

# 1 Government Failure

Why should we worry about government failures?

- Direct Costs

  - Loss in revenue

  - Limits to public action

    - undermines service delivery

    - limits redistribution to the poor

    - Frustrates regulation

- Indirect Costs

  - Red-tape

  - Rent-seeking

## 1.1 Evidence of corruption

- Mauro (1995) was first to use Business International data to look at corruption
- BI is a commercial firm that uses its experts to grade countries on corruption, bureaucratic efficiency, red-tape etc.
- The corruption question was "the degree to which business transactions involve corruption or questionable payments".
- What are problems with such indices?
- Finds that corruption varies enormously across countries and that it is positively correlated with underdevelopment.

- Concludes that one standard deviation increase in Bureaucratic Efficiency would increase growth rate by 0.5 percentage points.

### **1.1.1 Education grants in Uganda (Reinikka-Svensson)**

- In the 1991-95 period, the central Ugandan government spend on education in three ways:

1. Salary payments to teachers
2. Capitation grants for school inputs
3. Building Rehab expenditures

- The latter two were channeled through the Ministry of Local Government, district offices
- 23% of total government spending on primary education were the capitation grants

- 20% of salaries in 1993 were paid to "ghost" teachers
- Data from a survey of 250 government schools (out of about 8500 funded schools) carried out in 1996, covering the 1991-95 period.

Asked about the amount of capitation grants they received. They think that this was reported accurately, since there is no one outside who sees it.

Records in the Uganda Computer Center, based on issued cheques show the amount sent from the center

The district records of the amount received matches up with the amount sent.

- On average schools get 13% of the money sent. The rest is allocated by the district office to other things (it is suspected that it goes to patronage or is just stolen, but we do not observe this).

### 1.1.2 Political Connections in Indonesia (Fisman, 2001)

- As Suharto's health declined over the 1995-97 period there were frequent rumors about the possibility of his death. Fisman identifies 6 such episodes.
- Fisman runs a regression of the form

$$R_{it} = \beta_0 + \beta_1 \text{PoliticalconnectionswithSuharto}_i + \varepsilon_{it}$$

where *PoliticalconnectionswithSuharto* of firm *i* is measured on 1-5 scale by first identifying the business group it belongs to and then how close this group is to Suharto (his children run two groups, and so do his closest friends) and  $R_{it}$  is the return on firm *i*'s equity for the episode *t*.

- To get a better sense of the magnitude, he used the return on the Jakarta stock exchange net of broader South-east Asian effects ( $NR$ ) in these episodes instead of the episode identifier to get

$$R_{it} = \beta_0 + \beta_1 \text{PoliticalconnectionswithSuharto}_i + \beta_2 NR_t + \beta_3 \text{PoliticalconnectionswithSuharto}_i \cdot NR_t +$$

- As predicted the bad news about Suharto hurts connected companies more. A company that is 1 unit more connected loses 0.28% more when the market drops by 1 percentage points.
- No differential reaction for connected firms when the stock market drops for other kinds of reasons (the 1997 crisis).

### 1.1.3 Cheating on trade taxes (Fisman-Wei)

- Uses the difference between Hong Kong's reported exports to China and China's reported imports from Hong Kong to measure smuggling.
- One way smuggling happens is by under-reporting imports.
- Also by misclassifying goods within the same basic category.
- The incentive to do this comes from differential tax rates on imports.
- On average the export-import gap is negative for low tariffs and positive for high tariffs, within each 4 digit category of goods.

- Moreover for low tax goods, the gap is negative for those goods within the 4 digit category that face lower tariffs and positive for those that face high tariffs. Looks like misclassification
- For high tax goods both low and high tariff goods have a positive gap: suggests imports are under-reported.
- Overall a 1% increase in tariffs reduces reported imports of that good by 3%.
- When the tariff on similar goods goes up, the gap goes down, as a misclassification view would suggest.

## 1.2 Theorizing government failures

The government is an organization. What makes it special as an organization?

- The government is big and therefore society's expectations about it affects how people behave: As a result it is easy to get stuck in a bad equilibrium.
- The government has a monopoly over state power which is abused by those who control the government: This raises the question of why is this abuse is tolerated by the people—perhaps because the imperfections of the political control mechanism.
- The government is run by ideologues because the political process favors ideologues and ideologues take decisions that do not make economic sense.

- The government does things that other organizations do not try. These are harder and hence organizational performance suffers.
- Rules in government have a different legal status
- The government tries to keep too many people happy

## **1.3 Understanding specific government failures**

- Corruption:

Easy to get rid of corruption

Why is it still there?

- Red-tape

Is it always easy to get rid of it?

Who is in favor of it?

- Misallocation

Who is in favor of it?

Why is it costly to eliminate it?

## **1.4 An experimental study of corruption, red tape and allocative efficiency (Bertrand, Djankov, Hanna, Mullainathan)**

- A study of how to get a driving license in Delhi.
- 822 people who had showed up for licenses were recruited by IFC.

- 3 groups:

group 1 was offered Rs. 2000 (one third of the monthly wage in the sample) to get a license in 31 days (30 days is the legal minimum from the day of first application).

group 2 was offered upto 15 free driving lessons before they take the driving test.

group 3 was the control

All 3 groups were paid Rs. 800 for completing the survey

Everyone was given a surprise driving test at the end.

- Did the incentive work? (Table 4)

Group 1 applicants were 80% more likely to have got their license by the end of the study.

Group 1 got their licenses in 31 days, as against 48 days for the comparison group.

The incentive worked.

- Did the lesson work?

60% take up rate.

Group 2 applicants were 22% more likely to get a license than group 3, but it took them 5 days longer.

- How much did they spend? (table 7)

Group 1 and Group 3 both spent slightly above Rs. 1100 to get a license. Group 2 spent about Rs. 200 less.

The official charge is Rs 450. The rest was paid to an agent who "helps" getting a license. No direct bribes.

- Had they learnt driving (table 4)

Group 1 is almost 60% more likely than group 3 to say no one taught me driving

Group 2 is about the same amount less likely.

- Can they drive (table 4)

Group 3 is almost 75% more likely to say that they are not confident with driving

Between 60 and 70% of groups 1 and 3 automatically failed the surprise driving test (they did something egregiously wrong)

Only 10% of group 2 automatically failed.

Group 2 were almost 60% more likely to have taken the licensing authority's driving test (table 8)

- Does knowing to drive help them pass the test (table 6)

67% of those who take the test in all three groups succeed when they take the test

35% of the control, 43% of the bonus and only 12% of the lesson group automatically failed surprise test, conditional on having taken the test.

- How were the bribes paid?

The role of agents

The constraints on agents.

- What does this tell us about corruption?