procurement systems. This should enable member countries to develop an action plan to enhance transparency and capacity to conduct public procurement efficiently. A further important objective is to determine the compatibility of national procurement practices with the principles of economy and efficiency and with international procurement law and best practice.

a pervading lack of clarity about the application of the many instruments to the different levels of administration.” The Bank believes that this leaves the door open to corruption.

15. Recommendations to improve the system include: a clearer and more sustainable legal framework; consolidation into a single federal law, complemented by a reduced number of implementing regulations; harmonization between jurisdictions; standard procurement documents; and clearly defined legislation to facilitate implementation of externally funded projects. Finally, the CPAR reports that clear and effective enforcement mechanisms will be required, such as more effective monitoring and oversight functions, strict control procedures, and close scrutiny of waivers.

16. The CPAR also examines the strengths and weaknesses of procurement management under Bank-financed projects.³⁰ It notes that, even today, public procurement remains characterized by a high level of protection against foreign bidders and widespread discriminatory provisions against bidders from outside the purchaser’s own region. These restrictive measures, together with excessive use of non-competitive procurement methods and widespread corruption, reduce the efficiency of public funds.

17. Based on experience in other countries, Bank staff associated with the Russia program believes that increasing competition can yield cost savings of 20 percent or more, and that corruption has been shown to increase project costs by 25–50%. If these estimates are right, strengthening financial controls in the area of procurement alone could save Russia billions of rubles.

18. The development of sustainable and effective organizational models to implement Bank-financed projects, including procurement, effectively continues to be a subject of dialogue between the Bank and the government. While documentation in evidence of this dialogue was not provided, OED was informed that the authorities were very pleased with the recommendations made by the CPAR in this regard. Thus, the control environment for sound procurement is a matter of concern to both Russia and the Bank.

19. The Bank is currently awaiting a response from the government to the various recommendations for improving performance and related capacity-building. As of September 2000, an agreed strategy to strengthen institutional capacity for internal control arrangements for public procurement has not been developed. Specific steps to strengthen institutional capacity are expected to be formulated in fiscal 2000-01.

The IMF Report on Observance of Standards and Codes (ROSC)

20. The Bank’s knowledge of public financial accountability systems has been enhanced by the work of the IMF in fiscal 2000. The Fund’s fiduciary ESW, called *Report on Observance of Standards and Codes (ROSC)*, suggests that weaknesses in public financial accountability systems run across levels of government, and that the reliability of financial information provided by the government is considerably below par.

21. The report highlights major concerns with the quality of data, methodology for compilation, and dissemination practices, as well as the need to harmonize data standards at all levels of government. For example, the report observes that the absence of international accounting standards precludes proper analysis of the financial condition of the banking sector, a major handicap in the process of bank restructuring.

22. Commercial banks do not produce accounts on a fully consolidated basis, and, given the complex pattern of holdings and cross-holdings between enterprises and banks within financial-industrial groups in Russia, accurate assessments of banking system vulnerabilities cannot be made on the basis of data

³⁰ These are listed in the attachment (Paragraphs 6.4.1 and 6.4.2).

routinely available to the authorities. Bolstering the authorities' ability to address such problems is identified as an important area for capacity-building.

23. The report also points out that there are, at present, many gaps in fiscal coverage (notably, the Ministries of Defense and Interior) and a number of fiscal activities that are carried out by agencies outside government (for instance, by energy monopolies). Relationships between central and regional governments are yet to be fully defined. There is need to focus fiscal policy on agreed targets and to improve transparency at all levels of government.

24. The report also fully recognizes the need to modernize the treasury system and to report on all public financial transactions through the treasury. The public accounting process is incomplete in that many budget organizations substantially supplement their budget resources through commercial or quasi-commercial practices—some of which amount to informal public sector activity (for instance, renting real estate to the private sector, sometimes in exchange for equity).

25. The treasury, both at the federal and regional levels, has reportedly no means of independently monitoring the flow of off-budget revenues on "own resource accounts." A range of other issues of accountability and transparency has also been raised. These include: unrealistic budgeting and an inadequate accountability framework for enterprises; lack of transparency in the activities of the subsidiaries of the Central Bank of Russia, with quasi-fiscal implications; non-funded federal mandates that reduce the accountability and realism of regional budgets; weaknesses in the budget code that provides little emphasis on performance and the results of budget spending; the administrative capacity of the tax department; and so on.

26. The Fund recommends continued efforts to provide comprehensive coverage of the treasury system, continuing efforts to eliminate arrears and offsets (non-payments) and publication of information on contingent liabilities and tax expenditures.

27. Last, but not least, financial control is reportedly weak. There are unclear or incomplete internal control measures in a number of crucial areas. Given poor costing and recordkeeping systems, there are several weaknesses in the reliability and analytical quality of budget data that make assigning responsibility for public expenditure performance difficult. Reconciliation of accounts with budget appropriations and with bank accounts is ineffective and not timely. There is no statement of accounting policies attached to the government budget or final account presentation. Internal audit is narrowly focused on regulatory compliance. There is insufficient capacity to give assurance of effective compliance.

28. Another major concern is public availability of information. The budget code gives a strong basis for comprehensive provision of information to the public, but it is not yet fully implemented. Lags in reporting make it very difficult to provide accurate data on past years' spending in the budget presentation

29. Thus, the report presents an excellent analysis of accountability and transparency issues. The Bank would benefit from working closely with the IMF in this area

Evolution of PFA Considerations in the Bank's Country Assistance Strategy:

Year Document	CAS Objectives	PFA Objectives in CAS	Interventions to support PFA Objectives
1992 CAS	<ul style="list-style-type: none"> • Assist structural transformation based on private sector development; • Sector specific reforms to build productive capacity (energy and agriculture); • Strengthen social safety net; • Deepen human resource skills and institutional capacity 	<ul style="list-style-type: none"> • Support the Central Bank of Russia to develop sound commercial banking • Explore training needs for accounting on internationally based systems. 	<ul style="list-style-type: none"> • Additional technical assistance may be desirable to “establish appropriate accounting and procurement practices.”
1993 CAS	<ul style="list-style-type: none"> • Support macroeconomic stabilization; • Strengthen market-oriented institutions, including private sector; • Strengthen social safety net; • Achieve quick supply response in key sectors; • Improve donor coordination. 		<ul style="list-style-type: none"> • Enterprise Reform Project: Improvements in the system of corporate governance for enterprises remaining in the public sector. • Working on Management and Financial Training Project.
1994 CAS	<ul style="list-style-type: none"> • Support development of market-oriented economy based on private sector initiatives; • Encourage re-direction of public sector involvement in economy; • Establish the Bank as a trusted and reliable partner. 	<ul style="list-style-type: none"> • Develop commercial banking regulation and supervision; • Advise to strengthen the corporate governance structures in privatized and state-owned enterprises 	<ul style="list-style-type: none"> • Financial Institutions Development Project (FIDP) to develop a computerized payment and settlement system. • Explore involvement in TA where Bank has a comparative advantage, such as inter-governmental fiscal relations and public expenditure and revenue management. • Preparation of a Country Procurement Strategy Note
1995 CAS	<ul style="list-style-type: none"> • Support development of market-oriented economy based on private sector initiatives; • Develop public sector institutions and procedures to support market orientation; • Moderate the impact of transition on socially vulnerable groups; • Establish the Bank as a trusted and reliable partner. 	<ul style="list-style-type: none"> • Institutional development in areas where Bank has a comparative advantage. 	<ul style="list-style-type: none"> • Tax Modernization Project. • Management and Financial Training Project (MFTP). • CEM to focus on structural issues, such as inter-budgetary financial relations and tax reform
1996 CAS Progress Report		<ul style="list-style-type: none"> • Fundamental problems in banking sector. Urgent need to improve banking regulation, supervision, and oversight. • Lack of transparency in second stage privatization. 	<ul style="list-style-type: none"> • Bank to accelerate the development of a Capital Markets Reform Project.

(Cont.): Evolution of PFA Considerations in the Bank's Country Assistance Strategy

Year	CAS/Progress Report Objectives	PFA Objectives in CAS	Interventions to support PFA Objectives
1997 CAS	<ul style="list-style-type: none"> Support enabling environment for private sector development; Strengthen fiscal and economic management; Strengthen social services and the social safety net; Support sector reforms: agriculture and rural development, energy, infrastructure, environment. 	<ul style="list-style-type: none"> Establish regulatory and legal structures for an open and competitive economy. Upgrade Bank regulation and approve effective legislation for bank bankruptcy and liquidation. Strengthen capital markets. Improve budgeting process and rationalize public expenditures. Expand competition in public procurement. 	<ul style="list-style-type: none"> Policy dialogue via SALs. Banking Reform ESW FIDP Capital Markets Development Project Ongoing policy dialogue and support in procurement through IDF grant.
1998 CAS Progress Report		<ul style="list-style-type: none"> Given serious concerns about the transparency and efficiency in the use of public resources, efforts to strengthen public resource management likely to be a key area of Bank focus in future. Aims to continue dialogue with Government and Central Bank which are yet to commit to bank restructuring strategy proposed by Bank/IMF. 	<ul style="list-style-type: none"> Bank to conduct diagnostic survey analysis to document workings of the practices, policies and systems for public funds management. Bank was asked for assistance with a treasury management system. Restructured FIDP expected to finance advice and assistance.
1999 CAS	<ul style="list-style-type: none"> Emphasize public sector institutional reform; Reduce corruption; Support Social protection and services; Support private and financial sector development; Promote equitable access to basic health and education; Focus on sector-specific reform, including the environment and natural resources. 	<ul style="list-style-type: none"> Emphasize public sector financial management and administration In order to combat corruption, develop institutions, systems and processes that build checks and balances against corruption. 	<ul style="list-style-type: none"> Tax Administration II. Sub-National Fiscal TA Treasury Development. Anti-Corruption diagnostic. Diagnostic on budget process. WBI courses in taxation, budget processes and inter-governmental finance and a WBI workshop on fiscal decentralization. CPAR.
2000 CAS Progress Report		<ul style="list-style-type: none"> While GOR has made some anti-corruption efforts, lack of dialogue with the Bank is a concern. Corruption diagnostic not done. Government reforms in taxation, customs and sub-national fiscal management is fully consistent with on-going Bank projects.. Slow progress on banking reform.³¹ 	<ul style="list-style-type: none"> Initiating policy dialogue through CPAR and CFAA.

³¹ Bank concerns include excessive reliance on connected and overly concentrated lending, fragile deposit base, and lack of transparency due to outdated accounting standards and weak management and internal controls.

(Cont.): Evolution of PFA Considerations in the Bank's Country Assistance Strategy

Year	CAS/Progress Report Objectives	PFA Objectives in CAS	Interventions to support PFA Objectives
2001 CAS Progress Report		<ul style="list-style-type: none"> • Anti-Corruption and public sector governance now important areas of focus by Duma. • Government reform program addresses many PFA issues, but implementation is slow. • Bank has some concerns about the government's reform strategy for banking and about international accounting standards.³² 	<ul style="list-style-type: none"> • Anti-Corruption diagnostic delayed, but now underway with improved government participation. • CFAA underway. • CPAR completed and draft report awaiting comments from the government.

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³² The Bank is concerned that, although the government proposes introducing International Accounting Standards (IAS), it is not clear whether IAS will be introduced as an additional option to the Russian accounting standards or whether they will become the local standards. On banking, the concern is that, while the program mentions increasing competition, it is silent about the role of the increasingly dominant state-controlled banks. The government also favors the introduction of deposit insurance, which, without significant improvements in supervision and accounting, could create additional budget risks.