



Does fiscal decentralization mitigate the adverse effects of corruption on public deficits?

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ABSTRACT

Corruption is harmful for public finances and appears closely related to fiscal deficits. We open a new avenue in addressing the effects of corruption on public deficits through fiscal decentralization. For a sample of 31 OECD countries over the period 1986–2010, we find that fiscal decentralization contributes to mitigating the adverse effects of corruption on public deficits. In addition, our findings indicate diversity in the effects of fiscal decentralization, in that it appears related to lower deficits in countries with higher levels of corruption but not in less corrupt countries. Our results suggest that bringing the government closer to the people through fiscal decentralization in relatively corrupt countries leads to more responsible fiscal management.

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1. Introduction

Corruption is harmful to public finances (Abed and Gupta, 2002). In the view of the World Bank (2012a), corruption “reduces the effectiveness of public administration and distorts public expenditure decisions, [...] erodes the rule of law and harms the reputation of and trust in the state”. More specifically, corruption leads to adverse budgetary consequences by decreasing state revenue and promoting wasteful spending. Corruption is associated with tax evasion, an unofficial economy, illegality in customs administration, irregularity in procurement, theft and bribes or “white elephant” investment projects (World Bank, 2012b).

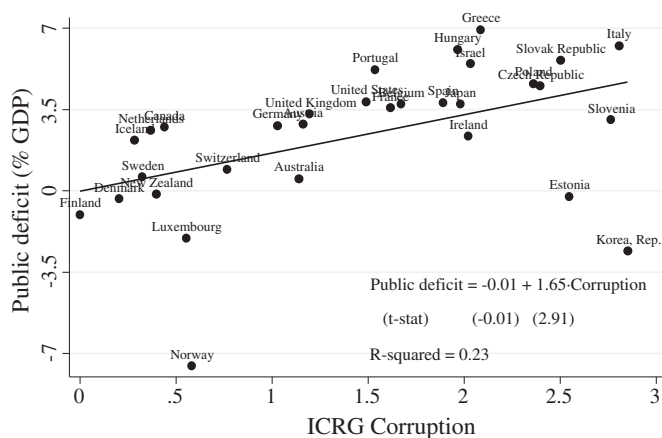
There exist large differences in corruption among industrialized countries (Kaufmann, 2010). To obtain an overview of these differences, for a sample of Organization for Economic Cooperation and Development (OECD) countries, the Global Corruption Barometer 2006 of Transparency International reported *bribe payments* values ranging between 1% (Finland, Sweden and Switzerland) and 17% (Czech Republic and Greece).¹ With respect to the consequences for public finances, Kaufmann (2010) observes a strong relationship between corruption and fiscal deficits in rich countries. An illustration of this relationship is presented in Fig. 1.²

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¹ The question in the Barometer is: “In the past 12 months, have you or anyone living in your household paid a bribe in any form?” (Transparency International, Several years).

² See below for the explanation of the variables employed. In addition, a scatterplot depicting the relationship between the standard deviation of corruption and the public deficit also shows a positive link. For space considerations, this plot is presented in an unpublished appendix accompanying this paper available from the authors upon request.



Notes: The variables represent the average of available data over the period 1986–2010. The definitions and sources of the variables can be found in Appendix A.

Fig. 1. The relationship between public deficit and corruption.

Table 1
Descriptive comparisons among country-pairs.

Country	ICRG corruption	Fiscal decentralization (subnational tax revenue)	Public deficit
<i>Two relatively corrupt countries</i>			
Greece	2.09	0.94	6.94
vs.			
Poland	2.36	10.47	4.62
<i>Two relatively non-corrupt countries</i>			
The Netherlands	0.37	3.01	2.62
vs.			
Canada	0.44	46.38	2.75

Notes: The variables represent the average of available data over the period 1986–2010. The definitions of the variables can be found in Appendix A.

This paper opens a new avenue in investigating whether the adverse effects of corruption on public deficits are mitigated through fiscal decentralization. When public office is used for private gain, close citizen control of politicians may be particularly necessary for accountability and for resolution of the principal-agent problem between politicians and citizens.

Greece, a country that is relatively corrupt, presents both the lowest level of tax decentralization and the highest deficit in the analyzed period. This stands in stark contrast to the experience of countries like Poland, which reports higher decentralization and lower deficits, despite having at least similar levels of corruption. The comparison of the two countries suggests a connection between more fiscal decentralization and lower deficits. In contrast, among less corrupt countries, decentralization appears unrelated to the public deficit. For instance, the Netherlands and Canada present similar levels of corruption and similar records of deficits, the former being much less decentralized than the latter. Table 1 summarizes the data of the four countries mentioned.³

These observations lead us to systematically study the relationship among corruption, fiscal decentralization and public deficits. Using a sample of 31 OECD countries, we find that the relationship between corruption and the public deficit is nonlinear and varies with the degree of fiscal decentralization. Our results show that the effect of corruption on increasing fiscal deficits declines as the level of decentralization rises. In addition, we observe that fiscal decentralization is related to lower deficits only in countries with higher levels of corruption, but not in less corrupt countries. Therefore the central message this paper conveys is that for the countries in our sample fiscal decentralization mitigates the adverse effects of corruption on the public deficit.

We adopt several econometric approaches to provide empirical evidence. First, we estimate cross-section regressions with ordinary least squares (OLS) for the period 1986–2010. An interaction model is used to explain the public deficit through corruption, fiscal decentralization and an interaction term of both variables. Second, we estimate panel regressions using both annual and five-year averaged data with pooled OLS and the system *Generalized Method of Moments (GMM)* estimator. In addition, as a complementary analysis, the sample is divided into three groups according to the level of corruption and then it is examined whether decentralization is related to lower deficits in each of them. For this purpose, we use fixed effects models. The results

³ When one observes decentralization across OECD countries, the differences are striking. Considering the amount of subnational tax revenue as a percentage of total general government tax revenue, we find great variability within our sample over the period 1986–2010. The range runs from countries like Greece, with a value lower than one percent, to countries like Canada, with a value near 50%.

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