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# Revealed Corruption, Taxation, and Fiscal Accountability: Evidence from Brazil

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**Summary.** — Fiscal contract theories hypothesize that government performance affects tax collection and that institutions that foster representation and accountability link taxes and services. We use randomly generated municipal audit reports with objective measures of corruption from Brazil to assess whether new information about corruption affects municipal property tax collection and the structure of fiscal institutions. We find short-run effects consistent with this theory: property tax revenue rises with clean audit reports and falls as revealed corruption increases; furthermore revealed corruption increases the probability that a municipality adopts participatory budgeting. Our results indicate modest demand-side constraints on taxation and budgetary institutions.

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*Key words* — fiscal contract, randomized audits, corruption, property taxes, participatory budgeting

## 1. INTRODUCTION

Fiscal contract theories of the state hypothesize that government performance affects tax collection and that institutions that foster representation and accountability link taxes and services. These propositions find considerable support in laboratory experiments and aggregate data, but they have yet to be tested rigorously with objective measures of corruption and relatively disaggregated data in a real world setting. This paper uses randomized auditing reports from the Brazilian federal government to test fiscal contract-like hypotheses about these relationships with a relatively high level of precision. The reports detail the way in which municipalities spent federal transfers: were projects finished, were there overpayments; were contracts awarded without bids, did politicians pocket the money, etc.?<sup>1</sup> We use the content of these reports to see whether revealed corruption affects local tax collection and/or affects the probability that a municipality will adopt Participatory Budgeting (PB) in the future.

The primary contribution of this paper is to use a high-quality research design with relatively disaggregated and objective real world data to demonstrate the link between exposed corruption and taxation. Our research design leverages both randomized selection and randomized timing of the audits, allowing us to make reasonably sound inferences. A second contribution is to reveal the link between revealed corruption and fiscal institutions. A third is to highlight the importance of high-quality information in terms of mediating the relationship between citizens and government. Our primary finding is that property tax yields fall as revealed corruption increases and rise when audits reveal little to no corruption. The main result, obtained with unit fixed effects estimators, is relatively robust with several measures of corruption and taxation and with municipal-specific linear time-trends. Placebo treatments of audit reports with prior property tax collection indicate no systematic difference before the audit, suggesting that the content of the audit reports only affects subsequent property tax collection. Although the effect is short-lived, the magnitude of the effect of revealed corruption would not be trivial for the multitude of municipalities that collect little revenue from property taxes. The difference in tax collection between

municipalities audited before and after the 2004 election—assigned randomly to groups through the auditing process—is small and insignificant, indicating that elections are not the only mechanism at work.

Using a less rigorous research design, we also find evidence that increases in revealed corruption substantially increase the probability that a municipality will adopt PB in the future, suggesting that PB is viewed as a mechanism for increasing accountability. Placebo treatments indicate that just being audited does not affect the probability of PB adoption. The relationship between revealed corruption and PB adoption is stronger when the audit was released before the election.

Our paper provides evidence that there are demand-side constraints on tax collection and fiscal institutions and suggests that the audits engender some increase in fiscal accountability: property tax revenue and fiscal institutions fluctuate based on the information citizens have about the integrity of their government. While the results are consistent with fiscal contract reasoning, they are only robust over the short-run. The general absence of persistence may indicate that re-occurring access to quality information is critical to maintaining a tight relationship between government performance and taxation, something Bobonis, Cámara Fuertes, and Schwabe (2013) highlight in their work on long-run political accountability in Puerto Rico. Even with this caveat, the results are important. Given that municipalities collect a relatively small share of total revenue, Brazil could be an unlikely case for finding a fiscal response to revealed corruption; nonetheless, our results are reasonably consistent with other papers indicating fiscal-contract-like tendencies at the local-level in Brazil (Gadonne, 2011; Schneider & Baquero, 2009).<sup>2</sup> They are also consistent with related work on Mexico that looks at the

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response of property taxes to the provision of local public services (e.g., [Gonzalez-Navarro, & Quintana-Domeque, 2014](#)).

## 2. BACKGROUND

The various relationships between government performance, fiscal structure, citizen control, and revenue collection have been the subject of considerable inquiry, dating at least back to Montesquieu. One crucial conjecture is that states operate like fiscal contracts, exchanging services and policies for revenue (e.g., [Bates & Lien, 1985](#); [Levi, 1988](#); [North, 1981](#); [Timmons, 2005](#); [Brautigam, 2008](#)). Fiscal contract theories rest on the premise that states are not endowed with sufficient coercive power to impose their will on society. Instead, they must bargain with citizens for revenue. Because there are supply-side constraints on government power and information, tax yields depend on citizen willingness to accept them ([Kirchler, Hoelzl, & Wahl, 2008](#)).

Furthermore, fiscal contract theories posit that at least some tax compliance is quasi-voluntary ([Levi, 1988](#)). That is, people accept taxes partly because they believe government is doing useful things with their money (proxied by trust in government and/or by actual evaluations of government expenditure) and/or because they believe they are receiving an adequate and fair share of public benefits relative to their contribution. Absent those beliefs, the cost of enforcing compliance will be higher (see [Andreoni, Erard, and Feinstein \(1998\)](#) for a summary of tax compliance).<sup>3</sup> Hence, holding state capacity and tax effort constant, states that better satisfy taxpayer preferences will raise more tax revenue. In other words, the more governments ask citizens to pay in taxes, the more that citizens will expect from government.

Fiscal contract theories predict equilibrium relationships between taxes and services and a general correspondence between the distribution of taxes and the distribution of services, but only partially explain why bargains (in effect, why the supply and demand-side constraints) vary across units in levels and structures (i.e., the tax mix). They also incompletely identify the mechanisms that consummate such bargains. Five general mechanisms, in particular, have been highlighted as devices that move units along the contractual line: external threats/war, voting, political parties, and labor market organizations are thought to increase taxes and services, while government corruption ([Bratton, 2012](#); [Goodspeed, 2011](#)) and windfall revenues, say in the form of oil or foreign aid, are thought to reduce them ([Brautigam, 2008](#); [Eubank, 2012](#)). Whereas the first set of mechanisms engage citizens with the state, the second set of mechanisms undermine citizen's confidence in state officials and reduce government's need to bargain for revenue, thereby diminishing government fiscal and political accountability ([Moore, 1998](#); [Morrison, 2009](#)). Elections are especially important because they are a low cost, regularized and inclusive means for citizens to sanction/reward politician performance. Because they generally enhance citizen control over taxes/expenditure, they not only help maintain the tax/spending equilibrium, but can push it upward as better government enhances services and induces tax compliance.

Fiscal contract approaches to understanding the state find support in labs, public opinion research and real world fiscal data. Laboratory experiments, for example, consistently show that the belief that tax revenues are spent on things citizen's value shapes individual compliance decisions ([Andreoni et al., 1998](#); [Bodea & LeBas, 2014](#)). There is also considerable public opinion data consistent with fiscal contract approaches (e.g., [Ali, Fjeldstad, & Sjursen, 2014](#); [Levi, Sacks, & Tyler,](#)

[2009](#)). Likewise, it is not too hard to find cross- and within-country relationships between measures of corruption and tax revenue, between government performance and tax revenue, and between perceptions of fairness/tax morale and tax collection (e.g., [Ghura, 1998](#)). Furthermore, there is also evidence in favor of the contractual mechanisms mentioned above (e.g., [Cusack & Beramendi, 2006](#); [Kato, 2003](#); [Thies, 2005](#)). Finally, the three-way macro-level correlation (between citizen stated willingness to pay taxes, mechanisms of citizen control over government, and citizen perception of government spending) also has support at lower levels of aggregation (e.g., [Gibson & Hoffman, 2007](#); [Olken, 2010](#)).

Even though data correlations are fairly well established, fiscal contract research has not generally reached the level of rigor or sophistication that one finds in some other areas of social science ([Slemrod & Weber, 2012](#)). As a result, we still do not know with much precision whether more tax revenue causes better performance, whether better performance increases tax revenue, or whether omitted variables are causing both. We also do not know the role played by information in aligning taxes and performance.

Our research design and dataset allow us to test several hypotheses about the relationship between taxation, revealed corruption, and accountability with greater reliability. Hence, one key contribution is inference quality, especially for taxes and revealed corruption. Our right hand-side measure of corruption is particular noteworthy, as much of the existing literature on corruption and public finance (e.g., [Ghura, 1998](#); [Tanzi & Davoodi, 1997](#)) uses subjective measures of corruption. Because such measures (e.g., Transparency International) are probably influenced by tax rates/levels/evasion, endogeneity almost certainly biases existing estimates.

Second, we contribute to the understanding of the role that information plays with respect to taxes and performance. That is, although information mediates between taxes and performance, few have studied it explicitly.<sup>4</sup> While it is widely recognized that informational shortcomings should generate disconnects between the actual level of services/corruption and the actual amounts paid by citizens, it is generally assumed (rather than tested) that people have sufficient information about their tax burden and government performance for fiscal contracts to exist. While this assumption may be reasonable in the sense that good institutions may lead to more transparency and higher compliance, it essentially relegates information to the error term. With our research design, we can identify the effects of new information on fiscal outcomes. We can also see if the effect is stronger when information is revealed right before elections.

Third, we add participatory budgeting to the aforementioned list of general contracting devices. Participatory budgeting is a process in which citizens directly negotiate spending priorities with each other and with government officials in organized meetings. Because these meetings are widely publicized, the amounts of money are fairly substantial, and the decisions relatively binding, participatory budgeting should increase citizen knowledge of and control over taxes and spending relative to other frameworks (e.g., via elected representatives). Increased citizen control over resource allocation should decrease government corruption ([Zamboni, 2007](#)), improve government performance, and increase citizen satisfaction with government spending, thereby increasing tax revenue. [Boulding and Wampler \(2010\)](#), for example, show that PB is associated with increases in health and education spending; [Gonçalves \(2014\)](#) shows that it is also associated with a decline in infant mortality; and [Schneider and Baquero \(2009\)](#) show that PB is associated with higher citizen

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