



Auditors and fiscal policy: Empirical evidence on a little big institution

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ARTICLE INFO

Article history:

Received 12 November 2008

Revised 7 September 2010

Available online 21 September 2010

JEL classification:

D70

H10

Keywords:

Public auditor

Audit court

Auditing

Transparency

Information asymmetry

ABSTRACT

Schelker, Mark, and Eichenberger, Reiner—Auditors and fiscal policy: Empirical evidence on a little big institution

Various political institutions designed to control the government have been analyzed in the academic literature. However, an important institution has been neglected so far: independent auditing institutions with an extended mandate to audit the budget draft and individual policy proposals. We argue that such auditors improve transparency and provide essential information on the impact of policy proposals on common pool resources, which leads to less wasteful spending. We empirically analyze the impact of such auditors on fiscal policy at the Swiss local level. Auditors who can evaluate and criticize policy proposals *ex ante* to policy decisions, significantly reduce the general tax burden and public expenditures. The results are similar for different datasets and robust to various changes in the econometric specification. *Journal of Comparative Economics* 38 (4) (2010) 357–380. SIAW-HSG, University of St. Gallen, Bodanstrasse 8, CH-9000 St. Gallen, Switzerland; Center for Public Finance, University of Fribourg, Pérolles 90, CH-1700 Fribourg, Switzerland; Center of Research in Economics, Management and the Arts (CREMA), Gellertstrasse 18, CH-4052 Basel, Switzerland.

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1. Introduction

In mature democracies, fundamental rules such as the separation of powers and regular elections have been established. Nevertheless ‘pork barrel’ and special interest group politics are well documented phenomena that often lead to the overuse of common pool resources. Even though various institutional mechanisms to mitigate these problems have been discussed, an important institution has been widely neglected so far: *independent public auditing institutions*.

Traditional auditors typically analyze the financial statements provided by the government and evaluate the use of public funds. All developed democracies feature some form of supreme auditing institution. Usually, these audit offices are fairly large: the German Bundesrechnungshof and its associated offices employ more than 1300 individuals and the US Government Accountability Office (GAO) counts more than 3000 employees and has a budget of more than 500 million USD. These auditors typically conduct *ex post* audits which target bookkeeping procedures and the effectiveness of policy implementation. Hence, they are carried out *after* decisions have been made in the political process and the budget or specific policies have been implemented. These *ex post audits* provide information on public governance and the use of public resources and are an important means of holding public officials accountable.

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In contrast to what is audited in *ex post* audits, most budgetary 'tricks' are adopted *ex ante* to decisions and are, hence, not subject to a typical auditor's evaluation. We argue that the standard *ex post* mandate of public auditing institutions should be complemented by a set of *ex ante audit* measures. *Ex ante* audits are not typically conducted by existing public auditing institutions. We present evidence that the *ex ante* and *ex post* auditing mandates of public auditing institutions have an important impact on policy outcomes. In addition to the standard *ex post* audit of the accounts and the performance of policy programs, auditors should analyze the fundamentals of the budget draft and evaluate individual policy proposals. The additional information provided by such a powerful auditing institution strengthens common pool interests, improves transparency, and reduces the overuse of common pool resources.

We test our hypotheses by analyzing a unique institutional setting in Switzerland where some local auditing institutions are actively involved during the policy making process. They not only evaluate programs *ex post* to the implementation, but also evaluate policy proposals *ex ante* to the political decision and report their findings to the public. Some auditors are even allowed to make counter-proposals, which are then put to the public vote. We construct a measure capturing the relevant aspects of the design of local auditing institutions and provide empirical evidence highlighting the importance of such powerful auditors.

The institutional designs of local auditing institutions are homogenous within cantons but vary substantially across cantons. This is the variance we rely on in the empirical exercise. We estimate the influence of local auditing institutions on fiscal variables such as public expenditures and taxes relying on municipal data as well as on municipal information aggregated at the cantonal level. We always control for institutional differences across cantons, e.g., the extent of local and cantonal direct democracy as well as the degree of decentralization measured by the extent of local autonomy. The study has to rely on cross-sectional variance since – almost by definition – institutions do not frequently change over time. We consistently find a strong negative and significant correlation between the power of local auditors and the level of taxes and expenditures. Even though we cannot present persuasive instrumental variable regressions, we address potential endogeneity problems from various perspectives: we take account of a wide range of control variables including measures of fiscal preferences that might drive the institutional design as well as fiscal outcomes simultaneously, and we formulate differential hypotheses based on our theoretical arguments that make it unlikely that some omitted factors drive our results in such a subtle way. We conclude that powerful auditors have a significant negative effect on taxes and expenditures.

In Section 2 we provide the main arguments for extending auditing competences beyond traditional *ex post* audits to include substantial *ex ante* audits. We discuss some important aspects of the institutional design for such a new type of auditing institution and formulate testable hypotheses. Section 3 introduces the test case in Switzerland and provides information on the institutional design of local auditors and the codification of the index capturing the auditor mandate. The presentation of the datasets and a discussion of the empirical identification strategy including our various approaches to deal with potential endogeneity follow in Section 4. In Section 5 we present our empirical results. Section 6 summarizes and concludes.

2. The (potential) role of auditors in the public sector

Democratic governance requires the delegation of decision-making power to agents. The resulting agency problem between citizens and government agents is well established. Because citizens do not have perfect control over, and lack information about, the agents' actions, institutional safeguards are necessary in order to restrain the government from exploiting its citizens. Conditional on the underlying political regime and its institutions, public finance outcomes differ.¹ In the last decade a wide range of political regimes and institutional arrangements have been analyzed.² This work builds upon these foundations and focuses on an institution directly influencing information cost and information asymmetry in the policy process.

The result of market interactions depends on the transaction rules and transaction costs present in such interactions. An important part of transaction costs is the cost to generate and analyze information. Institutions and rules fostering higher transparency tend to lower information costs and information asymmetries, and thus to improve market outcomes. Policy making in political markets also involves information cost and information asymmetries. Policymakers as well as citizens need information to make policy and electoral decisions, respectively. In the presence of significant information cost and information asymmetries political markets produce suboptimal results.³ In order to reduce such information problems in the democratic decision-making process, various political institutions have been established. One major factor is transparency requirements mandating information disclosure as well as the subsequent review of such disclosed information (e.g., Alt and Lassen, 2006). In this paper we focus on the second aspect, the review of disclosed information, and argue that such review is relevant at two instances in the political process. (1) When basic information is revealed that constitutes the fundamentals for policy decisions, and (2) when policies are implemented and the final information on policy outcome has to be verified. Typically, only the second aspect is regularly and systematically conducted by public auditing institutions.

¹ See e.g., Person et al. (1997, 2000) or more generally Acemoglu (2003).

² For an overview of the field, theoretical approaches and specific institutions see Persson and Tabellini (2000), Mueller (2003) or Besley and Case (2003), for institutions specific to Switzerland see Feld and Matsusaka (2003), Feld et al. (2003), Funk and Gathmann (2008) and Schaltegger and Feld (2009).

³ See e.g., Lohmann 1998; Besley (2006); Eichenberger and Serna (1996).

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