Why Governance Matters in the Allocation and Management of Public Revenue and Expenditure

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Introduction

IN RECENT YEARS there has been growing attention directed to the role of government. As a consequence, governance in general and corruption in particular have been much discussed because of the way they affect, and are affected by, the role of the government.

Dictionaries generally define governance as government. Thus, good governance is good government. In recent writing, governance has been taking a more substantive but still not precisely defined meaning.

Good governance is an essential part of a framework for economic and financial management that includes: macroeconomic stability; commitment to social and economic equity; and the promotion of efficient institutions through structural reforms such as trade liberalization, domestic deregulation.

Poor governance may result from factors such as incompetence, ignorance, lack of efficient institutions, and the pursuit of economically inefficient ideologies or misguided economic models.

However, it is often linked to corruption and rent seeking. It should be understood that corruption is not identical with poor governance. Poor governance extends well beyond corruption. However, poor governance often leads to corruption and corruption becomes an important element of poor governance.

I will focus on governance and corruption issues especially vis-a-vis public revenue and public expenditure.

Before dealing more fully with the topic, I would like to show two simple relationships in Figures 1 and 2. Figure 1 shows that corruption falls with economic development and Figure 2 indicates that growth and corruption are negatively correlated.

Taxation and Poor Governance

Taxes based on clearly written laws and not requiring frequent contacts between taxpayers and tax administrators are much less likely to lead to acts of corruption by tax administrators. However, when the following situation arise, corruption is likely to be a major problem in tax and customs administration (see Tanzi, 1998):
Figure 1. Corruption and Development
The laws have many exemptions and special treatments;

The laws are difficult to understand and are subject to different interpretations so that taxpayers need assistance in complying with them;

The determination of tax liabilities and the payment of taxes require frequent contacts between taxpayers and tax administrators;

The wages of the tax administrators are low;

Acts of corruption on the part of the tax administrators are ignored, not easily discovered, or, when discovered not penalized or penalized only mildly;

The administrative procedures (e.g. the criteria for the selection of tax payers for audits) lack transparency and are not closely monitored within the tax or customs administration;

Tax administrators have discretion over important decisions, such as those related to the provision of tax incentives, determination of tax liabilities, selection of audits, litigations, and so on; and

More broadly, the controls exercised by the state (the Principal) on the agents charged with carrying out its functions are weak.

In case of political corruption, those who represent the state (president, prime minister, ministers) or their close relatives may use the tax and customs administrations to pursue rent seeking and corrupt practices. In some cases, they can write the laws in ways that allows them to take advantage of them.

In some countries, at one time, corruption became so endemic in the tax administration (e.g. Peru and Uganda) that the government decided to close down the existing administration to replace them by new and more independent ones. In several countries, customs administrations have been very corrupt. In some countries this has led to the jailing of the director of customs and in several cases it has resulted in the replacement of the domestic customs organizations with the services of foreign companies engaged in pre-shipment inspections.

Reports from several countries indicate that the number of applicants for poorly paid jobs in administering taxes or customs duties has been unusually large, pointing to the possibility that applicants know that these jobs will create opportunities for extra incomes.

Public Spending and Poor Governance

Corruption can affect public expenditure in different ways. Discussion on the categories of expenditure most affected by corruption follows.
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Investment projects have lent themselves to frequent acts of high-level corruption or rent seeking. Because of the discretion that some high-level public officials have over decisions regarding public investment projects, this type of public spending can become much distorted, both in size and in composition, by corruption and rent seeking. Public projects have, at times, been carried out specifically to provide opportunities to some individuals or political groups to get “commissions” from those who are chosen to execute the projects or to benefit particular areas or individuals. This has reduced the efficiency of such expenditure and has resulted in projects that would not have been justified on objective criteria of investment selection such as cost-benefit analysis.

Procurement spending, i.e. the purchase of goods and services on the part of the government, is another area often affected by corruption or poor governance. To reduce corruption possibilities, some countries have developed complex and costly procedures that may have reduced corruption at the cost of sharply increasing the prices at which some goods are purchased.

Extrabudgetary accounts for given types of expenditures or revenue are common in many countries. Some of them are set up for legitimate purposes (pension funds, road funds, etc.). Others may be set up to reduce the political and administrative controls that are likely to accompany spending that goes through the budget. In some countries, the money received from foreign aid or from the sale of natural resources such as oil and other minerals is channeled toward special accounts that tend to be less transparent and less controlled than the money channeled through the budget. Some of this money may go into illegitimate uses or pockets.

Ghost workers, dead pensioners. Poor expenditure controls often allow some individuals to collect payments made to ghost workers or to dead pensioners.

In all these areas, lack of transparency and of effective institutional controls are the main factors leading to corruption or to poor governance more generally.

Provisions of goods and services at below-market prices. In most countries, the government engages in the provision of goods, services, and resources at below-market prices—for example, foreign exchange, credit, electricity, water, public housing, some commodities, access to educational and health facilities, access to public land, and so on. Even access to some forms of pensions, such as those for disability, fall into this category because the individuals who get them may not be genuinely disabled or have paid less in contributions to the pension funds over time than the pension they will get once their disability status is approved. In some countries, disability pensions and even general pensions have been a fertile ground for abuses and corruption. In others, some individuals benefited enormously when they were able to get access to large amounts of credit or foreign exchange at below-market prices.

At times, because of limited supply and large demand, rationing or queueing becomes unavoidable. Excess demand is created and decisions have to be made to apportion the
limited supply. These decisions are often made by public employees. Those who want these goods (the users) are often willing to pay bribes to get access (or a higher access) to what the government is providing. It is thus not surprising that in all the areas mentioned above, cases of corruption have been reported. Often poor institutions limit the possibility that abuses will be controlled.

Other Discretionary Decisions

Besides the areas mentioned above, in many countries, public officials may find themselves in positions where they have discretion over important decisions; in these situations, corruption, including high-level or political corruption or rent seeking, can play a major role. The most important of these discretionary decisions are as follows:

- Provisions of tax incentives against income taxes, value-added taxes, and foreign trade taxes, which may be worth millions of dollars in terms of the present value of reduced future liabilities to those who benefit from them;

- Decisions as to the particular use of private land (zoning laws) that determine whether a piece of land can be used only for agriculture, and thus have low market value, or for high-rise buildings, and thus be very expensive;

- Decisions as to the use of government-owned land, for example, for logging purposes, which may also be worth a lot to the recipients. Major cases of corruption related to permissions to cut trees from publicly owned forests, or to exploit public lands for their mineral wealth, have been reported in several countries;

- Decisions that authorize major foreign investments, often undertaken in connection with domestic interests, which often provide the privileged investors with a monopoly of power or access to some valuable natural resources;

- Decisions related to the sale of public sector assets, including the right to extract natural resources;

- Decisions on the privatization of state-owned enterprises and on the conditions attached to that process, such as the degree of regulation of the industry; and

- Decisions providing monopoly power to particular export, import, or domestic activities. “Crony capitalism” has often been linked to these decisions.

Decisions such as those described above are often worth a lot to individuals or enterprises. It is natural that attempts will be made by some of them to get favorable decisions, in some cases by paying bribes and in other cases by simply exploiting close personal relations with
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public officials. The bribes may be paid to public officials whose salaries may be very low and whose “temptation price” may be far less than the value of the potential benefit to the bribers from a favorable decision.

Some Quantitative Results

Corruption and poor governance may affect economic performance through their impact on tax revenue; public spending; and fiscal deficit.

To investigate empirically the impact of corruption on tax structure, each major source of tax revenue was regressed on a constant, real per capita GDP, agricultural share of GDP, trade share of GDP, and corruption index. The use of instrumental variables was intended to isolate the effect of corruption.

Basic results:

• Higher corruption reduces tax revenue.

• Corruption reduces revenue from social security tax the most; next, it reduces sales taxes; and last it reduces personal income taxes.

• A one point increase in the corruption index reduces tax revenue by 2.7 percent of GDP.

• Corruption increases tax evasion. For 21 countries see the relationship between corruption and the productivity of the value added tax for unit of nominal rate in Figure 3.

• Using some of the indexes of corruption now available, various researchers have tested several hypotheses that have a bearing on the question of the relationship between corruption and growth. I will summarize some of these results. They show that governance matters a lot for the allocation and management of public resources.

Corruption and investment. Most economists accept that a positive connection exists between investment and growth. Therefore, if corruption affects investment, it must also affect growth.

Corruption may affect investment in different ways. It may affect the size of total investment, the size of foreign direct investment, the size of public investment, and, of course, the quality of the investment decisions.

In several papers, Paolo Mauro of the IMF has shown that corruption can have a significant impact on the ratio of total investment to GDP. Regressing the investment ratio on a constant, the corruption index, GDP per capita in an earlier period (1960), secondary education
Figure 3. Corruption and VAT Productivity
in 1960 and population growth, he has shown that an improvement in the corruption index (i.e. a reduction in corruption) can significantly increase the I/GDP ratio (see Mauro, 1997). The fall in I/GDP caused by corruption is shown to have an important effect on growth. Mauro estimates that a reduction in corruption equivalent to two points in the corruption index, through its positive effect on I/GDP, will raise the annual growth rate by about 0.5 percent. In this relationship, the impact of corruption on the quality of investment is ignored.

Corruption and foreign direct investment. In a paper focusing on Foreign Direct Investment (FDI), Shang Jin Wei of Harvard (1997a) has shown that while a one percentage point increase in the marginal tax rate on foreign investment reduces incoming FDI by about 3.3 percent, an increase in the corruption index by one point reduces the flow of FDI into a country by about eleven percent. This would be equivalent to a 3.6 percentage points increase in the marginal tax rate. Wei calculated that an increase in the corruption index, from say, the Singapore level to the Mexican level, would have an impact similar to that of 21-24 percentage points increase in the marginal tax rate.

In a related work, Wei (1997b) has also shown that the predictability of corruption is also important for FDI. The less predictable is the level of corruption (the higher the dispersion of individual ratings of corruption level of host countries), the greater is the impact of corruption on FDI. A higher level of dispersion makes corruption behave like an unpredictable and random tax. He concludes that “the effect of uncertainty on FDI is negative, statistically significant and large. An increase in uncertainty from the level of Singapore to that of Mexico is equivalent to raising the tax rate on multinational firms by 32 percentage points.”

Corruption and public investment. Tanzi and Davoodi (1997) have argued that corruption is likely to increase public investment because public investment can be easily manipulated by powerful political or bureaucratic personalities. They have tested the hypothesis that, other things being equal, higher corruption is associated with higher public investment. Higher public investment often gives rise to higher “commissions” paid by those who carry out the project.

Regressing public investment (as a share of GDP) against a constant, the corruption index, real per capita GDP, and the share of government revenue in GDP, Tanzi and Davoodi have shown that the corruption index is highly significant (at the one percent level) and that the more corruption there is, the more public investment there will be.

The reduction in the I/GDP and in the FDI/GDP ratios can be assumed to have a clear, negative impact on growth. However, the increase in the share of public investment in GDP has a more questionable impact on growth. More evidence is needed to reach a conclusion. Some relevant evidence is provided by Tanzi and Davoodi (1997) and by Ades and Di Tella (1997).

Corruption and operation and maintenance expenditure. Although the difficulties in getting good data are great, Tanzi and Davoodi have provided some evidence that: (a) other
things being equal, high corruption is associated with low operation and maintenance expenditure; and (b) other things being equal, high corruption is associated with poor quality of infrastructure.

In terms of statistical significance, the impact of corruption is strongest on the quality of roads (paved roads in good condition), power outages, and railway diesels in use. Most of these relationships survive when real per capita GDP is added to the equation as an independent variable. Thus:

... the costs of corruption should also be measured in terms of the deterioration in the quality of the existing infrastructure. These costs can be very high in terms of their impact on growth.

Alberto Ades and Rafael Di Tella (1997) have tried to estimate the impact of industrial policies (identified with procurement preferences to “national champions” and unequal fiscal treatment to enterprises). They find that corruption is higher in countries pursuing active industrial policy.

Thus, in conclusion, corruption reduces total investment, distorts its composition, and reduces the quality of a country’s infrastructure. The combined impact of these changes on economic growth is bound to be negative and significant.

Corruption and the composition of public spending. We have already discussed the impact that corruption may have on growth through its effect on I/GDP, FDI/GDP, on PI/GDP, and on expenditure for O & M. However, corruption may have additional effects on expenditure. Some of these have been identified in recent papers. And some may be important for growth.

Mauro’s papers have shown that more corrupt countries spend less for education and health. This result has been confirmed by Gupta, Davoodi, and Alonso-Terme (1998). Because the expenditures for these categories are generally assumed to promote growth, it must be concluded that this is another channel through which corruption affects growth negatively.

Both Mauro (1997) and Tanzi and Davoodi (1997) have shown that countries with high corruption tend to have lower shares of taxes into GDP. Some of the tax revenue is diverted towards the pockets of tax administrators. Thus, the true burden of taxation for the taxpayers does not fall. Some taxes are not collected leading to less neutrality of the tax system. A too low level of taxation may lead to a sub-optimal level of public spending and, perhaps, to higher fiscal deficits.

Policy Conclusions

Governance problems may arise in connection with many principal-agent relationships. See Figure 4. In any of the relationships shown in Figure 4 (relations between principal and the agents charged to carry out the instructions of the principal) problems of poor governance can appear. These problems exist in any society but they tend to be more severe in some countries and under certain conditions. This raises the question of what can be done and what is being done.
One strategy is to pursue a zero-tolerance approach to corruption without changing the role of the state.

Such an approach would rely on (a) equity offices; (b) anti-corruption commissioners; (c) better controls on public officials; (d) higher penalties for those who are caught in acts of corruption; (e) higher wages for public sector employees; (f) reduction in the rights to privacy by government employees and by those who deal with them. For example, by requiring them to report on the value of their assets. (g) It could be supplemented by the anti-corruption efforts undertaken at the international level such as those being sponsored by the OECD or other regional or international organizations or at the national level, by the civil society and a free press.

This approach would be undoubtedly helpful in reducing poor governance but, unless accompanied by efforts aimed at modifying and reducing the role of the state in the economy, it may not go far enough. To make a significant progress against corruption and poor governance, it is also important to modify the role of the state by reducing its reliance on regulations, authorizations, quasi-fiscal activities and other tools that lend themselves to be
abused by public officials. It is also important to increase the transparency of what the state does.

In the context of the architecture of the international financial system, the IMF last year developed a *Code of Good Practices on Fiscal Transparency* aimed at increasing transparency in fiscal policy.

That code stated several principles that could be followed by countries and that would increase fiscal transparency:

1a. The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.

1b. There should be a clear legal and administrative framework for fiscal management.

2a. The public should be provided with full information on the past, present current, and projected activity of government.

2b. A public commitment should be made to the timely publication of fiscal information.

3a. Budget Documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

3b. Budget data should be classified and presented in a way that facilitates policy analysis and promotes accountability.

3c. Procedures for the execution and monitoring of approved expenditures should be clearly specified.

3d. Fiscal reporting should be timely, comprehensive and reliable, and should identify directions from the budget.

4. The integrity of fiscal information should be subject to public and independent scrutiny.

The application of these principles would make fiscal policy more transparent and in the process reduce the scope for poor governance.

In conclusion, the action to improve governance and to fight corruption needs to be conducted on several fronts. Both the demand for acts of corruption and the supply for such acts would need to be reduced.
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REFERENCES


