

Public Administration and Institutions in Latin America Alternative View Paper

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1. Introduction

The paper by Susan Rose-Ackerman is a *tour de force*. It contains a comprehensive survey of the literature and a careful description of the main challenges for institutional reform in Latin America. Since the Solution Paper (SP) is so comprehensive, it is almost impossible to focus on something that was not already mentioned in the SP and to prepare an alternative view paper highlighting the weaknesses of the SP.

An easy but, in my view, unfair way to criticize the SP would be to say that the discussion of solutions to the challenge is short and lacks a detailed cost and benefit analysis. This would be unfair because the challenge that Susan Rose-Ackerman was faced with was almost mission impossible. In fact, I can think of five types of challenges for a project like the Copenhagen Consensus. There are challenges for which we know the solution and for which we also know how to estimate the costs and benefits of the solution (think about preventing the spread of a disease for which there is a known vaccine). There are also challenges for which we do not know the exact solution but for which we have an idea of what may work well and, if we knew the solution, it would be easy to estimate its costs and the benefits (think about preventing the spread of a disease for which we still do not have a vaccine). There are also challenges for which we know the solution but for which we do not have a clear idea of the costs and benefits (for instance, reducing inflation). Next, there are challenges for which we do not know the solution and have no idea about the costs and benefits of such a solution (for instance, preventing earthquakes). Finally, there are challenges for which we do not know the solution, we have no ideas about the costs and benefits, and we even have problems in defining and measuring the challenge (how do we measure institutions?). This is the type of challenge Susan Rose-Ackerman had to deal with. Criticizing her SP for not providing a detailed set of solutions with a cost benefit analysis would be tantamount to Monday-morning quarterbacking.

Moreover, Susan Rose-Ackerman correctly makes the point that the quest for blueprints is not likely to bear any fruits for at least two reasons. First, Latin American countries are facing different constraints. For some, the most pressing need might be a tax reform; for others the most pressing need is a judicial reform or a custom reform. Second, blueprints may not work even for countries that have problems in the same area. A given solution may work well in one country but may not be appropriate in another.

There are three plus two fundamental areas of intervention for improving the quality of a country's public sector. The first consists of keeping the rules as simple as possible and eliminating unnecessary red-tape. The second has to do with providing

* All the opinions expressed in this paper are my own and should not be attributed to any organization I am or have been affiliated with. I would like to thank Mandana Hajj, Monica Yañez, and Francesca Recanatini for helpful suggestions and discussion. The usual caveats apply.

civil servants with the incentives to be efficient, honest, and hard-working. The third has to do with providing civil servants with the tools, organizational set-up, and continuous training necessary to perform their job.

Of course, there are close interactions among these three areas of intervention. On the one hand, lack of a proper work environment and the presence of Byzantine rules are likely to have a negative effect on the incentives of civil servants. On the other hand, providing dishonest civil servants who lack motivations and initiative with lots of resources might be a waste of money, at best, and counterproductive at worst.

Even assuming that we know how to deal with the three issues outlined above, nothing will happen if politicians do not have the incentives to improve public administration. Hence, the fourth area of intervention has to do with politics.

Finally, reformers need to recognize that improving institutional quality is a dynamic process. As there are no blueprints, each country needs to find its own way to implement institutional reforms and these reforms need to be subject to constant evaluation. Constant evaluation and monitoring is the fifth necessary element of any policy aimed at improving institutional quality.

As it is almost impossible to find a crucial point that was not mentioned in the SP, I will use my alternative view paper to highlight a few points that were mentioned in the SP but, in my opinion, not emphasized enough. The main point that I want to make is that incentive problems dominate everything else and that providing the right incentives is not necessarily costly.¹ This point is illustrated by the fact that when we look across countries we find almost no correlation between the amount spent in maintaining the public administration and the efficiency of the public administration. This suggests that most countries are far from the efficiency frontier and that things can be improved at no cost.

The paper is organized as follows. In Section 2, I provide evidence of the lack of correlation between public expenditure and quality of government, and conduct back-of-the-envelope estimates of possible benefits of improving public administration. In this section, I also make the point that low public sector wages are not the problem (again, this is discussed in the SP but, in my view, not emphasized enough) and that high public sector wages may even be a symptom of the problem. In Section 3, I briefly discuss reforms aimed at providing politicians with the incentives to improve the public sector. This is probably the only important topic not covered in the SP. In Section 4, I highlight the role of transparency and free press and discuss a "crazy" proposal for increasing the monitoring role of the press. Section 5 concludes.

2. Money Can't Buy You a Good Public Administration

This section discusses the relationship between institutional quality and public expenditure. The main point of the section is that increasing public expenditure is not an efficient way to improve government quality.

I focus on three measures of institutional quality: Government Effectiveness, Control of Corruption, and Rule of Law. All measures are from Kaufman et al. (2006), and are expressed as averages for the 1996-2005 period (Table 1 reports these indicators rescaled to take values between 0 and 100).

I also use three measures of public expenditure all expressed in USD per capita and averaged for the 1995-2004 period. The first (GEGS) is central government

¹ This perception might be wrong and due to the fact that my formal training was in economics and "Most of economics can be summarized in four words: 'People respond to incentives.' The rest is commentary." (Landsburg, 1995)

expenditure in public services minus public debt transactions (mostly interest payments) and transfers between levels of government.² In theory, GEGS should capture the cost of running the government. However, countries might not be consistent in classifying public expenditure. Therefore, I also use primary expenditure (PRIEXP) which is a more comprehensive measure of public expenditure. The third measure of public expenditure is expenditure for public order and safety (L&O EXP). This should be a good proxy of the cost of maintaining the Rule of Law. For all three variables, I use both data in current dollars and in purchasing power parity (PPP) adjusted dollars (Table 2).

Table 1: Governance Indicators

| | Levels | | | Residuals | | |
|----------------------|--------------------------|-----------------------|-------------|--------------------------|-----------------------|-------------|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| | Government Effectiveness | Control of Corruption | Rule of Law | Government Effectiveness | Control of Corruption | Rule of Law |
| ARG | 53 | 41 | 49 | 37 | 30 | 31 |
| BHS | 85 | 90 | 91 | 80 | 76 | 76 |
| BOL | 44 | 30 | 42 | 60 | 46 | 56 |
| BRA | 55 | 53 | 50 | 56 | 65 | 56 |
| CHL | 92 | 100 | 94 | 100 | 100 | 100 |
| COL | 51 | 40 | 38 | 56 | 54 | 41 |
| CRI | 70 | 79 | 78 | 71 | 79 | 78 |
| DOM | 43 | 39 | 46 | 38 | 43 | 41 |
| ECU | 31 | 26 | 39 | 38 | 46 | 53 |
| GTM | 39 | 28 | 33 | 39 | 39 | 33 |
| GUY | 49 | 41 | 48 | 63 | 52 | 52 |
| HND | 40 | 29 | 35 | 56 | 45 | 44 |
| HTI | 14 | 11 | 15 | 20 | 29 | 17 |
| JAM | 52 | 41 | 47 | 55 | 46 | 41 |
| MEX | 60 | 44 | 48 | 57 | 45 | 41 |
| NIC | 37 | 37 | 37 | 46 | 52 | 44 |
| PAN | 55 | 45 | 57 | 64 | 54 | 63 |
| PER | 46 | 46 | 42 | 53 | 61 | 49 |
| PRY | 26 | 19 | 31 | 21 | 22 | 24 |
| SLV | 49 | 41 | 46 | 56 | 52 | 48 |
| TTO | 70 | 58 | 64 | 69 | 58 | 54 |
| URY | 71 | 76 | 72 | 70 | 71 | 66 |
| VEN | 30 | 25 | 30 | 25 | 36 | 29 |
| Latin America | | | | | | |
| Mean | 51 | 46 | 50 | 53 | 52 | 49 |
| St. Dev | 18 | 22 | 19 | 19 | 18 | 17 |

The level data were computed as averages of the 1996, 1998, 2000, 2002, 2003, 2004, and 2005 data on Government Effectiveness, Control of Corruption and Rule of Law indicators compiled by Kaufman et al. (2005). The averages were then rescaled to range between 0 and 100 (the higher the value the better the governance indicator). The Residuals data were computed as the residuals of an OLS regression of the level data over the log of GDP per capita (measured in PPP), latitude, legal origin, ethno-linguistic fractionalization, log country area, log population, and a Latin American dummy.

As a first way of looking at the relationship between expenditure and institutional quality, I regress institutional quality over public expenditure controlling

² All data are from the IMF Government Finance Statistics. I use data from the central government because data for other levels of government are often not available.

for GDP per capita measured in PPP.³ I focus on a sample that includes all developing countries for which I have data and on a sub-sample of Latin American countries.

Table 2: Public Expenditure per capita

| | Current Dollars | | | PPP Dollars | | |
|---------------------------------|-----------------|---------|---------|-------------|---------|---------|
| | GEGS | PRIEXP | L&O EXP | GEGS | PRIEXP | L&O EXP |
| ARG | 96.29 | 891.50 | 36.45 | 157.49 | 1568.88 | 68.60 |
| BOL | 21.50 | 214.69 | 17.04 | 52.02 | 530.45 | 42.00 |
| BRA | 148.73 | 846.97 | 28.11 | 219.39 | 1257.90 | 41.57 |
| CHL | 41.06 | 983.57 | 58.50 | 77.92 | 1868.45 | 111.71 |
| COL | | 476.46 | | | 1518.70 | |
| CRI | 43.98 | 722.26 | 54.34 | 89.88 | 1492.94 | 111.82 |
| DOM | 29.13 | 303.01 | 13.04 | 84.09 | 895.10 | 38.70 |
| JAM | 239.45 | 667.21 | 62.13 | 306.94 | 851.57 | 78.67 |
| MEX | 122.97 | 532.11 | 11.81 | 215.97 | 945.79 | 20.39 |
| NIC | 15.70 | 148.78 | 10.34 | 64.79 | 620.66 | 42.68 |
| PAN | 72.08 | 748.35 | 67.96 | 109.51 | 1138.51 | 103.39 |
| PER | | 344.48 | | | 742.34 | |
| SLV | 11.52 | 156.99 | 25.05 | 25.52 | 347.72 | 55.54 |
| TTO | 262.59 | 1283.68 | 97.56 | 365.54 | 1827.76 | 134.56 |
| URY | 134.63 | 1581.82 | 58.84 | 179.83 | 2233.77 | 79.59 |
| VEN | 276.17 | 679.30 | 35.00 | 374.93 | 981.56 | 47.51 |
| Latin America | | | | | | |
| Mean | 108.27 | 661.32 | 41.16 | 165.99 | 1176.38 | 69.77 |
| St. Dev. | 93.47 | 402.80 | 26.02 | 116.14 | 534.02 | 34.46 |
| Min. | 11.52 | 148.78 | 10.34 | 25.52 | 347.72 | 20.39 |
| Max | 276.17 | 1581.82 | 97.56 | 374.93 | 2233.77 | 134.56 |
| All Developing Countries | | | | | | |
| Mean | 83.22 | 561.25 | 38.83 | 181.93 | 1297.56 | 87.37 |
| St. Dev. | 71.44 | 498.09 | 32.96 | 123.76 | 1079.90 | 70.30 |
| Min. | 1.52 | 28.60 | 1.35 | 12.57 | 122.59 | 5.22 |
| Max | 276.17 | 1788.89 | 137.40 | 513.55 | 4488.82 | 293.53 |

All data are from the IMF Government Finance Statistics and are computed as averages for the 1995-2004 period. GEGS is computed by subtracting lines 7017 and 7018 from line 701. Primary expenditure is line 2 minus line 24, Law and Order is line 703. The PPP adjustment is from the World Bank's World Development Indicators.

When the dependent variable is Government Effectiveness or Control of Corruption (Panels A and B of Table 3), I measure expenditure using both GEGS and primary expenditure. When I focus on Rule of Law (Panel C), I use expenditure for public order and safety. The regressions indicate that GEGS has no significant effect on institutional quality, while primary expenditure has a statistically significant effect on government effectiveness and control of corruption. This is surprising because GEGS should be a better measure of the cost of running the government. The results might be driven by the fact that countries do not classify public expenditure in a homogenous way. I also find that expenditure for public order and safety has a statistically significant effect on Rule of Law. These results hold for both the sample that includes all developing countries and for the Latin American sub-sample.

³ I control for GDP per capita because richer countries are likely to spend more for running the government (because real wages tend to be higher) and are also likely to have better working governments. Of course, GDP per capita is endogenous with respect to institutional quality but I have no way to deal with this issue.

Although the coefficients are statistically significant, the economic impact is small. For instance, Panel A shows that a ten-point increase in government effectiveness would require an increase in PPP-adjusted per capita primary expenditure ranging between \$700 and \$2500.⁴ Panel B suggests that a ten-point increase in control of corruption would require an increase in PPP-adjusted per capita primary expenditure ranging between \$400 and \$1200. Rule of Law seems to be cheaper. Column 4 of Panel C suggests that a ten-point increase in Rule of Law would require an increase in PPP-adjusted per capita expenditure in public order and safety ranging between \$33 and \$120.

Table 3: Institutional Quality and Public Expenditure

| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
|------------------------------------|---------------------|--------------------|---------------------|--------------------|--------------------|-------------------|---------------------|-------------------|
| A: Government Effectiveness | | | | | | | | |
| GEGS | 0.003 (0.07) | -0.032 (0.64) | | | | | | |
| GEGS_PPP | | | 0.006 (0.27) | -0.031 (0.77) | | | | |
| PRIM_EXP | | | | | 0.012 (3.04)*** | 0.013 (2.26)** | | |
| PRIM_EXP_PPP | | | | | | | 0.004 (2.08)** | 0.014 (1.98)* |
| GDP_PC | 15.799 (5.79)*** | 22.052 (2.51)** | 15.362 (5.16)*** | 22.622 (2.52)** | 9.450 (3.31)*** | 9.853 (1.49) | 11.054 (3.68)*** | 3.870 (0.56) |
| Constant | -79.16 (3.91)*** | -132.26 (1.83)* | -76.39 (3.53)*** | -135.48 (1.85)* | -34.33 (1.60) | -39.791 (0.73) | -46.36 (2.07)** | 3.38 (0.06) |
| Observations | 52 | 14 | 52 | 14 | 59 | 17 | 59 | 17 |
| R-squared | 0.57 | 0.39 | 0.58 | 0.40 | 0.61 | 0.40 | 0.60 | 0.45 |
| B: Control of Corruption | | | | | | | | |
| GEGS | 0.007 (0.17) | -0.060 (1.17) | | | | | | |
| GEGS_PPP | | | 0.005 (0.17) | -0.056 (1.36) | | | | |
| PRIM_EXP | | | | | 0.021 (3.92)*** | 0.020 (2.73)** | | |
| PRIM_EXP_PPP | | | | | | | 0.007 (2.90)*** | 0.024 (2.90)** |
| GDP_PC | 14.094 (3.94)*** | 27.729 (2.26)** | 13.963 (3.24)*** | 28.660 (2.30)** | 4.339 (1.25) | 10.755 (1.00) | 7.668 (2.13)** | -0.065 (0.01) |
| Constant | -72.08 (2.69)*** | -183.74 (1.85)* | -71.31 (2.30)** | -188.96 (1.88)* | -3.14 (0.12) | -57.10 (0.65) | -27.80 (1.03) | 21.40 (0.30) |
| Observations | 52 | 14 | 52 | 14 | 59 | 17 | 59 | 17 |
| R-squared | 0.41 | 0.37 | 0.41 | 0.39 | 0.54 | 0.41 | 0.49 | 0.50 |
| C: Rule of Law | | | | | | | | |
| LO_EXP | 0.219 (2.38)** | 0.295 (2.68)** | | | | | | |
| LO_EXP_PPP | | | 0.096 (2.87)*** | 0.309 (2.99)** | | | | |
| GDP_PC | 8.088 (2.47)** | 14.809 (2.07)* | 8.677 (2.94)*** | 12.422 (2.10)* | | | | |
| Constant | -23.809 (0.98) | -86.409 (1.43) | -28.623 (1.29) | -75.057 (1.50) | | | | |
| Observations | 49 | 14 | 49 | 14 | | | | |
| R-squared | 0.51 | 0.47 | 0.51 | 0.63 | | | | |
| Sample | All | LAC | All | LAC | All | LAC | All | LAC |

Robust t statistics in parentheses

* significant at 10%; ** significant at 5%; *** significant at 1%

One problem with the estimates of Table 3 is that they do not recognize that historical and geographical factors are key determinants of institutional quality, and

⁴ For instance, Column 7 of Panel A estimates that one extra dollar in PPP-adjusted primary expenditure yields a 0.004 point increase in government effectiveness. Hence, a ten-point increase requires $10/0.004=2500$ PPP-adjusted dollars. Note that I am interpreting the relationship as causal (i.e., I assume that an increase in primary expenditure has an effect on government effectiveness). While reverse causality is likely to be a serious issue, it is worth noting that addressing causality would probably make the coefficient even smaller and hence strengthen my argument.

that excluding these factors might distort the relationship between institutional quality and public expenditure. In Table 4, I address this issue by re-estimating the equations of Table 3, controlling for geography and history. The results are similar.⁵

Table 4: Regressions with Controls

| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) |
|--------------|--------------------------|---------------------|----------------------|----------------------|-----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| | Government Effectiveness | | | | Control of Corruption | | | Rule of Law | | |
| GEGS | 0.003 (0.08) | | | | 0.015 (0.35) | | | | | |
| GEGS_PPP | | 0.012 (0.52) | | | | 0.022 (0.77) | | | | |
| PRIM_EXP | | | 0.015 (3.18)*** | | | | 0.021 (3.87)*** | | | |
| PR_EX_PPP | | | | 0.009 (3.83)*** | | | | 0.013 (5.03)*** | | |
| LO_EXP | | | | | | | | | 0.184 (1.58) | |
| LO_EXP_PPP | | | | | | | | | | 0.116 (2.16)** |
| GDP_PC | 15.250 (5.16)*** | 14.285 (4.67)*** | 8.671 (3.04)*** | 7.385 (2.76)*** | 12.041 (3.08)*** | 10.837 (2.59)** | 3.333 (1.03) | 1.488 (0.53) | 8.581 (2.17)** | 7.646 (2.33)** |
| Latitude | 31.275 (1.73)* | 33.513 (1.83)* | 27.219 (1.50) | 27.364 (1.64) | 48.803 (2.20)** | 50.901 (2.36)** | 39.960 (1.89)* | 40.178 (2.08)** | 38.948 (1.95)* | 33.851 (1.72)* |
| French code | -3.470 (0.73) | -2.662 (0.58) | -4.208 (1.04) | -4.411 (1.12) | 0.768 (0.13) | 1.805 (0.32) | -0.327 (0.07) | -0.619 (0.14) | -3.325 (0.65) | -3.328 (0.70) |
| Soc. Code | -14.440 (2.48)** | -15.043 (2.69)** | -14.801 (2.75)*** | -19.200 (3.51)*** | -19.898 (2.49)** | -20.900 (2.74)*** | -20.462 (2.93)*** | -26.824 (4.16)*** | -20.841 (3.33)*** | -22.650 (3.61)*** |
| ELF | 7.050 (0.96) | 7.444 (1.04) | 3.862 (0.61) | 5.367 (0.88) | 2.554 (0.29) | 3.235 (0.38) | -0.133 (0.02) | 2.048 (0.31) | -2.787 (0.31) | -0.498 (0.06) |
| Log(Area) | -1.064 (0.68) | -1.131 (0.71) | -0.727 (0.49) | -0.408 (0.28) | -0.491 (0.25) | -0.565 (0.29) | 0.179 (0.10) | 0.641 (0.37) | 0.467 (0.22) | 0.588 (0.28) |
| Log(Pop) | -0.102 (0.06) | -0.037 (0.02) | 0.319 (0.20) | -0.265 (0.15) | -2.079 (0.92) | -2.075 (0.94) | -1.667 (0.87) | -2.513 (1.25) | -2.356 (1.08) | -2.401 (1.00) |
| Constant | -66.838 (2.64)** | -62.010 (2.25)** | -28.033 (1.10) | -14.084 (0.52) | -26.542 (0.84) | -19.478 (0.55) | 24.996 (0.89) | 45.085 (1.55) | 3.023 (0.09) | 8.597 (0.27) |
| Observations | 51 | 51 | 55 | 55 | 51 | 51 | 55 | 55 | 48 | 48 |
| R-squared | 0.62 | 0.62 | 0.68 | 0.70 | 0.51 | 0.52 | 0.62 | 0.66 | 0.59 | 0.61 |

Robust t statistics in parentheses

* significant at 10%; ** significant at 5%; *** significant at 1%

It is possible to use the estimates of Table 4 to do a back-of-the-envelope cost-benefit analysis of a policy aimed at improving institutional quality through an increase in public expenditure. Kaufman et al. (1999) estimate that a one standard deviation increase in governance can lead to an increase in GDP per capita that ranges between 150 and 300 percent. I take the upper bound of this range and assume that the transition to the new steady state takes about 30 years. These assumptions imply that a one standard deviation increase in governance leads to an increase in the growth rate of GDP per capita of approximately 3.7 percent. The present value of this increase will depend on the initial GDP. If we are in a country with an income per capita of \$1000, the per capita benefit in the first year will be \$37. Assuming a discount rate of 3 percent, the present value of the second year benefit will be $0.037 \cdot 1037 / 1.03 = \37.3 . The present value of third year benefit will be $0.037(1.037) \cdot 1037 / (1.03 \cdot 1.03)$, and so on. If we focus on a 30-year horizon, the per capita present value of the increase in growth will be \$1226.⁶ Of course, the higher the initial income per capita, the higher the present value. Thus, in a country with an initial GDP per capita of \$10,000, the per capita present value of the increase in growth will be \$12,226 (Table 5).

But what would the cost of this policy be? Let us start with a policy aimed at increasing the control of corruption. The standard deviation of the index measuring

⁵ The estimations of Table 4 do not control for settler mortality (Acemoglu et al., 2001). I exclude this variable to maximize sample size. Including the variable would not alter my basic results.

⁶ A one hundred year horizon would increase the benefits by approximately \$500. This small increase is due to the fact that (by assumption) the growth effect ends after 30 years.

control of corruption is approximately 18. The point estimates of Table 4 suggest that with an additional PPP dollar we can increase control of corruption by 0.013 (column 8). Hence, increasing control of corruption by one standard deviation will cost \$1,394 per year. The present value over 30 years is \$28,142. As the benefits range between \$1,226 and \$12,226, Table 5 shows that trying to increase the control of corruption by increasing primary expenditure is a very bad deal. Even in the best case scenario, the net present value of such a policy is negative and large (minus \$15,874, Table 5).⁷

Trying to increase Rule of Law by spending more in public order seems to be a better strategy. The standard deviation of the Rule of Law index is 17 and the point estimates of Table 4 suggest that an additional PPP dollar in expenditure in public order and safety can increase Rule of Law by 0.12 points. Therefore, increasing Rule of Law by one standard deviation would cost \$143 per year. The present value of this increase in expenditure is \$2,886. In this case, the net present value will be positive for countries with an initial income per capita of at least \$2,500.

Table 5: Cost Benefit Analysis

| Initial income per capita | 1,000 | 2,500 | 5,000 | 10,000 |
|--|---------|---------|---------|---------|
| A. Present value of one standard deviation increase in institutional quality | 1,226 | 3,066 | 6,133 | 12,226 |
| B. Present value of the cost of a one standard deviation increase in control of corruption achieved by increasing primary expenditure | | | 28,140 | |
| C. Present value of the cost of a one standard deviation increase in Rule of Law achieved by increasing expenditure in public order and safety | | | 2,886 | |
| Net Present Value A-B | -26,914 | -25,074 | -22,007 | -15,874 |
| Net Present Value A-C | -1,660 | 180 | 3,247 | 9,380 |

Assumptions: a one standard deviation increase in institutional quality increases long run growth by 3.7% per year for 30 years. The discount rate is 3% and the cost of increasing institutional quality is based on the estimates of Table 4.

While the above example suggests that targeting public expenditure towards promoting Rule of Law might be a good strategy for middle income countries, it is not clear whether a country can double its expenditure in public order and safety (in Latin America average expenditure in public order and safety is about \$70 PPP) without increasing other types of public expenditure. Moreover, the estimates of Kaufman et al. (1999) do not consider interactions among various measures of institutional quality and assume a linear (or log linear) relationship between Rule of Law and GDP per capita. Hence, it is not clear whether increasing the quality of Rule of Law (assuming that this is possible) while leaving the other measures of institutional quality unchanged will have a large impact on GDP growth. Moreover, too much rule of law (keeping the other institutional characteristics constant) may have a negative effect on growth as nobody will dare do anything which may lead to some probability of violating the law.

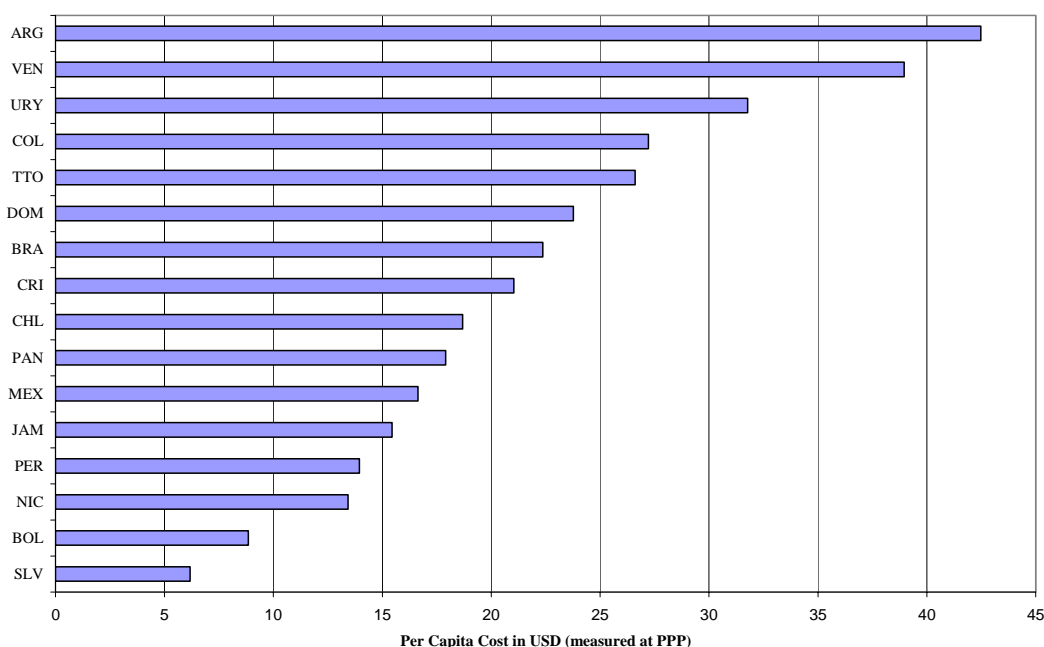
As an alternative experiment, I regress institutional quality over the same set of variables included in Table 4 but without controlling for public expenditure. The residual of this regression can be interpreted as a measure of institutional quality that nets out the role of history and geography.⁸ I report the values of this "residual" institutional quality in the last three columns of Table 1 (again, the values are rescaled

⁷ I obtain similar results if rather than focusing on control of corruption, I focus on government effectiveness.

⁸ Although the regressions use all countries for which I have data, from now on I will limit my analysis to Latin America.

to range between 0 and 100).⁹ As these residuals should not depend on the level of development and on geographical and historical factors, I can divide them by PPP-adjusted per capita public expenditure and obtain a measure of the "unit cost" of government quality under the assumption that all countries have the same history, geography, and level of development.¹⁰ Figures 1 and 2 plot the unit cost of government effectiveness and Rule of Law and show that there are enormous differences in the per-capita unit cost of institutional quality. A unit of government effectiveness costs more than 30 PPP-adjusted dollars in Argentina, Venezuela, and Uruguay and less than 20 PPP-adjusted dollars in Chile, Panama, Mexico, Jamaica, Peru, Nicaragua, Bolivia, and El Salvador. The same is true for the unit cost of Rule of Law which ranges from more than 2 PPP-adjusted dollars in Trinidad and Tobago and Argentina to less than one PPP-adjusted dollar in Nicaragua, Dominican Republic, Bolivia, Brazil, and Mexico.

Figure 1: Primary Expenditure Cost of a Residual Unit of Government Effectiveness



Of course, these differences might be due to the fact that in richer countries everything is more expensive. Hence, it is not surprising that running the government is more expensive in Argentina than in El Salvador. However, I am partly controlling for this by using PPP-adjusted figures. Moreover, Figure 3 shows that the correlation between GDP per capita and the unit cost of Rule of Law is far from being tight.¹¹

⁹ Figures A1, A2 and A3 plot the actual and residual values of institutional quality. Countries above the 45 degree line have levels of institutional quality which are higher than those predicted by the regression (i.e., given their history and geography, they are doing relatively well) and countries that are below the 45 degree line have levels of institutional quality which are lower than those predicted by the regression.

¹⁰ In the case of government effectiveness, I focus on primary expenditure because I found no statistically significant relationship between GEGS and government effectiveness. In the case of Rule of Law, I use expenditure in public order and safety.

¹¹ Figures A4 and A6 measure the unit cost as a share of GDP per capita. This affects the position of some countries (Argentina being the most notable example) but does not alter the basic message of

Figure 2: Cost of a Residual Unit of Rule of Law

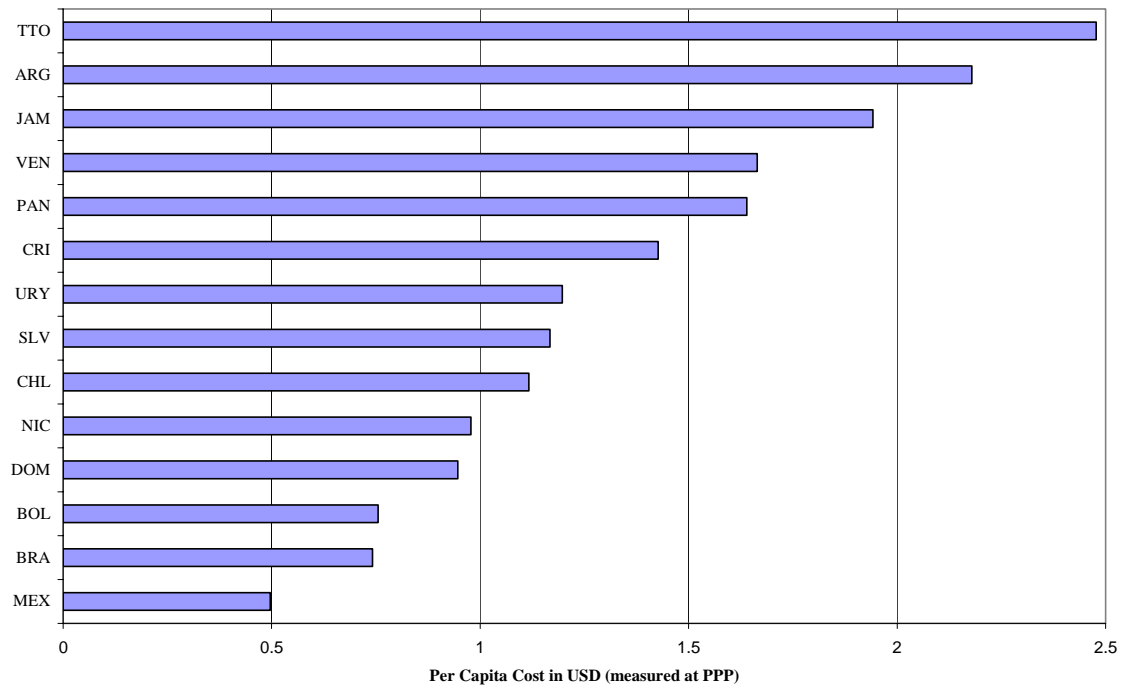
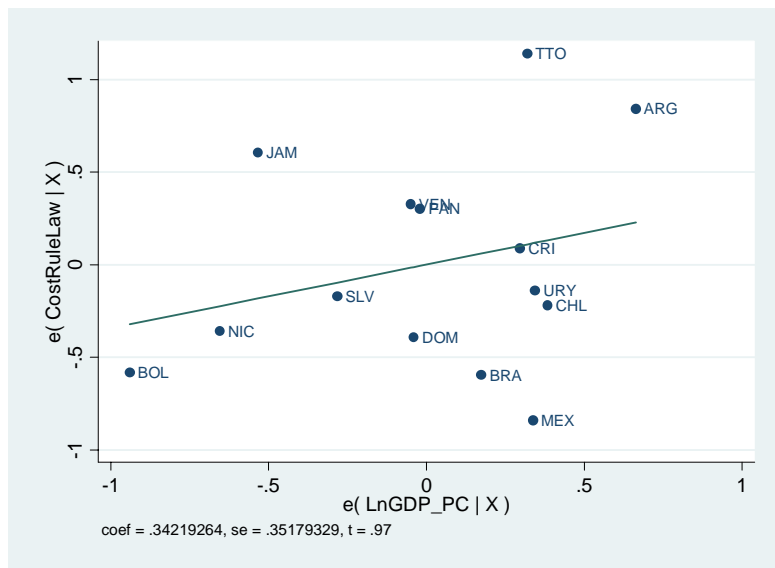


Figure 3: Correlation between the cost of Rule of Law and GDP per capita



In order to evaluate the benefits of increasing the efficiency of the public sector, I can focus on the countries with the highest unit cost and evaluate how much institutional quality could improve if their unit costs were equal to the Latin American median. Figure 4 focuses on government effectiveness and shows the level of residual

Figures 1 and 2 (see also Figures A5 and A7 which plot the relationship between the cost measured in PPP dollars and the cost measured as a share of GDP per capita).

government effectiveness (the light bars are from column 4 of Table 1), and the additional level of government effectiveness (the dark bars) that these countries could obtain by maintaining their expenditure constant but becoming as efficient as the median Latin American country. Figure 5 repeats the experiment focusing on Rule of Law.

Figure 4: The Effect of Increasing Efficiency in Primary Expenditure

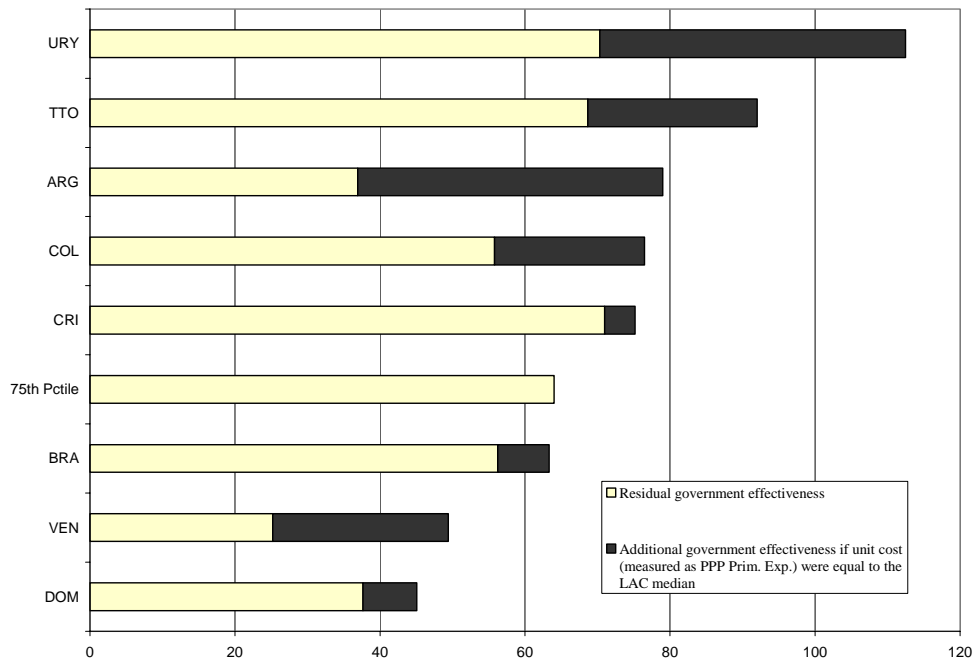
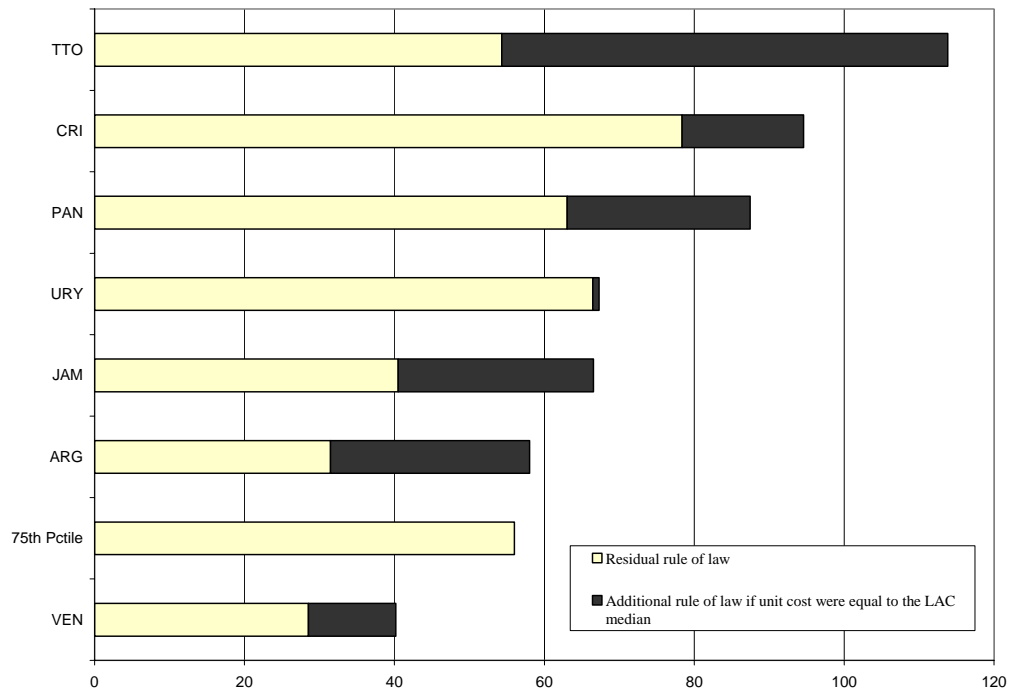


Figure 5: The Effect of Increasing Efficiency in Expenditure in Public Order and Safety



It is possible to use the increase in efficiency plotted in Figures 4 and 5 and the estimates of Kaufman et al. (1999) to calculate the present value of increasing efficiency (note that there is no cost because, by assumption, I am keeping total expenditure constant). Table 6 shows that in some countries these benefits are extremely large; in some cases, several times the country's GDP per capita.

The above analysis suggests that improving institutional quality can lead to very large benefits at basically no cost. Of course, these are back-of-the-envelope calculations based on a series of unrealistic assumptions.¹² However, they illustrate my main point: money is not the issue.

Table 6: Per Capita Benefit (in PPP USD) of having the same average cost of the median LAC country

| | GE PEXP | RL |
|---------------------|---------|---------|
| ARGENTINA | 93,816 | 32,493 |
| BRAZIL | 3,188 | |
| COLOLOMBIA | 12,119 | |
| COSTA RICA | 2,052 | 10,980 |
| DOMINICAN REPUBLIC | 2,968 | |
| JAMAICA | | 9,734 |
| PANAMA | | 16,052 |
| TRINIDAD AND TOBAGO | 25,015 | 227,859 |
| URUGUAY | 70,257 | 352 |
| VENEZUELA | 13,394 | 4,173 |

The benefits are computed as the present value (using a discount rate of 3%) of the additional growth in GDP per capita brought about by an increase in the efficiency of government expenditure.

It is often claimed that public sector workers lack incentives because they are underpaid. If this were the case, money would be an issue. Susan Rose-Ackerman's paper hints that this is unlikely to be the case in Latin America. My views on this topic are even more extreme than hers. She points out that "Increases in civil service salaries are not a sufficient policy response" (page 13). I think that in most cases such increases are not even necessary. There are two problems with the "poorly paid" civil servants argument.

First, it is not true that, on average, Latin American civil servants are underpaid (for evidence, see Panizza, 2000, 2001, and Panizza and Qiang, 2005). What is true is that public sector wages are more compressed than private sector wages. Hence, there is often a premium for low-skilled public sector workers and a penalty for high-skilled public sector workers (Panizza, 2001). This suggests that incentives could be corrected at basically no cost by increasing the steepness of the public sector pay scale. Of course, this may have no financial costs but serious political and social costs. I will say something about this in the concluding section.

Second, the evidence that higher public sector wages lead to lower corruption or better bureaucratic quality is, at best, mixed. Rauch and Evans (2000) find that there is no relationship between average public sector pay and bureaucratic quality. What matters is meritocracy. In my own work on Latin America (Panizza, 2001), I find the same result. Moreover, it is possible to use an efficiency-wage model to show

¹² First, they assume that the estimates by Kaufman et al. (1999) are correct and apply to all countries. However, several authors have emphasized that poor governance is not the binding constraint in each country (Hausmann et al. 2005, UNCTAD, 2006). Second, they assume a causal and linear relationship between expenditure and government quality.

that countries characterized by poor institutions pay higher (rather than lower) public sector wages (Panizza, 2002). If this is the case, high public sector wages are a symptom of the problem rather than a solution.

Di Tella and Schargrodsky (2003) find that higher public sector wages can reduce corruption but only with high levels of auditing. Van Rijckeghem and Weder (2001) find a negative relationship between public sector wages and corruption, but also find that reducing corruption through higher public sector wages is an incredibly expensive strategy. In particular, they find that if the average developing country wants to reduce corruption to the level of the average OECD country, it should push public sector wages to anything between 2 and 8 times average private sector wages. Thus, the findings of Van Rijckeghem and Weder (2001) are consistent with my back of the envelope calculations. In this sense, the title of the section is wrong. Money CAN buy you a good public administration, but you really need a lot of money, and this seems to be an inefficient way to proceed.¹³

3. Reforming the Reformers

One thing missing from Susan Rose-Ackerman's paper is an analysis of the relationship between institutional quality and the political process. This is a conscious choice. On page 1 of the SP, the author explicitly states that her "primary focus is on isolating reforms that appear to be successes with the aim of providing guidance to those willing to push for a change." On page 7, the author states that she takes "...as given a political process that generates a set of policy goals and translates them into laws" and that her goal is "...not to suggest ways to reform politics but, instead, to illustrate that failure to reform the state is costly for ordinary people and for economic progress." It is understandable why Susan Rose-Ackerman decided to stay out of the large literature that studies the links between politics and institutional quality. A complete survey of this literature would have added at least 20 pages to an already long paper.

However, it is important to note that politics does play an important role in institutional quality, not only because politicians write the law but also because they decide how to implement it and enforce it. In fact, any reform of the public administration needs to start in the political arena. If politicians do not have the incentives to improve institutional quality, nothing will ever happen. Hence, it is necessary to go beyond a purely technocratic approach to policy-making. As pointed out by Inter-American Development Bank (2005) in its report on the "Politics of Policies", the political process and the policymaking process are inseparable and failing to understand the former one risks failure with the latter.

One important link between politics and institutional quality goes through the electoral system. Research has found that electoral rules affect institutional quality because they play a key role in shaping politicians' incentives. In particular, Persson, Tabellini, and Trebbi (2003) find that corruption tend to be higher in countries with proportional electoral systems and lower in countries with majority-based electoral systems. Focusing on the degree of Political Particularism (Seddon-Wallack et al, 2003), I find that electoral systems characterized by intermediate levels of political particularism are associated with better institutional quality (Panizza, 2001).

¹³ A friend who teaches at Harvard University once told me the following: "You know that old saying that you cannot throw money at a problem. At Harvard I realized that this saying is wrong. If you throw enough money at it, the problem will go away." In 2006, Harvard had an income of \$150,000 for each enrolled student.

Another important mechanism is decentralization.¹⁴ Through yardstick competition, decentralization can give politicians (especially at the local level) the right set of incentives for an efficient provision of public goods and thus reduce corruption and increase the efficiency of the public sector. Moreover, decentralization can increase the variety of local public goods and tailor the supply of these goods to the preferences of the local population (Tiebout, 1956).¹⁵ However, decentralization can also lead to "commons" problem and fiscal profligacy. Moreover, local governments might be inefficient because of their small scale (Panizza, 1999) and local bureaucrats may be poorly trained and thus inefficient in delivering public goods and services. Tanzi (1996) suggests that these imperfections may prevent the realization of benefits from decentralization.

The above-mentioned considerations suggest that the relationship between decentralization and institutional quality can go either way. Fisman and Gatti (2002) were among the first to study the cross-country relationship between decentralization and corruption and found a negative relationship between these two variables, suggesting that decentralization reduces corruption. However, Nuptia (2005) shows that this result does not hold within developing countries. In assessing the possible effect of decentralization it is thus necessary to go beyond cross-country analyses and look at case studies. A study of the experiences of Uganda and the Philippines shows that decentralization has the potential of improving the delivery of public services but that this potential is often not realized (Azfar et al. 2001). This is clearly an area that requires more research.¹⁶

3. Subsidizing Transparency

Susan Rose-Ackerman correctly points out that auditing and transparency can play an important role in increasing institutional quality. I agree with her that setting up auditing agencies and improving existing ones is likely to be a cost-effective way to improve public service delivery and reduce corruption (Recanatini et al., 2005, provide evidence of the importance of internal and external auditing).¹⁷ I also agree with her analysis suggesting that effective auditing agencies may require independent media and that in several countries the government has subtle ways to influence the media and limit their monitoring role. Moreover, in several countries newspapers and TV channels are often perceived to be partisan. So, reporting of government corruption by an opposition newspaper can often be dismissed as being motivated by a political agenda. On the other hand, reporting by prestigious international newspapers is often perceived to be more balanced and impartial and hence more effective in exposing corruption and misgovernment.¹⁸ The news produced by the international newspaper can then be disseminated within the country by local newspapers and bloggers.¹⁹

¹⁴ Decentralization is briefly discussed on page 8 of the SP.

¹⁵ For an empirical analysis of the links between heterogeneity of preferences and decentralization, see Panizza (1999).

¹⁶ Tulchin and Selee (2004) discuss the experience with decentralization of 6 Latin American countries.

¹⁷ The SP paper and Recanatini et al. (2005) also point to the importance of increasing the available flow of information. In particular, Recanatini et al (2005) show that agencies that make their budget, procurement, and staffing decisions publicly available have lower levels of corruption.

¹⁸ There are, of course, some exceptions. Reporting by a US newspaper on a country with explicit anti-US policies is unlikely to be perceived as impartial.

¹⁹ The importance of the blogosphere should not be underestimated. See, for instance, the recent Financial Times article (July 28, "Quick off the Blog") that shows how a single blogger fuelled the

One problem is that the market does not supply enough of such reporting. The New York Times is more likely to publish a story about Paris Hilton than a story about corruption in some unknown Latin American country which does not even have a Hilton Hotel. As a consequence, able freelance investigative journalists will have more incentives to write stories about Paris Hilton than about corruption in Latin America.

How can this situation be changed? Here is a crazy proposal. The IDB could establish a list of ten or so prestigious international newspapers and magazines (of the caliber of the New York Times and The Financial Times, for instance) and pay a \$20,000 premium to each journalist who manages to publish a major story (where major is defined as being above some minimum number of words) about misgovernment in Latin America in one of these journals. An important feature of this proposal is that the premium should be automatic. After the author publishes the article she can directly collect the money from the IDB, no questions asked. Otherwise, member countries that are offended by a given article could prevent the IDB from awarding the prize or accuse the IDB of being biased against a given country and/or government. Given that the decision of whether to publish the article or not is in the hand of the editorial board of the newspaper and the prize is automatic, nobody can accuse the IDB of being biased against a given country.²⁰

Of course, this premium will provide incentives to write articles but not to publish them. However, if the prize increases the supply of good articles, it is likely that the newspapers in the list will publish some of them. Moreover, even if an article does not get published in a major journal, it is still likely to be published in some other journal and have some effect on reporting on corruption and bad government. The impact might be smaller, but the marginal cost of this article will be zero.

What would the costs and benefits of such policy be? As the conditions for paying the prize are easily verifiable, managing such an award will have very low administrative costs and, for the sake of simplicity, I will assume no administrative costs. Hence, the only cost would be the prize itself. Assume that the prize generates 50 articles per year (clearly an upper bound) and that each article reduces average corruption in Latin America by 0.017 points in our 0-100 scale (this is one-hundredth of one standard deviation).²¹ Then, the cost would be \$1,000,000 per year and the benefit would be an increase in yearly per capita GDP growth of 1.85 per cent (half of 3.7 percent, see the calculations in Section 2). If I assume an average GDP per capita of 7500 PPP-adjusted dollars (this is close to the current Latin American PPP-adjusted GDP per capita) and use all assumptions of Section 2, I find that a 1.85 percent increase in GDP per capita has a present value of 3,500 per capita PPP-adjusted dollars. Since this is a per capita value, we need to multiply it by the Latin American population which is about 500 million, yielding a total of 1.7 trillion PPP-adjusted dollars.

scandals which led to the dismissal of Senate Majority Leader Trent Lott and the incarceration of US vice-president top aide, I. Lewis "Scooter" Libby. However, while bloggers can play a key role in disseminating information, they do not have the resources to conduct the investigative journalism which is necessary to uncover a scandal.

²⁰ Member countries that think that they would not be treated fairly by the international press could opt out (either totally or partially) in advance (i.e., at the beginning of each year) but not after the article is published.

²¹ This reduction of corruption will be driven by both the direct and indirect effects of greater transparency. Brunetti and Weder (2003) find that freedom of press has a large effect on corruption. Besely and Burgess (2002) find that local governments are more responsive in Indian states with higher newspaper circulation.

These are back-of-the-envelope calculations and I am sure that the 1.7 trillion figure is a gross overestimation of the potential effect of my proposal. My assumptions on the effect of the program on corruption are probably too generous and so are my assumptions on the effect of corruption on growth. Moreover, I am comparing actual dollars with PPP-adjusted dollars.²²

However, the costs are so low (0.2 percent of IDB's administrative expenses) and the potential benefits so large that it may be worth trying.²³ In fact, the program would still yield a net benefit even if the benefits were one thousand times smaller than what I estimated.²⁴

4. Conclusions

If the organizers of the *Consulta* had asked a public administration scholar to write this paper, they would have probably received a paper with a series of detailed proposals on how to organize a public sector office. Given my training, I could only focus on much broader proposals aimed at improving incentives.²⁵ Moreover, since I fundamentally agree with most of Susan Rose-Ackerman's conclusions, rather than presenting an alternative view, I used my space to reinforce some of the points made in the solution paper.

My main point is that money is not the problem. Most countries are far from the efficiency frontier and hence they should be able to increase the quality of their institutions without increasing public expenditure. So, in theory, the costs are minimal and the benefits enormous. This is true in theory. In practice, things are more complicated.

First, we still know little on how to improve public institutions and more research in this field could have high returns (the SP points to the need of more research on page 21). Interestingly, the World Bank has spent a large amount of resources on collecting micro-level data that could be of great help in understanding how to improve institutional quality, but these data lie largely unused or underused.²⁶ One exception is Recanatini et al. (2005). This paper uses data on corruption at the public agency level in six countries in Latin America and Africa and derives a rich set of anti-corruption policy prescriptions. More papers along these lines could be of great help in devising anti-corruption policies. Rather than hiding its data, the World Bank should advertise them and create incentives for using these data (maybe establishing an award for the best paper written using these data).

Second, reforms of the public administration need political support and gathering such a support may be difficult. Susan Rose-Ackerman correctly points out

²² Another criticism to my proposal is that it may not generate the desired number of publications. However, this would have no effect on the cost-benefit ratio (unless there are important non-linearities) because if there are no publications there is no cost.

²³ Paraphrasing Nils Bohr, the experiment might be crazy enough to yield some positive result.

²⁴ Here I am cheating because I am considering the \$1,000,000 like a once-for-all expenditure. If the program is maintained every year, the present value of the cost would be \$20,000,000 and the program would break even only if the actual benefits of the program are about one hundred times smaller than my estimates.

²⁵ In my alternative view paper, I did not discuss reforms aimed at improving any specific branch of the public administration. However, since the SP explicitly discusses the case of tax evasion, it should probably discuss Ordoñez's (2001) clever incentive scheme for reporting tax evasion.

²⁶ See Panizza (2007) for a discussion on possible uses of the World Bank's BEEPS data. Some of these data are available to the research community but not well-advertised, and some are only available to World Bank staff.

that policy reforms may have no economic cost but a large political cost (page 34). In several countries, public sector workers' unions have been very active in protecting the status quo and blocking reforms. The SP points out that implementing reforms is easier during certain historical periods, but that in most cases reforms need to proceed very cautiously. An alternative approach would be to follow the suggestion of Delpla and Wyplosz (2007) and compensate the losers.²⁷ In particular, reformers could evaluate whether it is worth to buy back the privileges acquired by the group that will be damaged by the reform process and, if the reform is worth the price, buy back these privileges (assuming that the seller can commit to not asking back the privileges). This would be a cool experiment in cost-benefit analysis.

²⁷ Sometimes compensating the losers will be the morally correct thing to do and sometimes it won't (Alex Tabarrok at www.marginalrevolution.com reports a probably apocryphal story which says that while the British Parliament was debating how much slave owners should be compensated for their losses a furious John Stuart Mill rose to his feet thundering, "I should have thought it was the slaves who should be compensated."). The point is that some reforms will not be feasible without compensating the losers. Hence, we may go ahead with compensation even when it is not morally justified.

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Appendix

Figure A1

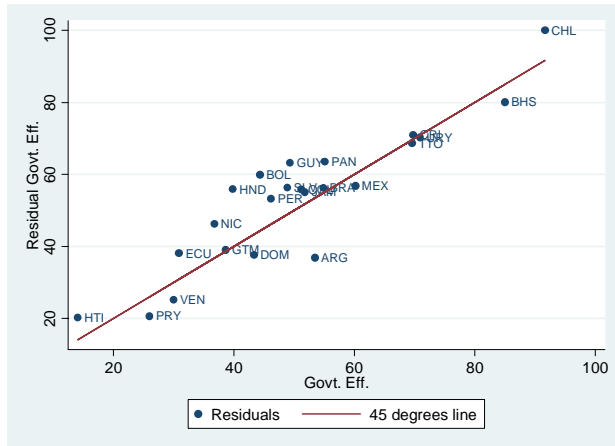


Figure A2

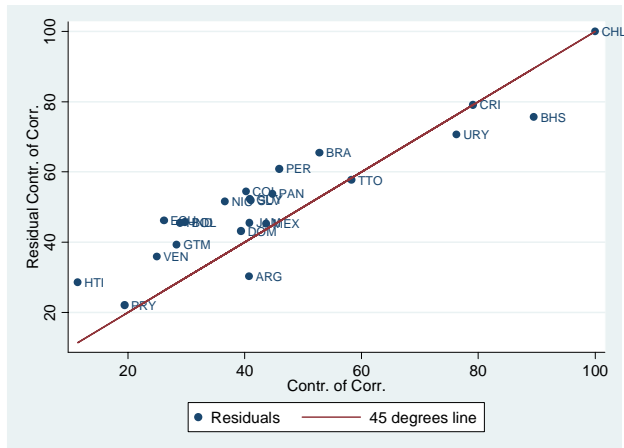


Figure A3

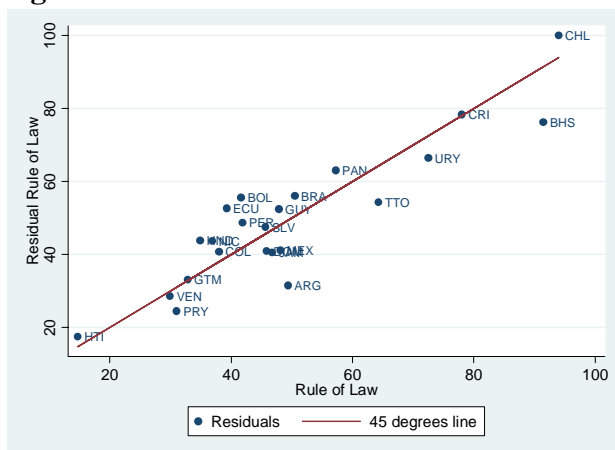


Figure A4

Cost of Government Effectiveness (measured using Prim. Exp.) as a share of GDP Per Capita

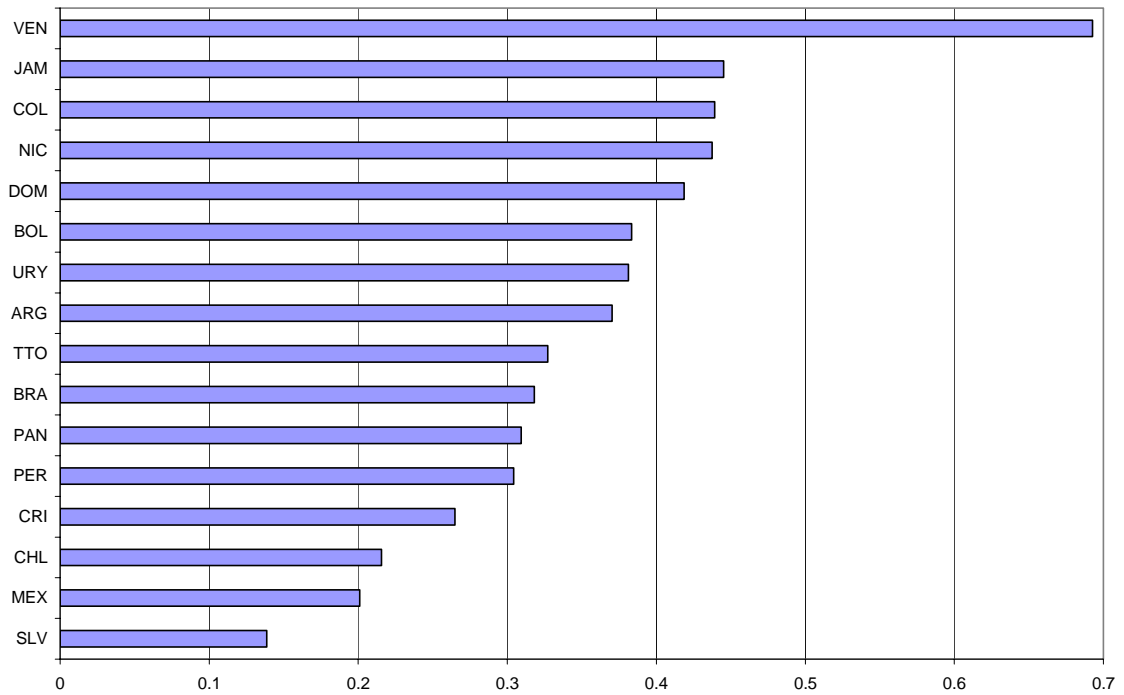


Figure A5

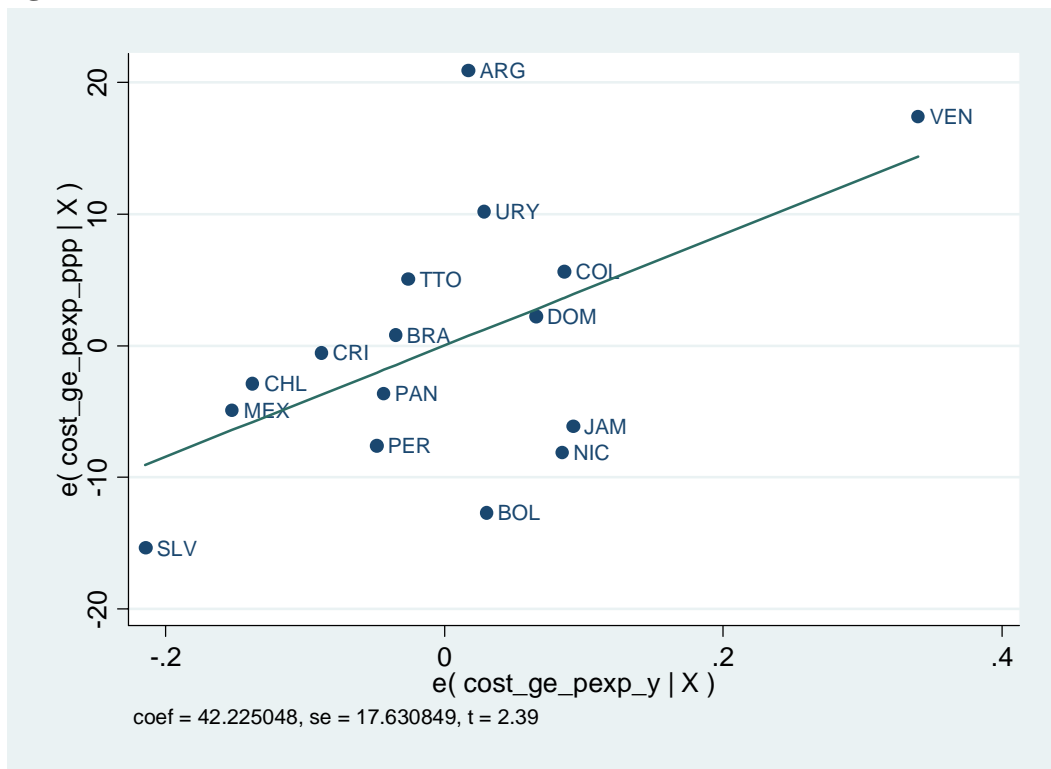


Figure A6

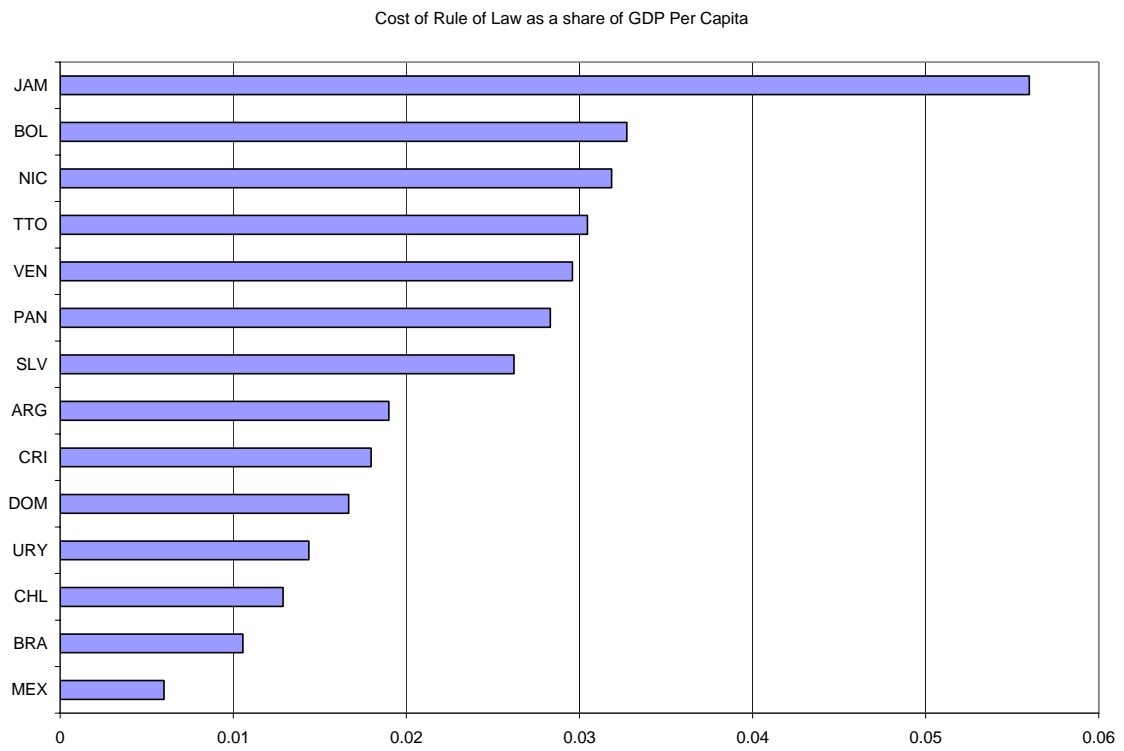


Figure A7

