

# Government

MANY OF THE INSTITUTIONS THAT SUPPORT MARKETS ARE PROVIDED by the state. The ability of the state to provide these institutions—often referred to as governance—is therefore fundamental to vibrant and broad-based markets. Chapter 5 on *Political Institutions and Governance* discusses how political institutions shape governance around the world by setting limits on the ability of the state to exercise its power arbitrarily. This broad theme also runs through chapter 6 on *The Judicial System*, which examines the determinants of the efficiency of the judiciary and emphasizes the importance of judicial accountability and independence from political pressures. Chapter 7 on *Competition* stresses the central role of competitive pressures in creating well-functioning markets, the institutions that support or undermine competition, and the role of competition in spurring institutional change. Chapter 8 on *Regulation of Infrastructure* takes up the interplay between competition and regulation in ensuring that the market for infrastructure services operates fairly and is accessible to all.



# Political Institutions and Governance

*In framing a government to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.*

—James Madison, 1788

Many of the institutions that support markets are publicly provided. The ability of the state to provide these institutions is therefore an important determinant of how well individuals behave in markets and how well markets function. Successful provision of such institutions is often referred to as “good governance.”<sup>1</sup> Good governance includes the creation, protection, and enforcement of property rights, without which the scope for market transactions is limited. It includes the provision of a regulatory regime that works with the market to promote competition. And it includes the provision of sound macroeconomic policies that create a stable environment for market activity. Good governance also means the absence of corruption, which can subvert the goals of policy and undermine the legitimacy of the public institutions that support markets.

Good governance matters for growth and poverty reduction. Many studies have documented strong associations between per capita incomes and measures of the strength of property rights and the absence of corruption. To a certain extent, this reflects the greater capacity of rich countries to provide good institutions. But recent findings also point to a strong effect running from better governance to better development outcomes.<sup>2</sup> There is evidence that excessive regulation undermines economic growth. There is also evidence that poor macroeconomic policy and restrictive trade

regimes adversely affect a country’s growth performance.<sup>3</sup> Through its powerful effects on overall economic growth, good governance is therefore central to the goal of poverty reduction. Moreover, several dimensions of poor governance—notably corruption and high inflation—impose costs that fall disproportionately on poor people.<sup>4</sup> Improvements in these dimensions of governance may be especially important for poor people.

Good governance requires the power to carry out policies and to develop institutions that may be unpopular among some—or even a majority—of the population. Public officials cannot enforce property rights without the ability to try, judge, and punish those who do not respect those rights. The state cannot provide costly public goods without the power to tax individuals and companies to raise public revenues. Public officials cannot promote competition without the power to enforce regulations against monopolistic abuses. They cannot provide a stable macroeconomic environment without the power to see the state’s policies implemented.

There is a tension in the development of the modern state between ensuring that public officials have sufficient power to deliver good governance and ensuring that they are constrained from using this power arbitrarily in the interests of the privileged few.<sup>5</sup> When they are not constrained, their ability to provide the institutions that support markets—by increasing access to information, enhancing competition, and enforcing contracts—is impaired. This is particularly important in the case of the protection of property rights, where the formal establishment of such rights has little effect in the absence of a credible commitment by the state to respect and enforce them.

**Box 5.1****Political institutions, property rights and fiscal outcomes in 17th century England**

In England in the early 17th century, the Stuart monarchy, to finance its expenditures, increasingly resorted to “forced loans”—where the lender had no recourse if loans were not repaid. This practice was one of many highly visible signs that the regime had no commitment to protecting property rights. Other indications included outright confiscation of land and funds, forced public procurement at below-market prices, a willingness to remove judges who ruled against the Crown, and the sale of monopoly rights over various lucrative economic activities. This arbitrary exercise of sovereign power was interrupted during the civil war in the middle of the century, but the restoration of the monarchy was accompanied by the return of the same excesses.

The Glorious Revolution of 1688 ushered in a series of fundamental changes in political institutions that limited the arbitrary exercise of power by the sovereign. The revolution established the supremacy of parliament over the Crown and vested in parliament the exclusive right to raise taxes and audit the expenditures of the Crown. These steps were followed by the establishment of the Bank of England, which exercised important independent control over public finances. The result of these changes was a more equitable division of power between the executive, legislative, and judicial branches of government. These restraints on the arbitrary exercise of power greatly enhanced the state’s ability to finance public expenditures by issuing debt.

The impact of these changes in political institutions and in the protection of property rights can be seen in the development of debt markets. In 1688 the Crown was able to place public debt equivalent to only 2 to 3 percent of GDP—and only of very short maturity and at very high interest rates. By 1697 the Crown was able to place and service debt equivalent to 40 percent of GDP, at lower interest rates and with longer maturities. The emergence of a functioning public debt market in turn benefited the development of the private capital markets that helped finance the Industrial Revolution that followed.

Source: North and Weingast 1989.

Political institutions help determine limits on the arbitrary exercise of power by politicians and bureaucrats. They do so by delineating property rights between the state and the private sector and providing for their *enforcement*. A historical example of this can be found in the changes in political institutions in 17th century England, which placed limits on the power of the Crown to expropriate property and so contributed to the security of private property (box 5.1). Political in-

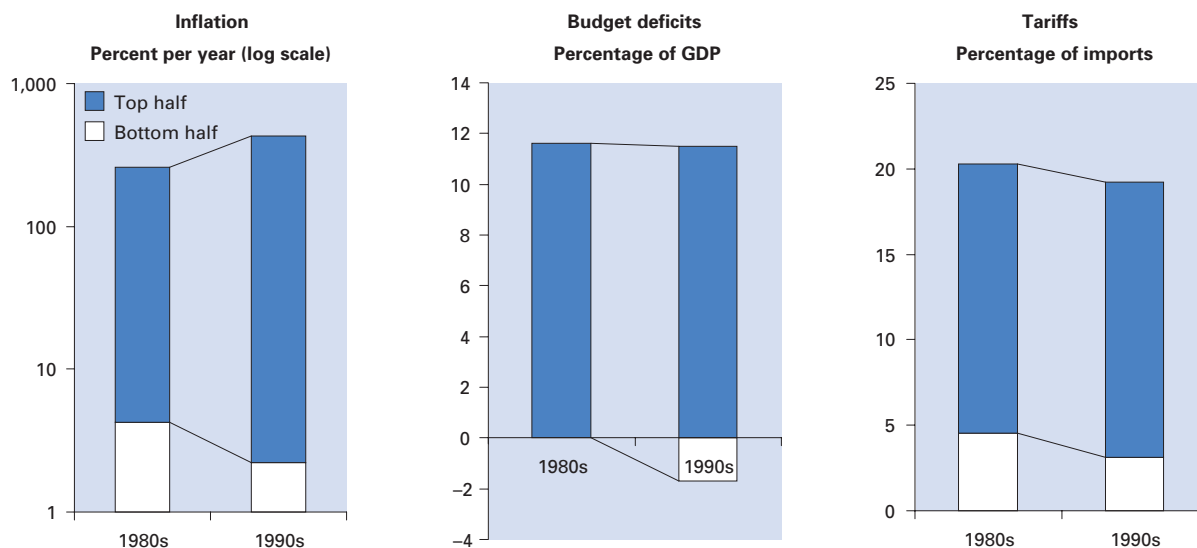
stitutions also influence the extent of *competition* in the political process and the extent to which this competition holds politicians accountable for their actions. For example, delegating responsibility to local governments can influence the incentives for competition between jurisdictions to provide improved public goods.

This chapter considers a wide variety of political institutions that, among other things, affect the behavior of public officials. In formal democracies, which constitute a growing share of the world’s countries, political institutions include the electoral rules that lay out the procedures by which governments are elected and replaced. They also include the constitutional rules that determine the division of power between the executive and legislative branches of government—and the limits on the power of each. In all countries, political institutions and traditions delineate the division of power between central and local governments and the assignment of responsibilities to different agencies within the government. These institutions may be formal (such as electoral rules), or they may be informal (for example, the role of shared beliefs among members of the same political party in shaping behavior). There are also important interactions between political institutions. For example, the credibility of autonomous agencies will depend on the extent to which other political institutions limit the power of governments to revoke the agencies’ independence in the future.

Institutions that limit the state’s capacity for arbitrary action will improve its ability to provide institutions that support broad-based markets. But too often among the poorest countries in the world, the ability of the state to provide market-supporting institutions is hampered by the absence of effective restraints on public officials. This illustrates the broader theme that runs through this Report of complementarities among institutions: policymakers need to adjust institutional designs to take these complementarities into account. For example, in the absence of effective checks and balances in the political process, independent regulatory agencies will be independent in name only. When state capacity is weak, simpler and less discretionary regulation is less likely to be undermined by corruption. And when central government control is ineffective, the potential benefits of greater decentralization and competition among jurisdictions may not be realized.

No single set of political institutions can successfully support market institutions everywhere and at all levels of development; this points to the importance of inno-

**Figure 5.1**  
**Variation in the quality of policies around the world**



Note: The labels top half and bottom half refer to the averages of the top half and bottom half respectively in a sample of 85 industrial and developing countries for which all three variables are available for the 1980s and 1990s.

Source: World Bank data.

vation and experimentation in the design of the institutions of the state itself. This chapter also illustrates how open information sharing can improve governance and reduce corruption (see also chapter 10).

This chapter builds on past World Development Reports, especially *World Development Report 1997* on the role of the state. Part of the 1997 Report was devoted to the institutions that restrain arbitrary state action and corruption, and it stressed the importance of judicial independence, the formal separation of powers, and international institutions as a counterbalance to the power of the state. Since then, a large body of research has shed new light on these issues, and this chapter emphasizes what is new. This chapter is also selective in the topics it covers. The role of the state in protecting property rights and promoting the rule of law through the judicial system is taken up separately in the next chapter. The role of the state as a regulator to promote competition in markets is discussed in chapters 7 and 8.

This chapter addresses three dimensions of governance in detail. The first section explores the ways in which political institutions influence policy choices, focusing on fiscal, regulatory, and trade policies. This section emphasizes the types of institutions that limit the ability of the state to provide policies that favor special

interests over the general interest. The second section discusses corruption. In light of the classic definition of corruption as the exercise of public power for private gain, the section emphasizes the types of institutions that limit the ability of public officials to act in their own self-interest in this way. The third section discusses how the institutions of taxation influence the incentives of the state to raise revenues and to provide the institutions that support markets.

### Political institutions and policy choices

The quality of policies adopted by governments around the world varies tremendously. Figure 5.1 illustrates this variation in policy for several measures of policy outcomes—inflation, budget deficits, and tariffs—averaged over the 1980s and 1990s. Each panel shows the average value of the policy variable for the top half of a sample of 85 industrial and developing countries and the corresponding average for the bottom half of the sample. Average inflation in the best-performing half of the sample was 4 percent per year in the 1980s and 2 percent per year in the 1990s. Among the worst-performing countries, inflation averaged upward of 200 percent per year. The same is true for budget deficits, which were insignificantly small or in surplus in the

1990s among the best-performing countries but averaged over 10 percent of GDP among the worst-performing countries. The difference in tariffs between the top and bottom halves of the samples is around 15 percent.

If these differences in policy outcomes across countries matter so much for growth and poverty outcomes, why then do some countries end up with much worse policies and performance than others? This section focuses on one particular factor: the extent to which countries' political institutions are able to resolve the conflicts that inevitably arise when policies benefit some at the expense of others.

This section considers several such institutions, including the nature of the electoral system and the existence of checks and balances among different branches of government. These checks and balances can be constitutionally mandated, as in the formal division of powers between the legislative and executive branches of government or between the chambers of the legislature. They can also reflect the outcome of the electoral process, as seen in the election of a minority government that must seek support from coalition partners and is limited in its agenda by the need to make compromises with these partners. Other political institutions include the procedures by which budgets are determined and international agreements that help governments commit themselves to policies that may be unpopular at home.

This section discusses how political institutions that limit the ability of government to act arbitrarily do matter for policy outcomes. Examples from three areas—budget deficits, regulation of financial markets, and trade policy—are considered. The purpose of this discussion is not to lay out a blueprint for changes in political institutions in order to improve policy outcomes. Rather, its purpose is to illustrate how policy advice can be improved by taking political institutions into account.

### *Budget deficits*

Budget deficits represent the difference between politically popular expenditure programs and politically unpopular taxation. Fiscal outcomes are therefore influenced by the extent to which governments are able to muster political support for necessary taxation and resist demands from interested constituencies for the expansion of spending programs that benefit them. Political institutions play an important role in this process. This section examines how cross-country differences in specific budget procedures, voting systems, and the tim-

ing of elections influence fiscal outcomes. While the overall message of this chapter emphasizes the importance of limits on state power, the discussion here illustrates some cases in which excessive limits can hinder the ability of governments to resolve conflicts over fiscal policy.

*Budget processes and fiscal outcomes.* Specific budget procedures can also affect the outcome of conflicts over fiscal policy. Two aspects of these procedures are noteworthy: whether governments choose to tie their hands using balanced budget rules, and whether the finance ministry has powers to resist demands from either the legislature or other branches of government for amendments to a proposed budget. To the extent that balanced budget rules—or, more generally, external constraints on finance—are effective, they can be a powerful motive for enforcing necessary compromises over fiscal policy. Similarly, when finance ministries have strong agenda-setting powers relative to the legislature or spending ministries, it is easier for central agencies to enforce fiscal discipline. Cross-country evidence from Latin America suggests that both these factors are important in determining fiscal outcomes. Countries with more hierarchical budgetary procedures favoring finance ministries tended to have better fiscal outcomes, controlling for a variety of other factors.<sup>6</sup> Similar evidence emerges from case studies of two Asian and three African countries. Success in instilling overall fiscal discipline was shown to be closely related to the strength of central agencies in the budget-setting process, the presence of hard budget constraints in the context of a medium-term budgeting framework, and institutions that held departments accountable for their spending.<sup>7</sup>

There is also some evidence from Latin American countries that balanced budget rules are associated with better fiscal outcomes.<sup>8</sup> But balanced budget rules alone are not enough. The design and enforcement of the rule matters as well. Evidence from the experience of individual states of the United States points to important differences in the effectiveness of different types of balanced budget rules.<sup>9</sup> While all U.S. states (with the exception of Vermont) have balanced budget rules, their stringency varies considerably. Some states only require the governor to submit a balanced budget to the legislature or allow the carryover of limited deficits from one year to the next. Other states strictly prohibit any deficits from being carried over by imposing end-of-year balanced budget requirements. Moreover, states

differ in whether the balanced budget rule is enshrined in the state constitution or not and in whether the balanced budget rule is enforced by a state supreme court that is appointed by the executive.

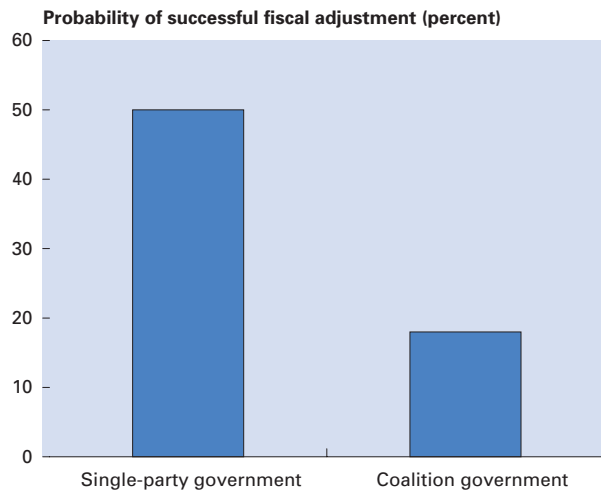
These differences in institutional design have important consequences for the efficacy of balanced budget rules. Evidence suggests that more stringent rules are more effective in reducing deficits. Controlling for a variety of factors, states that switched from weak to stringent balanced budget rules were half as likely to run deficits as those that did not. In addition, constitutionally mandated balanced budget rules were much more likely to be effective than those that were legislatively imposed and so were more easily reversed. Balanced budget rules enforced by governor-appointed courts were less effective than those enforced by more independent courts.

The general lessons of this experience for developing countries is clear. Balanced budget rules can be effective, especially at the subnational level where there is little compelling rationale for countercyclical deficit spending. However, such rules are more likely to be effective if they are voluntarily adopted, if they impose hard constraints, if the rules themselves are difficult to reverse, and if they are effectively enforced by a credible third party such as a genuinely independent court or a higher level of government that has sufficient information to properly monitor subnational public finances.

*Divided governments, electoral rules, and fiscal outcomes.* The extent to which governments are required to share power in coalition governments is an important determinant of budgetary outcomes in OECD countries. When the power of government is checked by the need to make compromises with coalition partners, fiscal outcomes are often worse than when majority governments are in power. Figure 5.2 shows that the probability that a coalition government in an OECD country is able to sustain a fiscal adjustment (defined as four successive years of significantly lowered budget deficits) is less than half as large as the likelihood that a majority government accomplishes a fiscal adjustment.

The likelihood that countries are governed by divided governments is in turn influenced by the constitutional rules that determine how governments are selected. Coalition governments are more likely to occur under proportional electoral systems, where seats in the legislature are awarded in proportion to shares in the popular vote. A study of 60 industrial and developing

**Figure 5.2**  
**Divided governments have difficulty with fiscal adjustments**

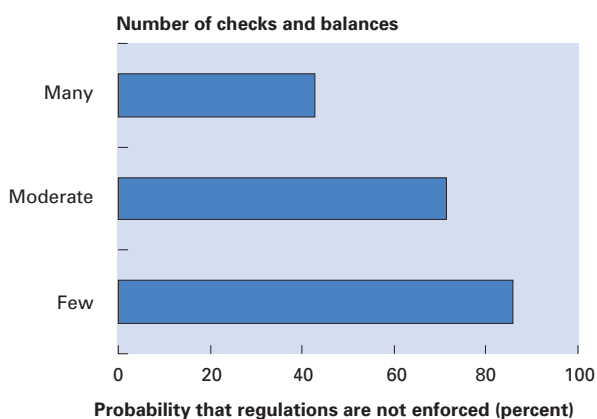


Source: Alesina, Perotti, and Tavares 1998.

countries shows that, after accounting for a variety of socioeconomic factors, countries with systems of proportional election tended to have larger government expenditure and larger fiscal deficits as a share of GDP than countries with majoritarian systems. On average, fiscal deficits were 1.5 to 2 percentage points of GDP larger in countries with proportional systems.<sup>10</sup>

*Electoral cycles in fiscal policy.* Politicians motivated by the desire to remain in office have strong incentives to manipulate the fiscal process to improve their chances of reelection. This creates a tendency for fiscal performance to worsen in election years, leading to debt accumulation and macroeconomic instability. A recent study examined the effect of elections on fiscal performance in a sample of 123 industrial and developing countries. Controlling for a number of other factors, it found that fiscal deficits were on average 1 percent of GDP larger in election years and that this larger deficit persisted for several years after the election.<sup>11</sup> More striking is the difference between the magnitude of these electoral cycles in industrial and developing countries. Among developing countries, election year deficits were on average 2 percentage points of GDP higher. The same study found that these larger cycles in developing countries reflect the confluence of two institutional features of these countries. First, on average there are greater opportunities for incumbent pol-

**Figure 5.3**  
**Governments with fewer checks and balances than others are less likely to enforce banking regulations during crises**



Note: This figure shows the probability that prudential regulations are not enforced, holding constant per capita income and the level of financial development.

Source: Keefer 2001.

iticians to extract rents from being in office, as measured by variables capturing the extent of corruption in the public sector. Second, the ability of politicians to successfully manipulate policy to influence voters was stronger when voters were poorly informed about the consequences of policy decisions. The study found that electoral cycles in fiscal policy were larger in countries where press freedoms were lower, providing evidence of the importance of open information sharing for institutional quality (chapter 10).

### *Financial market regulation*

Banks can have strong incentives to undertake lending that is riskier than is socially optimal. Governments therefore provide prudential regulation in order to reduce banks' opportunities to engage in such lending (chapter 4). Governments can also intervene following financial crises to encourage the liquidation of insolvent banks. But the need for such regulation results in two types of conflict. First, bank owners are often politically influential and can seek to prevent politicians from approving or enforcing prudential regulations. Second, although governments may wish to commit in advance to not bail out insolvent financial institutions, after a crisis the political pressure to intervene in failed banks can be irresistible.

Many countries have established independent regulatory agencies charged with implementing financial

regulation in order to reduce these conflicts (chapter 4). However, despite their nominal independence, such regulatory agencies are often subject to political pressures. New research reveals an important possible countervailing force to these pressures—the existence of checks and balances in the political process. A recent study examined 40 banking crises occurring in a sample of 35 industrial and developing countries.<sup>12</sup> The study examined how the policy response to these crises depended on the extent of checks and balances in the political process, measured in terms of the number of bodies with potential veto power over policy, such as the presidency and the upper and lower chambers of the legislature. In 26 of the 40 crises, the government chose not to enforce prudential regulations. Even among countries with similar levels of income, the likelihood that regulations were not enforced was significantly higher in countries with fewer checks and balances (figure 5.3).

The example of bank crises illustrates a general difficulty that governments have in credibly committing to policies, and the potential of delegating decision-making authority to an independent agency to overcome this problem. This issue arises in many other contexts that are discussed later in this chapter, including the delegation of tax collection to an independent revenue agency or the delegation of some control over trade policy to an international organization. Given the large costs of high inflation for poor people, another important example is the problem of credibly committing to stable and noninflationary monetary policy and the role of delegating monetary policy to an independent central bank to achieve this credible commitment.

However, the empirical evidence on the effectiveness of central bank independence has been mixed. Especially among developing countries, there is little evidence that the statutory independence of the central bank makes a big difference for inflation outcomes. New research shows that when effective checks and balances limiting the ability of politicians to interfere in the decisions of a formally independent central bank are present, central bank independence can have greater payoffs in terms of improving monetary policy.<sup>13</sup>

### *International trading rules*

Over the past decades countries around the world have made significant progress in reducing tariffs on international trade. Despite this progress substantial barriers to trade remain, ranging from high tariffs on certain goods in certain countries (notably industrial country



barriers to agricultural imports from poor countries) to a variety of nontariff measures that serve to restrict trade and competition (see chapter 7).

The decision to liberalize trade is not simply a technocratic one but also reflects the balance of political power between the gainers and the losers from reform. Research on the politics of trade reform has been an active area, tracing back levels of protection to their more fundamental determinants. These include the incentives of those affected by trade policy changes to form lobby groups to influence policy, and the susceptibility of governments to the influence of these lobbies.<sup>14</sup> Cross-country and cross-industry studies of industrial and developing countries have found evidence that industries in decline, industries that are highly unionized, and industries that make substantial campaign contributions all tend to be rewarded with higher tariff protection.<sup>15</sup> A variety of political institutions influence the ability of those affected by trade policy to form coalitions to lobby governments. In a federal state such as Mexico, for example, trade policy legislation required broad regional support in the 1980s. As a result industries that were more geographically dispersed were more successful in obtaining tariff protection than those that were concentrated in particular regions.<sup>16</sup> More broadly, institutions that hold politicians accountable for their actions can help reduce special interest influence in trade policy.<sup>17</sup>

A particularly important institution that influences the domestic and international politics of trade policy is the World Trade Organization (WTO). The essence of the WTO is an agreement to subject bilateral negotiations over trade policy to a set of multilaterally agreed rules. These rules have evolved over time and have become increasingly complex. But they are based on two closely related basic principles: *reciprocity*, meaning that countries' reductions in tariffs are expected to be met by equivalent reductions in tariffs by other countries, and *nondiscrimination*, meaning that countries must offer the same tariffs to all members. Recent thinking on the role of the WTO reveals two important functions that this institution provides.<sup>18</sup>

The first function is helping countries commit to trade policy reforms that they might otherwise be tempted to reverse. For example, if formerly protected industries fail to make necessary efficiency-enhancing adjustments to free trade, then governments become vulnerable to political pressures to restore the trade barriers they had previously removed. Since WTO rules allow for costly retaliation by trading partners if tariff

## Box 5.2 Packaging trade reforms

In the 1980s many developing countries turned their backs on import-substitution policies that protected domestic industries with high tariff barriers and began to liberalize trade. A lesson that emerged from this wave of trade reforms is the importance of "packaging" trade reforms to make them politically more palatable.

A widely cited study of trade liberalization episodes in developing countries identified 13 cases of particularly rapid trade reform in countries as diverse as Chile, Peru, and Turkey. In nearly half these cases, trade reforms were implemented during major macroeconomic crises as part of an overall stabilization package.

During such periods, political considerations driven by the distributional consequences of trade reform were overshadowed by a wider sense that "something needed to be done," providing the necessary political consensus for reforms. Once trade reforms had been given the opportunity to bear fruit, they created a new constituency for free trade that had not existed before. Chile's experience with trade liberalization in the 1980s is a leading example.

Source: Rodrik 1994.

cuts are reversed, governments can strengthen the credibility of their commitment to trade liberalization by subjecting themselves to the rules of this institution. Empirical evidence from the United States suggests that this credibility-enhancing role of the WTO is important.<sup>19</sup>

The second function that the WTO serves is to help create constituencies that provide political support for tariff reductions. In the case of unilateral tariff reductions, generating political support for trade liberalization is difficult since the efficiency gains from freer trade are widely dispersed, while the costs are highly concentrated among firms and workers in protected industries. The advantage of the WTO principle of reciprocity is that domestic tariff cuts that hurt particular protected industries can be "packaged" together with tariff cuts by trading partners, which benefit domestic producers in other industries. This means that the influence of the latter group can serve to counteract the influence of the former (box 5.2).

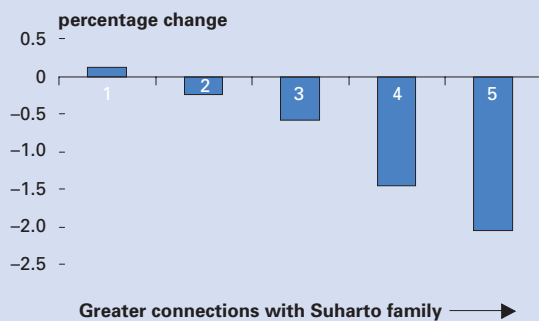
## Corruption

It is now widely accepted that corruption has large costs for economic development. Across countries there is strong evidence that higher levels of corruption are associated with lower growth and lower levels of per capita income.<sup>20</sup> In the context of this Report, corruption can be thought of as a force that undermines well-function-

### Box 5.3 Political connections and firm value in Indonesia

In Indonesia prior to 1998, many firms reputedly benefited from their close connections with the government in power at that time. A recent study examined 79 Indonesian firms with varying degrees of connectedness with the Suharto family and studied how their share prices responded to news about then-President Suharto's health. It found that the share prices of firms that relied more on connections with the Suharto family fell much more sharply than those of other firms in response to news that Suharto's health—and so his influence—were waning (see figure below). Based on this result, the study concluded that as much as one-quarter of the value of politically connected firms was attributable to their connections.

Response of share prices to news of Suharto's health



Source: Fisman forthcoming.

ing markets in three ways: as a tax, as a barrier to entry, and by subverting the legitimacy of the state and its ability to provide institutions that support markets.

Corruption can be seen as a tax, which distorts the choice between activities and lowers the returns to public and private investments. But corruption is much worse than a tax because the revenues do not contribute to the public budget, to be spent on socially useful activities. Moreover, since corruption is illicit, there is much greater uncertainty over this form of “taxation” than conventional forms, rendering the corruption tax even more costly.<sup>21</sup> A study examining the impact of corruption on foreign direct investment found that an increase in corruption comparable to the difference between Singapore (which is widely perceived to have low corruption) and Mexico (which typically ranks around the middle of countries in the world in rankings of corruption perceptions) would have the same negative effect on foreign direct investment as a 50 percentage point increase in marginal tax rates on foreign invest-

ment income.<sup>22</sup> Another study, of manufacturing firms in Uganda, found that a 1 percent increase in bribes paid by a firm was associated with a reduction in firm growth of 3 percent, while a 1 percent increase in taxation reduced firm growth by only about 1 percent.<sup>23</sup> Survey evidence from transition economies suggests that firms would be willing to pay significantly higher formal taxes in exchange for eliminating corruption.<sup>24</sup>

Corruption also undermines the competitive forces that are central to well-functioning markets. A robustly competitive environment depends on the continuous entry of new firms (chapter 7). But when potential new firms must pay bribes at every turn in order to register and begin operations, many will decide simply not to enter, and competition will suffer. Evidence from transition economies indicates that this anticompetitive effect of corruption is important and that small firms and new entrants were significantly more likely to report corruption as an obstacle to business.<sup>25</sup> Corruption is also associated with lower public spending on health and education, which in turn limits opportunities for poor people to invest in their human capital and to participate in markets.<sup>26</sup> This problem is compounded by the fact that across countries, greater corruption is also associated with lower overall tax revenues.<sup>27</sup> At a deeper level, corruption undermines the legitimacy of the state itself and weakens the capacity of the state to provide institutions that support markets. A particularly pernicious form of corruption is “state capture,” the ability of firms to subvert the entire political process to ensure that policies and regulations favorable to their business interests are implemented. This phenomenon has been studied most systematically in the transition economies of Eastern Europe and the former Soviet Union, but close and questionable links between businesses and governments are not unique to this region, nor are they unique to democratic systems.<sup>28</sup> A study of firms in Indonesia with close links to the Suharto regime concluded that one-quarter of the value of these firms was directly attributable to their political connections (box 5.3).

Given the high costs of corruption, research and policy advice have increasingly focused on identifying the root causes of corruption. *World Development Report 1997* emphasized three factors: a distorted policy environment, which creates greater opportunities for public officials to manipulate rules for their own benefit; a weak judiciary that is unable to provide a credible threat of punishment when official misconduct is discovered; and poor civil service management and low public sec-

tor pay. Subsequent research has highlighted additional factors contributing to corruption and has provided more evidence on the factors identified in *World Development Report 1997*. These are discussed below.

There is growing evidence that countries that are more *open to international trade* have lower corruption.<sup>29</sup> This may reflect a combination of factors. Greater openness induces more competition (chapters 1 and 7), which in turn lowers rents and lessens opportunities for corruption. Greater openness also improves information flows, which help expose official wrongdoing and also create constituencies in support of anti-corruption activities among trading partners abroad. In addition, countries that are naturally more disposed to trade because of favorable geographic characteristics will invest greater resources in developing institutions that make trade more attractive (see also chapter 1). Finally, there is some emerging evidence that as countries dismantle formal tariff barriers to trade, opportunities for corruption decrease.<sup>30</sup>

The evidence also shows that, controlling for the level of income, a more *complex regulatory environment* breeds corruption (chapters 1 and 7). Studies have found that countries with more elaborate procedures for registering new businesses have higher levels of corruption.<sup>31</sup> This in part reflects the fact that complex regulations increase opportunities for corruption. It may also reflect the fact that corrupt bureaucrats will favor the proliferation of rules and regulations that in turn create further opportunities for corruption.<sup>32</sup> In either case, the more complex the rules, the greater is the likelihood that officials will have discretion in how they are applied, creating opportunities for corruption (box 5.4).

Closely related to this are the effects of *inflation* on corruption. When inflation is high and variable, information about prices is difficult to obtain, creating greater opportunities for corruption in public procurement. Cross-country evidence shows that, controlling for a variety of other factors, corruption is significantly higher in countries where inflation is high and variable.

One area where the evidence is less clear-cut than the findings presented in *World Development Report 1997* is the issue of *public sector pay* and its effects on corruption. There is plenty of anecdotal evidence that the low wages available to civil servants in many developing countries drive them to take bribes in order to supplement their incomes. While at least one study has found systematic cross-country evidence of higher cor-

#### Box 5.4

#### Discretion and truck inspection in Gujarat, India

Inspectors responsible for enforcing restrictions on overloaded trucks in the Indian state of Gujarat were notoriously corrupt. They had considerable discretion over which trucks to stop for inspection. Moreover, since there was no system for reporting to the motor vehicle department the number of trucks found in violation of overloading rules, individual inspectors could negotiate a combination of reported fines and unreported bribes with individual truckers.

In 1998 a program to reduce corruption using information technology was implemented. Individual checkpoints—and their weigh-scales—were connected by computer to central offices, so that information on vehicle weights and collected fines was automatically reported to the motor vehicle department. In addition, inspectors' discretion over which trucks to stop was removed. The combination of these two measures to reduce discretion dramatically reduced opportunities for corruption.

Source: [www1.worldbank.org/publicsector/egov/gujaratcs.htm](http://www1.worldbank.org/publicsector/egov/gujaratcs.htm).

ruption being associated with lower wages in a sample of 28 countries, other studies covering more countries fail to do so.<sup>33</sup> Many of these studies also do not distinguish between countries where petty corruption (which is more likely to be influenced by salaries) and grand corruption (which is less likely to be influenced by salaries) are important.<sup>34</sup>

Careful country-specific analysis is beginning to provide more nuanced evidence on the relative importance of wages and other factors for corruption. For example, a study of procurement contracts in public hospitals in Buenos Aires, Argentina, found that a 10 percent increase in the salary of procurement officers was associated with a 1.2 percent reduction in prices paid for hospital supplies.<sup>35</sup> However, this relationship between pay and performance was apparent only *after* a crackdown on corruption had been in effect for a period of six months. The crackdown itself also had significant effects on procurement prices, initially lowering them by an average of 18 percent—although this effect weakened over time. Interestingly, this particular crackdown achieved significant results without threats of penalties for wrongdoing. Instead, the staff of the health secretary simply collected data on the procurement prices of basic hospital supplies from each hospital and then circulated this information among all hospitals on a regular basis.

Political institutions that restrain politicians from arbitrary actions, and institutions that hold politicians accountable for their actions, can help reduce the opportunities and incentives for corruption. The rest of this section focuses on three such institutions that matter for corruption: the degree of decentralization, electoral rules, and press freedom and civil society. This is not an exhaustive list of political institutions that can affect corruption. Some countries have attempted political reforms as fundamental as redrafting the entire constitution, in part to reduce incentives for corruption (box 5.5). However, systematic evidence on the effects of these three institutions is beginning to emerge.

### *Decentralization and corruption*

Many studies have considered the costs and benefits of decentralization. Advocates of the devolution of political power to lower levels of government point to the possibility of better tailoring of public services to local needs. However, there can also be costs, associated with weaker capacity to provide services on the part of governments at local levels. Similarly, decentralization can in principle either strengthen or weaken opportunities and incentives for corruption. To the extent that decisions on spending are devolved without commensurate responsibilities for revenue collection, public officials at lower levels may face looser budget constraints and hence have greater opportunities to engage in corrupt practices. Incomplete devolution of power to local levels may also result in a proliferation of regulations emanating from different levels of government, with a commensurate increase in opportunities for corruption. On the other hand, to the extent that citizens are more informed about the actions of their leaders at the local level, they may be better able to monitor and influence those in power and demand honest behavior. In addition, greater decentralization of power may encourage competition among jurisdictions to provide a corruption-free environment conducive to business.

A recent study of 55 industrial and developing countries shows that, on average, the greater the share of state and local governments in total public expenditures, the lower the perceptions of corruption.<sup>36</sup> But this result does not imply that decentralization will always reduce incentives for corruption in every country. For decentralization to be effective in meeting local needs, it must include a significant delegation of responsibility to local levels of government. With this responsibility come opportunities for corruption. The in-

### **Box 5.5** **Constitutional reform for anticorruption in Thailand**

In 1997 Thailand adopted a new constitution. One of the three main objectives in redrafting the constitution was to enshrine at the highest level a system to fight corruption and ensure transparent and accountable decisionmaking. The constitution specifies that the government must “adopt and enforce moral and ethical standards in order to prevent misconduct and create efficiency.” It also establishes an ombudsman, a National Counter-Corruption Commission, and a State Audit Commission.

It is still too soon to determine what the eventual impact on corruption of such a fundamental legal reform will be. But there have been some positive indications. In 1999 Thailand’s minister of the interior was successfully prosecuted for corruption. And while there are indications that vote buying and other forms of electoral corruption were widespread during the most recent election, 62 seats were investigated by the National Election Commission and were recontested.

Source: Uwanno 2000.

centives of local government officials to take advantage of these opportunities in turn depend on the extent to which they are held accountable for their actions—by their constituents at the local level, as well as by higher levels of government.

Evidence from a recent study of the decentralization of health and education services in Uganda and the Philippines shows that these channels of accountability need not always work well.<sup>37</sup> Accountability to local electorates depends on the extent to which individuals are informed about local government actions. However, a survey showed that in the Philippines only 1 percent of respondents were able to name their municipal mayor or vice-mayor, while 41 percent of respondents were able to name the national-level vice-president. In addition, respondents indicated that local government officials were the main source of information about local government issues, leading to concerns about the independence of this information source.

### *Electoral rules and corruption*

In democracies, elections serve as an important discipline on public officials. Citizens who are fed up with cronyism and corrupt politicians can express their dissatisfaction at the ballot box. However, the effectiveness of elections as a disciplining device depends on two factors. The first is the extent to which elections are free

and fair. Without this minimum condition, elections cannot serve to discipline politicians and sanction them for corrupt practices. Second, provided that elections are in fact free and fair, there is evidence that the design of electoral rules themselves influence the accountability of individual politicians to their constituents.

Recent research has focused on two dimensions of electoral rules that matter for accountability. The first is the extent to which electoral systems reward or punish individual candidates relative to political parties. When legislatures are selected by proportional representation, with candidates chosen from party lists, voters can vote only against particular parties and not against individuals whom they perceive as corrupt. As a result individual politicians have less reason to fear that they will be punished at the ballot box for engaging in corrupt practices. The second is the extent to which electoral rules create barriers to entry for new political parties. When new parties find it difficult to gain representation in the legislature, it is more difficult for them to challenge corrupt incumbents. One factor determining the ease of entry for new political parties is the number of representatives per electoral district, since it is easier for smaller parties to win seats in districts with multiple representatives.

New empirical research suggests that both these factors are important predictors of corruption across countries. A recent study found that, controlling for a variety of other factors, countries where a greater fraction of legislators are selected from party lists, and where electoral districts have fewer representatives, tend to have more corruption.<sup>38</sup> Moreover, policymakers are aware of these considerations. Although constitutional changes are typically infrequent, when they do occur, there are cases where these considerations are explicitly taken into account. An example is the new Thai constitution (box 5.5).

### *Press freedom and civil society*

Lack of information breeds corruption. When the actions of public officials are not subject to scrutiny by the general public, opportunities for official misconduct become more attractive. The availability of information can be a force for changing behavior in several dimensions. Without information on the prices that are supposed to be charged for public services—such as the provision of tax documents, or permit or registration fees—individuals cannot determine if they are being overcharged. Without information about the details of

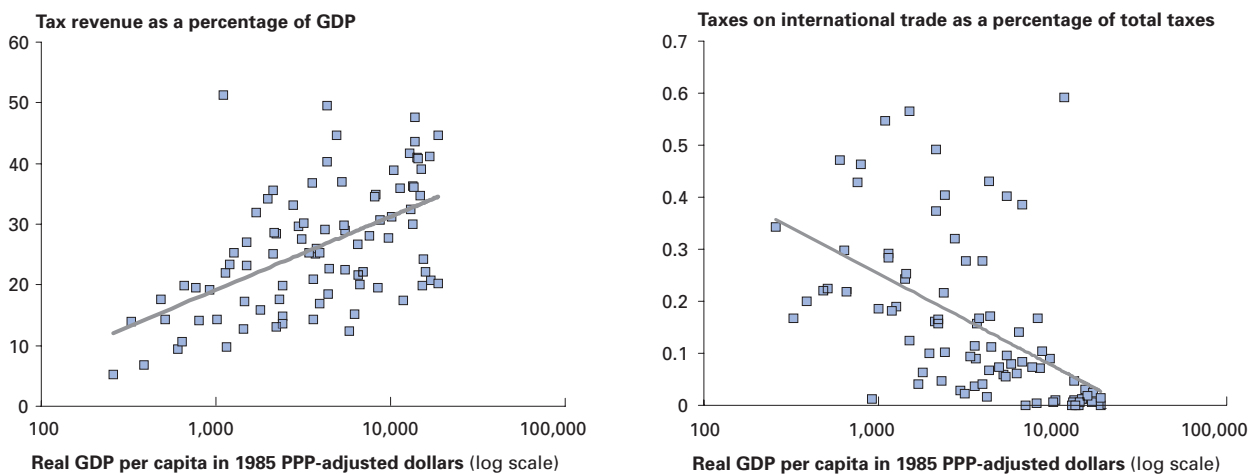
regulations, individuals are vulnerable to bureaucratic harassment and demands for bribes. Without widespread information on the extent of public wrongdoing, the public disgust with corruption that is essential to implementing reforms is slow to form. Policymakers can take actions to provide information on public laws and regulations to those affected by them. Where those affected are not literate, special measures need to be taken to keep them informed of institutions that affect them.

The media can help provide information by vigorous investigation and reporting of allegations of public malfeasance. For the media to be effective in this role, they need to be free from political pressures that prevent investigation and reporting of scandals that would embarrass those in power. Across countries, there is a clear association between indicators of press freedom and absence of corruption. An important factor in this regard is media ownership. When the media are controlled by the state, they are more likely to be subject to political pressures (chapter 10).<sup>39</sup> The quality of media coverage is also likely to be important in determining the extent to which decentralization will lower corruption. When information concerning local government actions is scarce, it is less likely that decentralization will be effective in reducing corruption. In Uganda, for example, one study found that there was significantly less media coverage of local governments than of the national government.<sup>40</sup> At the same time, a study of voting patterns in 14 Indian states found evidence that state governments' performance while in office had a greater influence on their subsequent success in the polls than that of the central government, suggesting that voters were better able to monitor and reward local governments for good performance.<sup>41</sup>

Provision of information to civil society can also help in building institutions that reduce opportunities for corruption. Diagnostic surveys sponsored by the World Bank in several countries in recent years provide an example of this type of institution building. These diagnostic surveys gather information on perceptions of corruption in different public agencies and use this information as a basis for public discussion between government and civil society. One such survey, carried out in the municipality of Campo Elias in Venezuela, identified complex and poorly understood municipal procedures as facilitating corrupt practices (consistent with the cross-country evidence on regulatory complexity and corruption discussed above). In response, ad-

**Figure 5.4****Tax collection around the world**

Revenue effort improves with income and reliance on distortionary taxation falls



Note: PPP stands for purchasing power parity.

Source: International Monetary Fund, Government Finance Statistics.

ministrative procedures were simplified, and several measures were enacted to improve public participation. While it is still too early to determine the long-term effects, immediate results were promising, with follow-up surveys indicating strong improvements in satisfaction with public services.<sup>42</sup>

### Politics, institutions, and taxation

For the state to provide the institutions that support markets, it requires resources. Access to resources in turn depends on the effectiveness of the institutions of taxation. In too many countries around the world, especially poor countries, these institutions do not function adequately. This can readily be seen from the strong negative relationship between average tax revenue as a share of GDP and per capita income, as shown in the left-hand panel of figure 5.4. There is considerable room for debate about the appropriate size of public spending as a share of national income. But when tax collection is abysmally low—for example, dipping below 10 percent of GDP in Peru in the late 1980s—it is clear that the state does not have the resources necessary to build the institutions needed for markets to function effectively.

Weak tax collection institutions undermine well-functioning markets in several ways. When tax administration is weak, governments tend to focus their energies on easily collected taxes, which are often the most

distortionary. A prime example of this is the disproportionate reliance of poor countries on taxes on international trade (shown in the right-hand panel of figure 5.4). This is not uniquely a developing country problem. As recently as the early 20th century trade taxes accounted for half of public revenues in the United States, and before 1870 trade taxes accounted for over 90 percent of U.S. public revenues.<sup>43</sup> Nor is it any accident. International transactions are among the most visible and easiest to tax. But taxes on trade undermine competition by sheltering inefficient domestic producers (chapter 7). And by limiting openness, taxes on trade can also undermine institutional change.

Another consequence of weak tax administration is the disproportionate reliance on tax revenue from large firms, which are more visible and easier to tax (box 5.6). When these firms are also the most dynamic in the economy, the disincentive effects of taxation are particularly costly for smaller firms. High tax burdens, along with harassment by tax officials and unnecessarily high costs of compliance, can contribute to a firm's decision to exit the formal economy, with adverse consequences for competition and the functioning of markets. Weak tax administration may also increase the temptation for governments to rely on inflation taxes as a source of finance. Finally, low tax revenues can encourage governments to tax banks by forcing them to

hold public debt at below-market interest rates, thus undermining the effectiveness of the financial system in supporting markets (chapter 4).

This section focuses on the interplay between politics and the institutions of taxation, using two examples: the experience with autonomous revenue agencies in Latin America, and the incentives for local governments created by intergovernmental tax-sharing arrangements.

### *Autonomous revenue agencies*

The power to tax that is invested in the state is considerable, and so also are the temptations to use these powers to further political ends. Politicians can use tax policies to reward their friends and supporters with exemptions and other loopholes. They can also use the institutions of tax administration to persecute their enemies with repeated audits and harassment by tax inspectors. These actions undermine the effectiveness of tax administration by increasing the complexity of tax laws and encouraging the proliferation of exemptions, loopholes, and regulations. Arbitrary actions also contribute to perceptions of unfairness that feed taxpayer noncompliance.

Recognizing this temptation and its consequences, governments in industrial and developing countries—ranging from Canada and Japan to Mexico and Colombia—have delegated responsibility for tax collection to revenue agencies with varying degrees of autonomy from the rest of the public sector bureaucracy.<sup>44</sup> Two common ingredients of this particular institutional design are greater autonomy from the ministry of finance, especially over personnel decisions, and a budget that is linked to taxes actually collected. The former provides the opportunity to significantly strengthen the human capital of the agency to improve performance. The latter can in principle create incentives for greater revenue effort on the part of the agency. Moreover, to the extent that the establishment of an autonomous agency improves perceptions of the fairness and depoliticization of tax administration, taxpayers' incentives to comply with tax laws may also improve.<sup>45</sup>

However, the potential benefits of agency autonomy have not always been realized. The success of an independent revenue agency in improving tax compliance and tax collection depends to a great extent on the degree of political commitment to its autonomy. The experiences of Bolivia, Mexico, Peru, and Venezuela show that this commitment is not always sustained.<sup>46</sup>

### **Box 5.6**

#### **Business taxation in Uganda**

Tax revenue in Uganda increased from less than 5 percent of GDP in 1986 to more than 11 percent of GDP in 1998. Uganda's experience in raising revenue collection is a cautionary tale about the adverse effects on businesses of sharp increases in revenue collection unsupported by effective tax administration and a widening of the tax base.

Large businesses in the formal sector represent a small share of the economy, but given their visibility they form a large portion of the effective tax base and are taxed more heavily than small firms. Prior to the 1997 tax reform, large firms in the manufacturing sector were subject to high marginal tax rates, combined with a variety of tax holidays that were granted on a fairly arbitrary basis. Firms faced marginal effective tax rates averaging 42.5 percent, if they did not qualify for tax holidays, or 22.3 percent, if they were successful in obtaining tax holidays. Small firms faced only a presumptive tax of 1 percent of their turnover, with an overall marginal effective tax rate of 8.9 percent. The overall high rates of taxation discouraged investment among large firms. As important, the arbitrary nature of the tax holidays contributed to perceptions of unfairness of the tax system, which in turn undermined incentives for compliance. This necessitated a very intrusive and inefficient rate of audits: nearly 70 percent of large firms were audited annually.

The 1997 tax reform abolished new tax holidays, with the result that unified marginal effective tax rates fell to 32.5 percent, and the distortions associated with existing holidays are gradually disappearing as they expire. However, much remains to be done to strengthen revenue administration. Survey evidence from 1997 indicates a very high level of dissatisfaction with the Uganda Revenue Authority. Respondents estimated that fully half of their competitors benefited from tax evasion, often by taking advantage of ad hoc tax holidays permitted by less-than-transparent tax regulations. Tellingly, firms that were successful in obtaining tax holidays were also much less likely to be audited. The proliferation of regulations facilitates arbitrary application of tax laws. Value added tax refunds were also identified as slow: 58 percent of firms that applied for the refunds received either no refund at all or only a partial refund.

*Source:* Chen and Reinikka 1999.

Nominally independent revenue agencies were established in these countries during times of fiscal crisis. In all four countries, noncommodity tax revenues as a share of GDP were very low—less than 10 percent of GDP when their respective autonomous revenue agencies were created. However, the extent of the actual autonomy of the tax collection agency varied considerably. In Bolivia and Mexico, where a tradition of using

public agencies for patronage appointments was entrenched, only limited autonomy over personnel matters was granted to the revenue agencies. Only in Peru was the beginning of the operations of the revenue agency in 1991 accompanied by wholesale personnel reform. In Mexico and Venezuela the autonomy of the revenue agency was undermined by frequent changes in leadership, and in Bolivia the revenue agency survived only two years.

An important reason for the problems with these autonomous agencies was the intragovernmental conflicts that their establishment created. In all four cases, the revenue agencies were carved out of the ministry of finance, with a commensurate decline in the power and prestige of the latter. In the case of Mexico, 36,000 of the finance ministry's 39,000 employees were transferred to the revenue agency. At the same time, the ministries of finance remained to some extent accountable for the tax collection performance of the revenue agency. This combination of accountability without authority, as well as a desire to regain status, led to pressures to restore some of the powers of the revenue agencies to the ministry of finance, thus undoing the initial reforms. The lessons from this experience show that building autonomous revenue agencies requires much more than a simple declaration of autonomy. It requires a strong political commitment, which can be supported by fostering constituencies in the private sector that recognize that competent and fair tax collection is good for business.

#### *Incentives and intergovernmental tax sharing*

Numerous countries—often supported by the World Bank—have taken advantage of the opportunities offered by decentralization to transfer greater responsibility for public service delivery to lower levels of government, which can in principle tailor programs to local needs and tastes. But local governments require financial resources to provide these services. How these expenditures are financed can have important implications for the incentives to collect taxes and to build institutions that support markets.

To realize the full benefits of decentralization, local governments should ideally finance their expenditures with taxes under their control, with most of the cost borne by their local constituencies. In this way, local governments have the power to vary the level of local expenditures to reflect local preferences, and face strong incentives to collect taxes. Local citizens are also able to

see the direct link between the taxes they pay and the services they receive. This can be achieved by directly assigning taxes to local governments or by “piggybacking” schemes in which local governments levy taxes as a proportion of national taxes (as, for example, is the case with provincial income taxes in Canada).

However, this ideal is far from practical in most countries—and especially in many developing countries—for three reasons. First, the revenue raised by the taxes best assigned to local governments (such as property taxes) tends to be modest, resulting in large fiscal gaps for subnational governments. In India, for example, state government spending during the 1990s averaged 46 percent of total government spending, but state government-collected tax revenues represented less than half of state government revenues, with the balance made up by transfers from the central government.<sup>47</sup> Second, when local governments do receive some autonomy over taxation, they may choose not to set rates high enough or may not enforce collection vigorously enough, in the expectation that they will be bailed out of local budgetary shortfalls with grants from the central government. This effect contributed to weak municipal government finances in Hungary in the 1990s and prompted an innovative institutional response to instill fiscal discipline (box 5.7). Third, differences in the revenue-raising capacity of local governments may lead to unacceptable regional differences in public service provision.

In these situations, some form of revenue sharing between levels of government is necessary to supplement local revenues. Central-local transfers can take one of two broad forms: direct grants from higher to lower levels of government, and tax-sharing arrangements whereby tax revenues are collected by one level of government and are then divided according to a prespecified formula, with central control over rates and the sharing formula. Many countries employ both.

Direct grants are often discretionary and can be the subject of protracted annual negotiations between levels of government, undermining overall fiscal discipline. A potential advantage of tax-sharing arrangements is that they rely on prespecified formulas that can ensure greater predictability. In the case of India, for example, the Finance Commission sets tax revenue shares for five-year periods.<sup>48</sup> In Argentina the bulk of tax sharing occurs through a complex “co-participation” scheme. There have been changes in the revenue/tax-sharing arrangements over the past ten years, but they have gen-



erally left transfers quite stable. In fact, this stability makes transfers acceptable as collateral for provincial borrowing. The problem, however, is that the system is overly complex. For example, there is one main revenue-sharing pool plus several other tax-sharing pools. These factors affect the transparency of the system.

A difficulty with both methods of revenue sharing is that they can weaken governments' incentives to invest in tax collection capacity. If direct grants are based on actual revenue shortfalls, local governments have little reason to levy or collect local taxes, since the additional revenue will be offset by a reduction in grants from the center. In contrast, matching grants, which require local governments to commit their own resources to receive transfers, are less likely to have these perverse effects. Similarly, under tax-sharing systems, each level of government has weaker incentives to administer and enforce a shared tax because part of the revenues gained by improved administration must be shared with other levels of government. Each level of government has strong incentives to "free ride" on the others' tax collection efforts. This incentive problem can be mitigated when tax administration is efficient, technocratic, and free from political influences. But when the institutions of tax administration are weak and subject to political manipulation, tax sharing can succumb to these perverse incentives (box 5.8).

The incentive effects of revenue-sharing arrangements go much further than simply the effects on revenue collection discussed above. The design of revenue-sharing arrangements can also have important implications for how subnational levels of government use the economic policies at their disposal to foster market development. China and Russia's experience with intergovernmental fiscal relations illustrates the powerful effects of these incentives. In both China in the 1980s and Russia in the 1990s, substantial authority over local economic policies was delegated to subnational levels of government. Both countries also experienced declines in tax revenues relative to GDP, with a growing share of revenues and expenditures under the control of subnational levels of government.

Tax-sharing arrangements have had important incentive effects in both countries. In Russia a Law on Basic Principles of Taxation, specifying the assignment of taxes to different levels of government, was passed in 1991 but was not implemented consistently. In practice, the authority of different levels of government to levy taxes, and the rates at which revenues from shared

### Box 5.7

#### Market discipline versus state discipline: municipal bankruptcy in Hungary

In 1996 Hungary adopted a law that established bankruptcy procedures for municipal governments. The objective of the law was to prevent municipalities from defaulting on their debt obligations by providing a clear set of rules to be followed in cases of financial distress. If a municipality falls behind in its debt service or other obligations, bankruptcy proceedings can be initiated either by creditors or by the municipality itself. The municipality then formulates an emergency budget covering mandated public services. It is prohibited from issuing new debt while it enters into negotiations with creditors. If all parties can reach a compromise debt workout agreement, it is implemented. If not, the case is turned over to the court system, which enjoys a constitutional guarantee of independence. The courts can then order liquidations of municipal assets to pay off creditors.

Since 1996 there have been nine cases of municipal bankruptcy, seven of which were resolved during 2000. Importantly, the central government has not provided financial assistance to any of the municipalities involved. This experience has served to strengthen the credibility of the central government's commitment not to bail out municipalities in financial distress. This in turn has helped to harden municipalities' budget constraints, as municipalities now face "market discipline" from their creditors, as well as "state discipline" in the form of monitoring and supervision by the central government. It is too soon to determine the ultimate effect of this institutional innovation. However, the fact that municipal debt service obligations are now well below centrally mandated ceilings is a promising sign.

Source: Wetzel and Papp 2001.

taxes were divided, were subject to continuous renegotiation, with the outcome reflecting shifting balances of political power.<sup>49</sup> Lower levels of governments that succeeded in raising local tax revenues often saw commensurate reductions in tax-sharing payments from higher levels. One study found that for some Russian cities, this reduction was almost exactly one for one.<sup>50</sup> The same study found that the extent to which local governments had control over incremental tax revenues mattered for local economic activity. The more that a city's incremental tax revenues were eroded by reduced transfers, the lower the rate of new business formation.

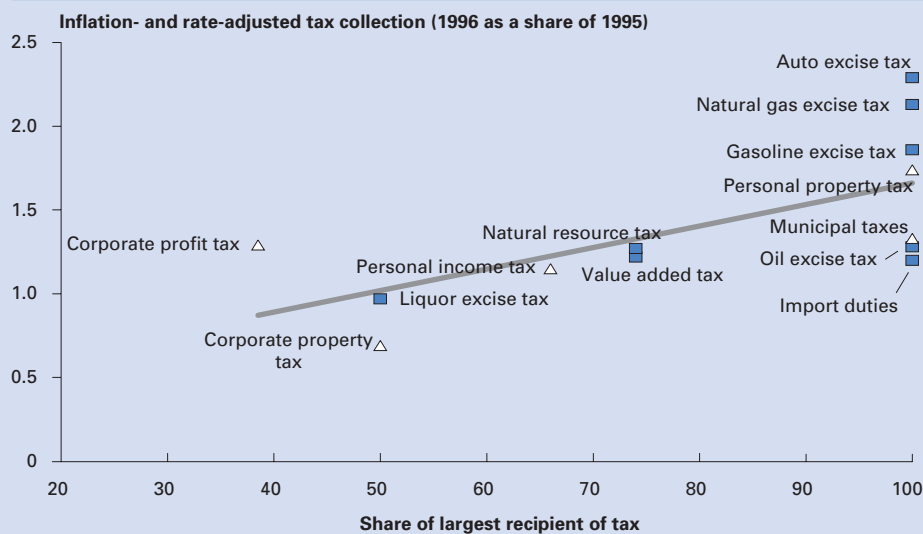
In China in the 1980s the central government set rates and defined the base for many taxes, but tax collection was delegated to provincial governments. Tax revenues were shared according to a "tax contracting"

**Box 5.8****Tax sharing with weak tax administration: the case of Russia**

The case of Russia in the 1990s provides a vivid illustration of the perverse incentives created by tax sharing when tax administration is weak. In the 1990s Russia experienced a sharp decline in tax revenues, with federal tax revenues collapsing from 18 percent of GDP in 1992 to 10 percent of GDP in 1997. A portion of this decline can be attributed to the overall poor performance of the Russian economy during this period and to declines in several key tax rates. Another factor was a decline in the effectiveness of tax administration, driven by competition between different levels of government. While in principle tax collection in Russia was a federal responsibility carried out by the State Tax Service, in practice local branches of this agency were heavily influenced by local governments. Local governments in turn tried to protect firms located in their jurisdictions from having to pay taxes to the federal government or simply lobbied for general tax relief for local firms, thus subverting tax administration. For example, firms would agree to pay their tax obligations "in kind" to local governments by providing goods or public services directly, so that cash payments that needed to be shared with higher levels of government were avoided. Another example was the vigorous and successful lobbying of the federal government for a reduction in the tax arrears of the truck manufacturer Kamaz undertaken by the president of Tatarstan, where Kamaz was located.

The federal government would also attempt to enforce collections at the expense of the local governments, again subverting tax administration. When the automobile manufacturer Avtovaz was threatened by bankruptcy proceedings by the federal government due to mounting tax arrears, it eventually came to an agreement to pay current taxes only to the federal government, with no mention of its delinquent obligations to the local government. More generally, all levels of government had weaker incentives to collect shared taxes precisely because a portion had to be shared with other levels.

The figure below illustrates more systematically the adverse consequences of this competition over tax revenues. While the effectiveness of tax collection in 1996 relative to 1995 (measured as the ratio of actual collections in the two years, adjusted for inflation and changes in rates) increased for almost all taxes, the increase was most pronounced for those taxes that were subject to the least revenue sharing. This case illustrates the importance of a competent and autonomous tax administration for limiting competition over tax revenues between levels of government that can subvert the entire process of tax collection. Wide-ranging reforms in the tax system since 1998 have reduced the complexity of the Russian tax system and have increased the transparency of revenue-sharing arrangements, representing important progress.

**Shared taxes were less effectively collected in Russia**

Note: Higher values on the vertical axis indicate improved tax collection effort.

Source: Treisman 1999.

system. Between 1985 and 1988 these contracts allowed provinces that ran deficits to retain a greater share of revenues, and provinces that ran surpluses a lower share. This weakened incentives to collect taxes, and revenue growth slowed in the richest provinces.

In response, between 1988 and 1993 the system was changed to give provincial governments greater claims over incremental tax revenues. For some provinces this amounted to an agreement to deliver a fixed sum to the center, with any additional revenues accruing to the

province.<sup>51</sup> Throughout this period local governments also increasingly relied on “extrabudgetary revenues”—consisting of a range of locally collected fees and levies, as well as profits from state-owned enterprises under local government control—that were not subject to sharing with the center to finance local expenditures. This strengthened local governments’ incentives to improve tax collection effort and to encourage local economic growth to expand the local tax base. A study found that during 1982 and 1991 the provincial budgetary revenues and expenditures were highly correlated (correlation coefficient 0.75); for extrabudgetary revenue and expenditure, the relationship was almost one for one.<sup>52</sup> The same study found that an increase in the marginal fiscal retention rate of 10 percent in a province was associated with a one percent increase in the growth rate of employment of nonstate enterprises in that province.

But even if tax-sharing arrangements create incentives for local governments to support market development, there are risks that local governments will do so in inefficient or anticompetitive ways. In China in the 1980s, for example, many provincial governments erected barriers to interprovincial trade to develop a wide range of manufacturing industries locally, rather than allow specialization in industries compatible with local comparative advantage.<sup>53</sup> Increased reliance on extrabudgetary funds reduced fiscal accountability and limited the central government’s capacity for macroeconomic management. And differences in economic performance across provinces led to large differences in the level of provincial government expenditures per capita. In Russia one of the most dramatic manifestations of these risks was the high degree of tax competition between regions, which encouraged firms to shift accounting profits from one jurisdiction to the next in search of the most favorable tax treatment, all the while shrinking the overall tax base.<sup>54</sup>

In this environment, mechanisms of central government control are required to ensure healthy interjurisdictional competition. One important mechanism is the availability of information, since central governments need information on subnational governments’ policy action to exert necessary control. This points to the importance of transparency in subnational government finances and policymaking. To this end China’s fiscal reforms since the mid-1990s have emphasized increased accountability for extrabudgetary funds and a stronger central government share in revenues.

Another mechanism to limit local policymaking that conflicts with national interests are the incentives created by the political system for local government leaders. In many democracies, strong national political parties can use ties of party loyalty and party discipline to limit excesses in local policies. The absence of such strong national parties contributed to harmful interregional competition in Russia during the 1990s. As the Soviet Union disintegrated, there was a surge in regional political autonomy. Newly elected regional and local government officials no longer owed their allegiance to Moscow but rather to their local constituencies. This encouraged the pursuit of policies that benefited local interests at the expense of national interests. In China one mechanism of central government control over provincial policymaking was the center’s influence over senior provincial-level appointments.<sup>55</sup> A study of these appointments found evidence that the exercise of this central control strengthened during the 1980s and 1990s, even as more and more economic powers were being delegated to lower levels of government.<sup>56</sup> One way in which this was done was to encourage rotations of senior officials from one province to another to prevent local officials from becoming too associated with local interests.

These experiences illustrate a broader principle relevant to other countries where economic power is shared between different levels of government: local government interests need not coincide with national interests. The design of intergovernmental relations needs to involve mechanisms of accountability to the center to ensure that the benefits of interjurisdictional competition are realized.

## Conclusions

The ability of the state to provide those institutions that support growth and poverty reduction—often referred to as good governance—is essential to development. Countries that have failed in this respect have seen incomes stagnate and poverty persist. This chapter emphasizes the importance of political institutions in creating incentives for governments to provide good governance. Political institutions such as constitutional rules, the division of power among levels of government, independent agencies, mechanisms for citizens to monitor public behavior, and rules that inhibit corruption all succeed in restraining officials of the state from arbitrary action, and good governance will likely take root.

There is no blueprint for change in political institutions to support good governance. Political and social forces can push countries in diverse directions. But the nature of political institutions and the interaction of public officials with their constituencies dictate the type of policy advice most effective in a given country and affect the policies adopted. In designing particular government structures, it is critical to consider the incentives facing public officials in a particular country. Institutions can affect these incentives by helping to monitor the behavior of public officials. Institutions affect how responsive governments are to a broad spectrum of citizens in society, and how responsive they are to social and economic concerns. They do so by providing information, increasing competition, and clarifying and enforcing rights among different government agencies and between the state and the governed. This needs to be kept in mind when building particular structures. For example, the current popularity of policies such as greater decentralization, or greater formal autonomy for regulatory or revenue agencies, needs to

be tempered with the realization that the success of these innovations depends heavily on complementary political and social institutions. If governments lack the broader checks and balances that would keep them from intervening in independent agencies, these agencies will be independent in name only. If political institutions that align local government incentives with national interests are absent, and if local governments are no more accountable to their constituents than central governments, the benefits of decentralization may not be fully realized. Further, local capacity and general literacy levels may hinder the types of activities that can be effectively decentralized.

A degree of experimentation and competition can help identify effective political institutions both at the broader regional level and at local levels. Open information sharing, public debate, and information flows among regions and between public and private actors can facilitate this process. It can affect public officials' incentives and can also create pressures for change.